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The Independent Operation Of The Shut-in Clause Of An Oil And Gas Lease

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Cases Considered:

Kensington Energy Ltd v. B & G Energy Ltd 2008 ABCA 151

In this important decision (hereafter *"Kensington"*) the majority of the Alberta Court of Appeal (Hunt and Slatter JJA; Romaine JA dissenting) concluded that the third proviso to the habendum of an oil and gas lease does not establish a set of conditions precedent that the lessee must fulfill before it can rely upon the shut-in wells clause and shut-in well payment to deem production, thereby continuing the lease – at least, and this is an important caveat - where the language of the shut-in wells clause does not track that of the third proviso. In reaching this conclusion the Court effectively distinguished its earlier decision in *Freyberg v. Fletcher Challenge Oil and Gas Inc*, 2005 ABCA 46 ("*Lady Freyberg*").

Oil and gas leases in western Canada provide for a primary term and a secondary term which together govern the duration of the lease. The primary term establishes the initial estate and is typically for a fixed term (historically 10 years, then 5, and these days more likely for a shorter period still) subject to earlier termination. The secondary term extends the lease beyond the end of the primary term in the event of production. While actual production obviously serves to extend the lease, drafters acting for lessees usually try to expand production to include deemed production which might be defined as the existence of a shut-in well. Alternatively, the drafter might elect to adopt a more neutral and expansive term such as "operations" and then define that term broadly as a replacement for the concept of production. In some cases the shut-in well might be defined simply as a well that is capable of production but in other cases the definition might be more circumscribed such that the shut-in well will only be deemed to be a producing well for so long as there is no market for the product, or where the shut-in accords with good oil field practice. In the Kensington case the lease defined "a shut-in, suspended or otherwise not producing well" as "a well which has not been abandoned by the Lessee in accordance with applicable regulations".

In stipulating for an expanded understanding of production there are at least two places in the lease on which to focus attention: one is the habendum and the other is the shut-in clause of the lease.

There is a certain logic to looking first to the habendum. After all it is the habendum that governs duration. The habendum clause of the lease is usually complex and comprises a preliminary

statement of the primary term, a statement that the lease will be continued by production (the secondary term), and then a series of provisos that deal with different eventualities in the life of the lease. It is important to emphasise that the provisos are provisos to the habendum and as provisos to a clause dealing with duration, each proviso may serve to expand or contract the meaning (and therefore duration) of the initial statement of duration. Each lease is different and each must therefore be the subject of individual analysis and interpretation (the mantra and golden thread that joins the case law on the private oil and gas lease in Canada). As the majority put it in this case (at para 15): "Each dispute must be resolved by reference to the terms of its own lease. Previous decisions are often of little assistance because, although the general terms of freehold leases are similar, there is considerable variation in their specific language." The provisos (usually three, sometimes four) deal with a number of eventualities that may arise during both the primary and the secondary term and it is usually the third proviso that deals with shut-in scenarios during the secondary term.

This was the case in *Kensington*. The third proviso stipulated for a number of eventualities such as drilling over at the end of the primary term, but then closed with a sub-proviso which, along with the opening language of the habendum, read as follows:

> TO HAVE AND ENJOY the same for the term of Five (5) years (hereinafter called *the "said term"*) from the date hereof and so long thereafter as the leased substances or any of them are produced from the said lands. . ., subject to the sooner termination of the said term as hereinafter provided:
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> **….provided further that notwithstanding anything hereinbefore contained or implied to the contrary**, if drilling or working operations are interrupted or suspended as the result of any cause whatsoever beyond the Lessee's reasonable control **or if any well on the said lands or on any spacing unit of which the said lands or any portion thereof form a part, is shut-in, suspended or otherwise not produced for any cause whatsoever which is in accordance with good oil field practice, the time of such interruption or suspension or non-production shall not be counted against the Lessee**. (Emphasis added by the Court.)

On the plain meaning of this sub-proviso, a lessee that needed to rely upon this text would only be able to do so to the extent that it was able to show that its shut-in was in accordance with "good oil field practice". This should be a question of evidence. The lessee (Kensington) would need to lead evidence to show why the well was shut-in and why that conduct was consistent with practice in the industry. At trial Justice LoVecchio refused to allow the lessee to lead that evidence and that of course became a principal ground of appeal, but the lessee also had a more important and indeed a prior argument.

The prior argument was this. The lessee argued that it did not need to bring itself within the language of the third proviso; it was entitled to succeed if it could bring itself within the language of the shut-in wells clause. And it was an important adjunct to this argument that the

language of the sub-proviso (and in particular the good oil field practice language) did not control the circumstances in which the shut-in wells clause might be triggered.

So, on to the language of the shut-in wells clause. What did it provide for?

> **Subject to the provisions hereinbefore set forth**, if all wells on the said lands are shut-in, suspended or otherwise not produced during any year ending on an anniversary date, the Lessee shall pay to the Lessor at the expiration of each such year, a sum equal to the delay rental hereinbefore set forth and each such well shall be deemed to be a producing well hereunder, provided that this clause shall not impose an obligation upon the Lessee to make the payment of a sum equal to the delay rental unless all wells on the said lands are shut-in, suspended or otherwise not produced for a period of ninety (90) consecutive days in any such year. (Emphasis added)

Ignoring for one moment the underlined opening text of the clause, the lessee's argument was that a shut-in payment served to deem production and that was all that was required in order to trigger the opening language of the habendum and provide for continuation – at least for so long as the lessee continued to make those annual shut-in payments. There were at least two difficulties with this argument. The first such difficulty was the opening language of the shut-in clause. Did this clause effectively connect the shut-in clause and the third proviso in such a way as to establish a condition precedent for triggering the deeming effect of the shut-in clause (as in *Lady Freyberg*, where the condition precedent for a valid shut-in was not oil field practice but the absence of a market)? That is to say, was this a case where payment of the shut-in fee could only have a deeming effect to the extent that the well was shut-in on grounds (in accordance with oil field practice) covered in the third proviso? A second difficulty (effectively a variant of the first argument) is simply that a broad and independent interpretation of the shut-in wells clause forces one to question why the sub-proviso to the third proviso is necessary. What comfort does it give to a lessee that a lessee has not already gained through this broad interpretation of the shut-in clause?

Neither of these difficulties troubled the majority of the Court of Appeal. The majority reversed the trial judgement and declared that the lease had never terminated. Because the majority found for the lessee on the basis of the shut-in clause, they did not need to review the trial judge's decision to exclude evidence of oil field practice.

How then did the majority deal with these two objections? As to the first objection the majority observed that the "subject to" language was not on its face referable to and only to the sub-proviso to the third proviso. In fact the Court identified several other clauses of the lease to which this might reasonably refer, including the opening language of the habendum itself. In addition, the majority also noted that the "subject to" words would prevent a lessee arguing that payment might revive a lease that had terminated on the basis of some other language in the provisos to the lease (e.g. non-payment of a delay rental during the primary term). In short, the Court did not need to read the "subject to" language as importing the specific oilfield practice language of the third proviso into the shut-in clause. And on this point the Court was able to

distinguish the *Lady Freyberg* decision since in that case there was a parallel construction between the third proviso and the shut-in clause – both were in effect subject to a condition precedent, the absence of a market.

As to the second potential difficulty, the majority was similarly untroubled, holding that the sub-proviso to the third proviso did have a distinct field of operation insofar as it allowed a lessee to maintain a lease in force absent production so long as it was acting in accordance with good oil field practice and might do so independent of any payment. This of course raises the possibility (always arguable at least since *Kissinger v. Keith* (1984), 54 A.R. 100 (Alta. C.A.)) that a lessee can try to save its lease on the basis of the third proviso alone when it has failed to make a shut-in payment in a timely way. In *Kissinger* Justice McDermid held that the words "shall not be counted" must be interpreted as meaning "that the time of non production is not to be counted. Therefore you have a well on the lands which is eventually to be produced when there is a market. It is the same as if the well had been completed and produced, for the hiatus between completion and production is not to be counted. For the purposes of the clause, the well should be considered as producing from its completion."

In sum, the majority decision stands for the proposition that there is no necessary connection between the third proviso of a lease and the shut-in clause of a lease. As a result, unless the lease itself makes the shut-in payment conditional upon satisfaction of the same conditions established in the third proviso, then the shut in clause can have an independent operation and allow for deemed production without any connection back to the third proviso. By the same token, it continues to be at least arguable that the third proviso may have a similar independent operation, thus allowing a lessee to keep its lease in force without having made a shut-in payment so long as it can comply with the conditions precedent of the third proviso (whatever they may be). As Justice Hunt for the majority put it (at para. 37): "no delay rentals arguably need to be paid to keep the lease in force if it would stay in force under one of the provisos, for example, under the exception for wells shut-in in accordance with a good oil field practice, or the interruption of drilling for causes beyond the lessees (sic) control".

I think that this decision is correct. There were grounds to distinguish the language of this lease from the language of the third proviso and shut-in clause in *Lady Freyberg*. In that case the Court did have good reason for concluding that the lessee could only rely upon a shut-in payment if it were able to prove that there continued to be the absence of profitable market for the gas; but that was because both the third proviso and the shut-in clause in that lease used the same language. This decision above all else confirms, once again, that each lease is different and that subtle differences in language may well lead to different results.

Justice Romaine dissented although she would have sent the matter back to trial to allow the lessee (Kensington) to adduce evidence as to oil field practice. Justice Romaine was not prepared to accord the third proviso an independent sphere of operation. In her view the "subject to language" opening the shut-in wells clause created a hierarchy such that "the provisions that precede Clause 3 [the shut-in wells clause] will prevail, even if they conflict with or nullify its provisions" (at para 53).