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Court of Appeal grants relief from forfeiture in an oil and gas lease case

By Nigel Bankes

Cases Considered:

Canpar Holdings Ltd. v. Petrobank Energy and Resources Ltd., 2011 ABCA 62

The principal significance of this case is that it confirms that the Court may relieve against the forfeiture of an oil and gas lease that is terminated for cause (in this case failing to calculate and tender royalties as prescribed by the lease) - as opposed to termination in accordance with its own terms (e.g. for failure to drill or produce), in which case there can be no relief. In granting relief the Court signals that it will draw guidance from non-oil and gas cases dealing with relief from forfeiture. I think that this is the first reported decision in which the Court of Appeal has exercised its discretion to relieve against forfeiture in an oil and gas lease case.

The decision also confirms that a royalty clause which provides that the royalty is to be paid on market value "at the time and place of sale …. all without any deductions" does not allow the lessee to charge the royalty owner with a pro rata share of the fuel gas levied by a shipper to move contract gas from a point of measurement downstream of a processing plant to the point of sale (i.e. in a royalty clause framed in this manner royalty is payable on fuel gas).

I blogged the trial decision in "Damages for production on a dead oil and gas lease" and I refer the reader to that blog for a summary of the facts and issues.

On appeal the Court dealt with two issues: (1) whether royalty was payable on fuel gas, and (2) whether the Court should relieve against forfeiture. The Court held that the standard of review on the first question (including the related question of the failure to consider evidence) was correctness and on the second question the standard was reasonableness, understanding that the reviewing Court (at para. 12) "should not substitute its own discretion unless it finds that the trial judge did not give sufficient weight to relevant considerations, proceeded arbitrarily, or on wrong principles on an erroneous view of the facts; or that the result is likely to create a failure of justice …".

Royalty is payable on fuel gas

The majority of the Court of Appeal (Justices Bielby and Martin) agreed with the trial judge that royalty was payable on fuel gas. Justice McDonald dissented on this point merely noting (at para. 61) that "I am not able to agree with the analysis contained in paragraphs 13 through 37".

Petrobank's (the lessee's) arguments that it should not have to pay royalty on fuel gas fell into three categories: (1) a contextual approach to lease interpretation, (2) evidence as to custom, and (3) evidence as to the intentions of the drafter.

Under the first category of arguments Petrobank suggested that since fuel gas is used rather than sold no royalty should be payable on it. The majority rejected that argument noting that this part of the clause established *the point* at which value was to be calculated for royalty purposes; it did not establish the *volume of gas* on which royalty was payable. Similarly, Petrobank could take no comfort from the lessee's duty to rateably market the lessor's royalty share or the lessor's right to take in kind (at para 24): "The fact the Appellant had a practice of physically removing the fuel gas between the point of production and the point of sale does not exempt it from paying royalties on that fuel gas any more than if it siphoned off natural gas between these two points to sell to third parties." Finally under this head, the majority held that the lessee could not exploit the lease provision which expressly provided that the royalty share should be delivered to the measurement point free and clear of any charges, or the lease provision that allowed the lessee to use royalty gas for operations on the leased area or pooled area (fuel gas is used downstream of the point of measurement and off the leased lands; and pipelining is not included within the definition of operations).

Petrobank's claim that the trial judge erred in failing to take account of industry custom in interpreting the lease also failed — and that for two good reasons: (1) the lessee did not lead evidence as to industry custom (at para. 29), and (2) such evidence can only be considered if there is ambiguity and in this case the words of the lease were not ambiguous (at paras 26 and 31). The majority also relied on this last reason for concluding that the intentions of the drafter were irrelevant (at para. 36).

Relief from forfeiture

Drawing upon *Saskatchewan River Bungalows Ltd. v. Maritime Life Assurance Co* [1994] 2 SCR 490, as well as two Alberta landlord and tenant cases, the court concluded that it should take into account three factors in deciding whether to grant relief from forfeiture: (1) the conduct of the applicant; (2) the gravity of the breaches; and (3) the disparity between the value of the property forfeited and the damage caused by the breach. The circumstances in each case favoured the lessee. The lessee acted reasonably and not in a high-handed manner. It paid the bulk of the royalties on a continuing basis. The breach was a shortfall rather than a complete failure to pay. The underpayment amounted to $147,000 versus the value of continued production (not quantified) plus the $1.5 million dollars that the trial judge ordered the lessee to pay based on the value of the gas produced by the lessee after the lease had terminated for breach.

Based on all of this the court granted relief on terms, those being: (1) the lessee was denied its costs at trial and on appeal, (2) the lessor is entitled to a royalty on all produced gas, (3) the lessor is required to repay the $1.5 million referred to above.

Although that was enough to dispose of the case the court went on to critique the internal contradictions in the trial judge's reasoning with respect to the assessment of damages and\or an accounting. The court noted that the trial judge had apparently awarded not only the $1.5 million based on trespassory production but had also ordered the lessee to pay a royalty on that same amount — which was double dipping and a windfall (at para. 56); and hardly consistent with the trial judge's election to apply the mild rule for assessing damages for tortious production.

The public duty to provide reasons

Judges may not have a legal duty to provide reasons when they decide cases but they have a public duty to do so. The trial judge elected to give oral reasons and was then forced to clarify those reasons in his order in a manner that led to "apparently contradictory decisions" (at para. 54).

Justice McDonald elected to give no reasons at all for being unable to agree with the majority's judgement on the royalty issue. Neither did he offer his own analysis as an alternative to the majority's analysis. I think that this is unacceptable. Appellate judges are expected to clarify the law, not just decide cases between the parties before them. The duty to clarify requires judges to provide reasons for reaching a particular conclusion since a mere conclusion offers no guidance to those who seek to assess the extent to which a particular decision can be applied in a different context. While this duty applies with most force to the majority judgment, there is no reason for thinking that a dissenting appellate judge should get a pass. After all, the effect of a dissent is to question the authority of the majority's judgment and a dissent may form the basis for a new line of reasoning in a later case. As things stand we don't know if Justice McDonald disagreed with all or some of the majority's reasoning on the fuel gas point and we certainly don't know why or if the "why" is a good reason or a bad reason.