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Co-ownership is a messy business (even with an operating agreement)

By Nigel Bankes

Cases Considered:

San Juan Resources Inc (Re) 2009 ABQB 55 (Registrar in Bankruptcy).

Co-ownership is a legal relationship for parties who are able to get along together. For those who cannot the court will order partition or sale under the *Law of Property Act*, R.S.A. 2000, c. L-7. But co-ownership is also the typical foundation for oil and gas operations in this province and elsewhere since oil and gas companies will typically be tenants in common (working interest owners) of their title documents (the freehold and Crown leases) on which their operations rely.

The CAPL (Canadian Association of Petroleum Operators) standard form operating agreements are designed to supplement the very thin common law default co-ownership rules with detailed provisions as to how the co-owners of an oil and gas property are to get along. But the agreements are still premised on a minimum level of co-operation. The fact pattern underlying this decision of Master John Prowse (sitting as a Registrar in Bankruptcy) shows what happens when even that minimum level of co-operation is absent. It illustrates the vulnerability of a joint operator who fails to take in kind thereby leaving an unscrupulous operator in possession of the entire revenue stream from the property.

Ostensibly the case involved a narrow point of law (should an appeal from the trustee's disallowance of a claim in bankruptcy be an appeal on the record or a de novo hearing) but my interest in the case lies in the oil and gas issues outlined above.

The Facts

Hampstead (25%) was a co-owner with San Juan (75%) in two oil and gas properties of which San Juan was the operator. San Juan persistently failed to account to Hampstead for its share of the proceeds of production from the properties in spite of court orders and subsequent contempt proceedings. Hampstead was about to bring on an application to have the court appoint a receiver to administer San Juan's assets when San Juan filed notice of intention to make a proposal under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (*BIA*), thereby bringing about an automatic stay in Hampstead's action against San Juan.

Hampstead filed three proofs of claim with the trustee which were substantially disallowed. Hampstead appealed and the question before the registrar was as to the form of an appeal.

Should it be an appeal de novo or an appeal on the record? The *BIA* (s.135) is silent as to the process to be followed and the existing case law (from the Maritimes and British Columbia) is not entirely consistent.

The judgement

Master Prowse sitting as the Registrar in Bankruptcy, ordered a de novo hearing following the procedure in Alberta for summary trials with the right to cross examine on expert witness affidavits. In addition, Hampstead was to have the right to reasonable access to documents in the trustee's possession.

While concerns for efficacy, expedition and expense in bankruptcy proceedings would normally point in the direction of an appeal on the record, the Registrar should have the discretion to order a de novo hearing where the circumstances of the case suggest that a hearing on the record might result in an injustice.

In this case it was appropriate to order a de novo hearing. Hampstead needed access to documents in possession of San Juan and the trustee in order to establish its claim to the proceeds of production from solution gas. It would likely have been able to obtain those documents through the discovery process in the action that it had commenced (but which was now stayed). In addition it was essential that Hampstead be able to cross examine experts (presumably experts on oil and gas production accounting matters) as part of the appeal since the trustee had conflicting opinions before it and had preferred San Juan's experts.

Comment

Given the background to this case and the manipulative and fraudulent behaviour of San Juan and its principal (including a false affidavit) it is hardly surprising that Registrar\Master Prowse thought that this was an appropriate case for a de novo hearing. Anything else would have compounded the list of injustices that Hampstead seems already to have suffered. This was certainly not a case (to use the analogy of chambers applications under the current rules of court) where one of the parties does not put its best foot forward and treats the chambers application as a mere stalking horse for the "real" application before the court; this was a case where the bankrupt had effectively made it as difficult as possible for the claimant to make its case.

But the facts also cause one to reflect on what Hampstead might have done to better protect itself in a situation where the parties seem to have been arguing (and San Juan withholding) production monies from the jointly owned properties for over ten years. San Juan's former lawyer certainly knew how to protect himself since he emerges from all of this with a secured claim in the amount of $342,000 - presumably in some part at least for fighting to prevent Hampstead from getting its 25% share of revenues and defending San Juan's principal on contempt charges - but what about Hampstead? What should Hampstead have done? The best option was likely for Hampstead to insist on taking its share of production in kind and separately marketing it - assuming that it had the capacity to do so or could contract for that capacity.

Short of that, the options seem limited. For example, while monies received by San Juan for the sale of Hampstead's share of production would be trust monies (CAPL Article 507, *Sorel Resources* [1988] 4 WWR 232 (Alta. CA) and *Brookfield Bridge Lending Fund Inc. v. Vanquish Oil and Gas Corporation*, 2008 ABQB 444 and my blog of this decision) the operator might still dissipate the trust fund (although but for dissipation cl. 507 should certainly have accorded Hampstead a provable claim in bankruptcy). And all the precedents suggest that it would certainly be difficult for a minority owner to bring about a change of operatorship against an operator and majority owner who resists, even where the operator is in persistent default under the terms of the agreement but particularly in the case of an insolvency: *Norcen Energy Resources Ltd v. Oakwood Petroleums Ltd* (1988), 63 Alta. L.R. (2d) 361 (QB), *Mutual Oil and Gas Ltd v. DSWK Holdings Ltd* (unreported judgement of Justice Kenny, January 5, 1996, rev'd on appeal [1996] AJ 582), and *Rimoil Corporation v. Hexagon Gas Ltd*, unreported May 5, 1989 (Alta. QB); but for a case in which the new operator successfully sought the assistance of the court to give effect to a change of operatorship (see *Signalta Resources Ltd v. Land Petroleum International Inc*, [2007] AJ 496, 2007 ABQB 290).

For other litigation involving San Juan Resources and default under the operating agreement (although this time as a joint operator) see *Energy Power Systems v. San Juan Resources Inc* [2006] AJ 956, 206 ABQB 583.