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When is a lease issued "in lieu" of an existing lease?

Written by: Nigel Bankes

Case commented on:

Canadian Natural Resources Limited v Jensen Resources Ltd, 2012 ABQB 786

In the early 1980s the Government of Alberta decided to make a clearer distinction in its tenure regime between grants of conventional petroleum and natural gas (PNG) rights and grants of oil sands rights. In implementing this policy the province went so far as to redefine the rights contained in existing Crown PNG leases. But in return, it allowed the affected PNG lessees to apply for a form of oil sands tenure for the rights that had been excluded from the PNG leases. That's what happened in this case and the issue was whether Jensen's gross overriding royalty (GOR) which clearly applied to the PNG leases also carried over to the oil sands rights. Justice Jo'Anne Strekaf held that it did.

Facts

Jensen Resources claimed a GOR on oil sands production in three sections of land (sections 1, 4 and 32). The GOR agreement provided (at para 5) that

> The [GOR] interest herein conveyed shall attach to and encumber the Petroleum and Natural Gas Lease above described, and any renewals or extensions thereof, or any new leases which may be executed in lieu thereof, subject to the terms of this agreement.

At the time that the GORs were granted (1978 – 1980), the grantor (Kissinger) held three separate Crown PNG leases for the three sections which included oil sands rights. Subsequently, with the passage of the *Oil Sands Conservation Act* (now RSA 2000, c O-7) the Energy Resources Conservation Board issued Oil Sands Area Order 3 (1984) which "deemed the hydrocarbon substance, with the exception of natural gas and coal, found in certain geological zones from the top of the Mannville formation through to the base of the Woodbend formation in the Athabasca, Cold Lake, and Peace River areas" to be oil sands. This Order included the lands under the three PNG Leases and had the effect of reducing the rights held under the three PNG Leases (at para 39). A contemporaneous Information Letter (IL 84 – 15) issued by Alberta Energy and Natural Resources contemplated that holders of Crown PNG leases that were affected by Oil Sands Area Orders would be able to apply (at para 40) for "a substitute oil sand agreement … to the whole or any part of the location upon completion of a well located on the location… where the "hydrocarbon substance" is able, in its naturally occurring viscous state, to flow to a well and has sustained recoverability to the satisfaction of the minister." Kissinger's successors in interest took advantage of this policy and as a result acquired either an oil sands lease (OSL) (sections 1 and 4) or an oil sands prospecting permit (OSPP) for lands that included

section 32. Ultimately an OSL was also issued for the section 32 lands. The OSLs all became vested in CNRL.

Oil has been produced from section 4 since May 1997 and from section 1 since December 2003. Neither CNRL nor its predecessors have paid any royalties to Jensen in respect of such production. Oil has been produced from section 32 lands since May 1999. CNRL and its predecessors have paid royalty on the section 32 production. In all of these cases production was obtained by conventional means albeit under the terms of the OSLs rather than the PNG leases. Jensen had no actual knowledge of production from the section 1 and 4 lands until 2007.

By originating notice Jensen sought a declaration that it was entitled to a royalty on the OSLs pertaining to the three sections of land and an accounting from CNRL for all royalties not paid since production commenced. CNRL in turn commenced an action claiming that Jensen had no royalty interest in any of the producing properties and sought to recover all royalties paid in relation to the section 32 lands.

Decision

Justice Jo'Anne Strekaf concluded that Jensen's GOR applies to the sections 1 and 4 OSL and to the section 32 OSL on the basis that the OSLs were issued in place of the PNG Leases with respect to the Mannville zone for those sections. CNRL's action was dismissed. While an applicant for oil sands rights needed to complete additional steps and while the OSLs were not automatically issued to the PNG leaseholders and the issuance of the oil sands rights was not expressly stated to be "in substitution" for the removal of the Mannville zone from the PNG leases resulting from the issuance of the Oil Sands Area Order 3, that (at para 55) was the substance of the arrangement.

Jensen's recovery was subject to the 10 year limitation period of section 3(1)(b) of the *Limitations Act* (RSA 2000, c L-12). Jensen was not precluded from recovery by the discoverability rules of section 3(1)(a) of the Act. In particular, Jensen was entitled to expect that the royalty payor would honour its obligation (at para 68). There was no clear information that the royalty payments were improper. Absent that, a royalty interest holder should not be expected to be required to take positive steps to ensure that they are being correctly paid.

Commentary

This seems to be an appropriate result. The original leases conferred rights to hydrocarbons in the Mannville which were removed as a result of Oil Sands Area Order No. 3. The clear policy of the government was to ensure that PNG lessees obtained substitutionary oil sands rights if they wished to, whether in the form of a permit or a lease. The relevant IL expressly referred to such substitutionary rights being issued under what was then section 8(1)(f) of the *Mines and Minerals Act* (RSA 1980, c M-15) which provided that:

> 8(1) The Minister may:
> (f) if he consider that the circumstances warrant it, agree with a lessee to grant an agreement to the lessee in substitution for an agreement held by the lessee.

Thus, as a matter of contract, it seems clear that, as between the original parties to the GOR, the grantor of the GOR was contractually obliged to ensure that the GOR continued on as against the new oil sands tenures which now conferred the rights that were originally contained in the PNG

leases. But the parties to this litigation were not the same parties. The issue is easy on the benefit side of the equation since the benefit of the GOR was expressly assigned to Jensen Resources Ltd. But what of the burden?

There is little if any discussion of this in the decision and unfortunately Justice Strekaf does not give us a complete picture of the chain of title. There is some discussion of the chain at paragraphs 14, 15 and 20 which suggests that some of the early changes in ownership were the result of corporate amalgamations in which case existing contractual obligations would continue. But it is not clear that the subsequent changes in ownership can be explained in the same way. CNRL, for example, acquired its interests in the OSLs "through its acquisition of assets from Petrovera Resources Inc" (at paras 15 and 21) and that sounds more like acquisition by way of a purchase and sale agreement than it does by way of a corporate amalgamation. And if that is the case then it would seem that Jensen has an additional challenge, at least in relation to the sections 1 and 4 lands where CNRL had never paid a royalty.

To succeed Jensen must be able to make the burden of the positive promise (to apply the royalty to the new agreement) run against CNRL. And to do that it must show that that promise is a legal or equitable interest in land that binds CNRL. Since the lands were Crown lands the interests would be unregisterable and so the interests in land (if established) would bind automatically (if legal) or with notice (if equitable). There is no discussion of this point in the case. Perhaps counsel was prepared to concede that the proprietary language of the GOR was so obvious that the GOR clearly established the intention of the parties to create this GOR as an interest in land as laid down in *Bank of Montreal v Dynex Petroleums Ltd,* [2002] 1 SCR 146. But is that enough? Or does Jensen also need to show that the additional promise to attach the GOR to the new lease also qualifies as an interest in land? If so that would be much more challenging. It may also be that the decision can be explained (and there is a strong hint of this at para 71 referring to the Agreed State of Facts) on the basis that CNRL, because of contractual commitments made to a predecessor in title, simply conceded that it would be liable if the original contracting parties would have been liable.