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What happens when parties operate an oil battery without a formal agreement?

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Cases Considered:

Husky Oil Operations Limited v. Gulf Canada Resources Limited 2008 ABQB 390

Husky Oil has complicated facts, some complex law (unjust enrichment, fiduciary obligation, rectification) and a confusing judgment, but surely only one possible result. Indeed, we wonder why it ever went to court at all.

Husky (63%), Gulf (20%) and Sabre (14%) (as well as two other parties who were not involved in the litigation) were co-owners of the Killarney Oil Battery. The battery was originally constructed to service wells that were co-owned by the five parties in the same percentages, but later the battery provided service: (1) to wells owned by the same parties (or some of them) but as to different interests (unequal ownership wells); and (2) to wells in which none of the battery owners had an interest (outside wells). The parties never executed a Construction, Ownership and Operation (CO & O) Agreement although two drafts of such an agreement were circulated (para. 5(2)). As a matter of practice, Husky acted as the operator of the battery for the co-owners and established and collected fees (subject to objections from time to time which objections were resolved through discussion and adjustments, paras. 3, 71). The battery was operated on this informal basis for some 15 years. In 1996, Husky tied in six wells, of which five were 100% owned by Husky and the sixth 97% owned. In response to an inquiry from Sabre as to the processing fees that were to be charged to these wells, Husky wrote that the well owners would be charged fees, retroactive to the date of tie-in, of $5.50/m3Total Fluid and 2.50/m3 salt water disposal, with the fees allocated to the Killarney battery joint account. The evidence showed that this was the fee that was typically charged to production from trucked-in wells.

Some three years later Husky took the view that it had been seriously overcharging for these wells and proposed to make a retroactive adjustment, with new fees to be based on some version of the Jumping Pound Formula. Discussions and correspondence followed. Sabre never agreed to the adjustment, and while Gulf signed off on one version of the proposal, other versions followed. Gulf's agreement was based on the impression that the adjustments would result in a credit and not a liability. Husky invoiced Gulf and Sabre based on its proposed adjustment, but both parties refused to pay.

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Husky commenced this action claiming to be entitled to the invoiced sums on the basis of either unjust enrichment or rectification (para. 5(17)). There was no claim for a quantum meruit and neither party led evidence tending to show a custom in the industry as to the basis for charging fees for unequal ownership wells (paras. 8 & 35).

The holding

Justice Rosemary Nation dismissed Husky's claims. With reference to unjust enrichment, she concluded that Gulf and Sabre were enriched and that Husky suffered a net deprivation (at para. 36) as a result of the manner in which it had established fees for the six wells. Those fees were the equivalent of trucked-in fees which were higher than those generally expected for tied-in unequal ownership wells (paras. 33-36). However, there were two juristic reasons for concluding that the enrichment in this case was not unjust. First, the relationship between Husky and the other joint battery owners had fiduciary components (para. 15) and yet, in its dealings with the co-owners in relation to the adjustments, Husky had failed to make full disclosure (paras 42-45) both as to the manner in which the fees were to be calculated and as to whether the adjustment would result in a credit or a liability. This was a breach of Husky's fiduciary duty to act in the interests of all owners and not just in its interest as one of the joint owners (paras. 47, 15). As a result Husky was not entitled to the benefit of the "equitable remedy" of unjust enrichment (at para 47). Second, there was in fact a contract to charge fees at the $5.50/2.50/m3 rate based on Husky's written statement in 1996 and the silence and acquiescence of the other co-owners of the facility (at para. 53). A contract constitutes a juristic reason for an enrichment (at para. 48).

Assuming that there was a contract based on the $5.50/2.50 rate, Husky had not made out a case for rectification to set fees on the basis of a modified Jumping Pound Formula. There was no convincing proof that the parties in 1996 were *ad idem* that charges such as those circulated in 2000 and based on the Jumping Pound Formula were intended to apply to these six wells (paras. 56-57).

Nor did Gulf and Sabre contractually agree to a retroactive change in the fees. Although Gulf did appear to accept one version of the proposed new fees, Sabre never did. Accordingly there could be no new contract since this was a case of a joint contract (para. 68) which would set the processing fees for all joint battery owners and could only be concluded if all parties accepted. Husky could not unilaterally impose a mode of acceptance which involved incorporating a deadline in a letter and deeming failure to respond as deemed acceptance. The parties had no contract setting up such an arrangement and such a mode of proceeding was not consistent with the actual practice of the parties. In any event, Husky's continuing negotiations with Sabre and subsequent changes in the rates after Gulf had signaled its agreement, established that there was no clear agreement of all of the battery owners to one rate (at paras. 71-72).

Analysis and comment

The legal relationships between the parties involved in this litigation were undoubtedly complex. And they were rendered more complex by the failure of the co-owners of the battery to enter into

a formal agreement appointing one of their number as operator and setting out the basis on which the co-owned facility would provide services, both to the owners and to non-owners. But Husky stepped into the breach and acted as an operator, and held itself out as the agent for the co-owners of the facility in their dealings with others, including, where necessary, dealing with itself as a potential and actual user of the jointly owned facility. Part of its assumed responsibilities included establishing, at least on a tentative basis, the rates that would be charged different categories of users. The rates were tentative in the sense that they would prevail unless one of the co-owners objected (paras. 3 & 64). In establishing those rates Husky no doubt had certain objectives in mind. In particular, it would want to make sure that receipts from rates were sufficient to cover the revenue requirements of the battery. Moreover, if it chose to charge different rates to different classes of users, it could do so (given that Husky was neither a public utility nor a common processor), provided the market could bear the charge and its co-owners did not object to its tentative proposals.

One result of this is that one class of users might contribute more than its fair share of the costs (in utility parlance, cross-subsidize the other categories of users). And that seems to have been the nub of Husky's contention here. But note how Husky had to frame the case. Essentially Husky has to argue that it was required in its capacity as a user of the facility (rather than in its capacity as co-owner or as *de facto* operator) to over-contribute to the costs of the facility and that it was required to do as a result of a decision made by itself as *de facto* operator. In effect Husky, the well-owner, is trying to reach a result which might obtain were Husky, the operator, in a regulated utility, obliged to offer the service to all-comers on a non-discriminatory, cost-of-service basis. But in fact that was not the position here.

So what could Husky resort to? Well, the most obvious approach was probably the rectification argument, but there was just one snag. The facts simply did not support rectification. Where was the common understanding of what the rates should have been other than the rates that Husky actually charged (itself)? Justice Nation was quite right to summarily dismiss this clutching-at-straws argument.

That left Husky with its cause of action in unjust enrichment or, as Justice Nation would have it, the "equitable remedy" of unjust enrichment (para. 37). And this is where it seems to us that Justice Nation makes extraordinarily heavy going of what should have been a fairly simple case. The superficial explanation for this lies in the manner in which Justice Nation organizes her judgment. After reciting the facts, she turns to the relationship between the parties and characterizes it as fiduciary, concluding that Husky has breached its fiduciary obligation and is therefore disentitled to an action for unjust enrichment. Only later does she consider the possibility that the basic relationship is contractual, and that it is the contract which provides the essential juristic reason for the apparent enrichment that Gulf and Sabre had enjoyed at Husky's apparent expense. But the deeper explanation for the heavy going seems to be a misunderstanding of the nature and requirements of the action for unjust enrichment.

As mentioned, on a number of occasions Justice Nation refers to the "equitable remedy" of unjust enrichment. But first of all, unjust enrichment is not a remedy, it is a cause of action, just

like tort and breach of contract are causes of action. Assuming a successful action, the remedy for unjust enrichment is restitution, just like compensatory damages is the primary remedy for tort and contract. Secondly, it is mistaken and misleading to speak of unjust enrichment as an "equitable" action. The roots of unjust enrichment lie deep in the common law, not in Equity and the Court of Chancery. Although certain equitable concepts, such as constructive trust, play a role in the modern law, this cannot detract from unjust enrichment's fundamental nature as an action at common law rather than in Equity. Neither is unjust enrichment "equitable" in the more colloquial sense of being a subject for broad judicial discretion. Like any other area of the law, unjust enrichment largely depends on evolving legal principle and available precedent, and trial judges and their decisions are governed accordingly. (See further on all this, M. McInnes, "The Equitable Action in Unjust Enrichment: Ambiguity and Error" (2007), *Can. Bus. L. J.* 253.) Thirdly, the structure of the action for unjust enrichment is currently set out in *Garland v. Consumers' Gas Co.* (2004), 237 DLR (4th) 385 (SCC). The onus initially rests with the plaintiff to establish a prima facie case, by showing that the defendant was enriched, that the plaintiff suffered a corresponding deprivation, and that there is no juristic (lawful) reason why the defendant should retain the enrichment. Garland then prescribes the recognized categories of juristic reason, including contract. The plaintiff having established a prima facie case, the onus shifts to the defendant to rebut it on the basis of the "reasonable expectation of the parties" and "public policy", or any of the standard defences such as change of position. In accordance with the Garland structure, this is why we suggest that Justice Nation should have considered contract first, rather than fiduciary obligation, which should have been discussed later, if at all.

Assuming defendant enrichment and plaintiff corresponding deprivation, focusing immediately on the contractual analysis serves to reveal Husky's enormous difficulty. Surely it was obvious that there was a valid contract here. How else (absent a utility/customer relationship) can we explain this decade-long commercial relationship? While there was no executed CO & O Agreement to point to, there was, as Justice Nation, almost reluctantly, concedes, a pattern of behaviour that was completely consistent with a contract; an arrangement in which Husky proposed terms, those terms were reviewed by their co-owners (and no doubt others proposing to use the service offered by the battery) and in the absence of any objection those terms prevailed unless and until Husky proposed to alter them. In the end, then, the unjust enrichment argument clearly fails on the basis of contract as a juristic reason, a contract that was entirely of Husky's own making. No doubt this was all a bit messy, and one might have to resort to ideas of reasonableness and good faith in (re)constructing the contractual terms, but there are plenty of examples of courts using such interpretive tools to construct the terms of contracts in oil and gas cases even where there is a written contract: consider for example *Mesa v. Amoco* (1994), 19 Alta. L.R. (3d) 38 (CA) (the part of the decision requiring reserves-based pooling); *Erehwon Exploration Limited v. Northstar Energy Corp* (1993), 15 Alta. L R. (3d) 200 (the part of the decision (para. 155) dealing with reasonable notice to change the terms and conditions for marketing the plaintiff's gas) and *Kaiser Francis Oil Co of Canada v Bearspaw Petroleum Ltd* (1999) ABQB 128.

But we think there are other difficulties with the unjust enrichment argument. First, the nature of the alleged enrichment. After all, it's not as if Husky as well-operator was paying anything

directly to Gulf or Sabre. Husky was actually paying Husky as agent for all of the co-owners. So what was the benefit to Gulf and Sabre? Justice Nation never really tells us (see para. 36 for her conclusions) and so we have to guess a bit along the lines of the ideas outlined above. Presumably the benefit was either: (1) that the rates that were charged to other users (and note that this class might be much larger than just Gulf and Sabre) was lower than it might otherwise be; or, (2) that Husky actually received in total, from all of the clients of the battery, amounts in excess of revenue requirements (however defined, including, for example, a return on actual or deemed equity as would be provided for by the application of the Jumping Pound formula) and returned a share of this "profit" to the co-owners including Gulf and Sabre. The point is simply that the enrichment is much more indirect and not quite as obvious as Justice Nation seems to suggest in her judgment. Certainly the precise quantum of any enrichment was highly debatable.

And what of the fiduciary duty analysis here? Apart from the continuing over-emphasis on vulnerability rather than when is it reasonable for parties in a commercial setting to have an expectation of loyalty (*Hodgkinson v. Simms*, [1994]. 3 S.C.R. 377), we think that Justice Nation formulated the test (or her conclusions) in an appropriate way when she says (para. 15) that "Husky had obligations to act in the interests of all owners, not just its interest as one of the joint owners." And why was it appropriate to find a fiduciary duty here? Well, at least in part because the contractual relationship was so rudimentary. The very basis on which Husky set rates (when it had a monopoly on the relevant information because of its position as de facto operator) suggested not only vulnerability but also that it was reasonable for the non-operator co-owners to conclude that Husky would act in the best interests of all of the co-owners rather than in its own best interests.

As a fiduciary, Husky owed a duty of full disclosure as to the basis of the rate calculations as well as a duty not to self-deal. Processing your own gas at a discounted rate without disclosure might well be self-dealing, but in this case there was no suggestion that Husky had given itself preferential treatment. This only became an issue when Husky attempted to unravel the existing arrangement, and at that not simply on a go-forward basis. At that point the failure to disclose did become material. Nevertheless, while there are cases where the court declines or adjusts an equitable remedy to ensure that the court is not party to an inequity (one thinks for example of *Lac Minerals Ltd. v. International Corona Resources Ltd.*, [1989] 2 SCR 574, and the conditions placed on the court's declaration of a constructive trust), it seems unnecessary and inappropriate to invoke that line of reasoning here, for two main reasons. First, there was a much simpler way of proceeding and that was to invoke the existence of a contract between the parties. And second, in using this line of reasoning Justice Nation incorrectly characterizes the cause of action in unjust enrichment as an equitable remedy, thereby confounding cause of action and remedy as well as lumping equity and unjust enrichment together, rather than recognizing unjust enrichment as a discrete source of obligation.

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