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A farmee that spuds in the test well has the right to a default notice

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Case commented on:

EOG Resources Canada v Unconventional Gas Resources Canada Operating Inc., 2013 ABQB 105 (MC)

This decision interprets the default clause (Article 13) of the Canadian Association of Petroleum Landmen's (CAPL) Farmout and Royalty Procedure. It confirms that there is no automatic termination of the farmee's right to earn provided that the farmee has spudded in the earning well; the farmee is entitled to proper notice of default and the opportunity to rectify that default.

The facts

UGR as farmor entered into a Farmin and Option Agreement (the head agreement) with EOG under which EOG was to earn a 75% interest in certain lands in return for drilling to completion a horizontal well at its sole cost, risk and expense (the test well). The head agreement incorporated by reference the CAPL Farmout and Royalty Procedure and the CAPL Operating Procedure (1990). EOG spudded in and drilled the test well and was engaged in completion operations between March 9, 2011 and March 20, 2011 but was required to leave the land during a sensitive period for woodland caribou. Some subsequent discussions between the parties about having EOG participate in the drilling of an option well on adjacent lands led to an amendment to the head agreement. The option well was never drilled and the test well was never completed before UGR began to allege that EOG was in breach, ultimately taking the view in correspondence and in the pleadings that as a result of EOG's breach EOG had lost the right to earn under the head agreement. UGR conceded that if EOG was entitled to notice of default and the opportunity to correct that default then UGR had not provided adequate notice.

EOG sought a declaration that its right to earn under the head agreement in respect of the test well remained valid and subsisting. The Court proceeded on the assumption that EOG had failed to continuously conduct operations to complete the test well (at para 27 and see below).

The Decision

Master Judith Hanebury concluded that EOG was entitled to notice of default. Article 13 of the Farmout and Royalty Procedure governed the issue. Article 13 deals with a number of different circumstances: (1) a farmee that fails to spud in the test well by the prescribed date loses its right to earn; (2) a farmee that fails to honour other obligations is entitled to notice before losing its interest, and; (3) a farmee that has earned an interest is entitled to the protection of that interest unless its default is in relation to a condition subsequent (at para 47). This situation fell within

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the second category and accordingly EOG was entitled to notice and the opportunity to cure the default.

Commentary

There were really two issues in this case: first, was EOG in breach of its obligation to continuously conduct operations to complete the well, and second, if it was in breach did such breach automatically terminate the farmee's right to earn or was it entitled to notice of default and the opportunity to cure that default. The first issue is evidently a mixed question of fact and law and Master Hanebury was perhaps surprised to have the matter before her in chambers rather than the subject matter of a trial. In response she took the prudent course of action and left that matter for another day, noting that the parties had not provided evidence of practice in the industry relating to continuous operations and therefore concluding (at para 27) that:

> Without this law and information the Court risks making a decision that is not sensitive to the commercial realities of the industry and is, simply, a bad precedent. Therefore, for the purposes of deciding the next question I will assume, without deciding, that a failure to continuously conduct operations to complete the well occurred.

Article 13 of the CAPL farmout and royalty procedure deals with default issues under that agreement and the head agreement. Clause 1301 is headed "farmor's default remedies." Clause A deals with the farmee's failure to spud the test well in which case the "Farmee's right to conduct operations hereunder terminates." This is all subject to the application of the force majeure provisions of the agreement. Clause B deals with the failure to make overriding royalty payments. Clause C deals with any other defaults under the head agreement or the procedure and specifically provides for the farmor to provide the farmee with a notice "stating the nature of the default." The farmee must take steps to remedy the default within 30 days failing which the Farmor, may by notice "terminate all or any portion of the interest of the Farmee acquired in the Farmout Lands …." Clause D provides that termination will not apply to any Working Interest already earned by the farmee thereby making a distinction between this defined term and the more generic term "interest" as used in Clause C. It is perhaps this distinction that leads Master Hanebury to speculate (at paras 37 and 45) that while EOG has earned a vested interest in the lands it does have "a contingent or conditional interest in the lands."

In sum, the plain language of the agreement suggests precisely the distinction that Master Hanebury made in her judgement: the matter is covered by Clause C. UGR seems to have tried to get around that interpretation of the agreement by relying on two lines of authority. One line of authority comes out of the freehold oil and gas leases. These leases contemplate that they may terminate automatically in some cases without affording the lessee any access to the default clause (i.e. notice of breach and the opportunity to cure the default). Thus, an "unless" lease will terminate automatically during its primary term where the lessee fails to either drill or pay; and pretty much any lease during its secondary term will terminate automatically for failure to produce (or some proxy for production such as operations). Since no duty is engaged there is no default and therefore no right to notice. The most recent case supporting this line of reasoning is *Freyberg v Fletcher Challenge Oil and Gas Inc*, 2005 ABCA 46. The difficulty with that line of reasoning in this case is two fold: (1) this was not a lease case, and (2) the express language of Article 13. This line of cases may be of assistance to a farmor that seeks to rely on the default described in clause 13.01(A), failure to spud an earning well, but it is hard to see how this line of cases is of any utility in those circumstances in which the agreement itself does not contemplate automatic termination.

The second case on which counsel relied for the proposition that EOG had lost its right to earn was *Royal Bank v Joffre Resources Ltd* (1985), 38 Alta LR (2d) 216 (QB). The issue in that case was whether Joffre had fulfilled all of its earning obligations under a participation and farmout agreement. In that case the farmor (Pacific) was participating along with the farmee in drilling the wells and consequently was required to provide funds for the drilling operations in accordance with an attached CAPL operating procedure. The operating procedure required Joffre to make adjustments at the close of each month as between actual and estimated costs. Joffre had failed to do that leaving a significant indebtedness to Pacific. Since Joffre was now insolvent the question for the court was whether Pacific had a security interest in the interest that Joffre was earning – or in other words, was Pacific entitled to refuse to execute transfers of the interests that Joffre for properties on which Joffre had drilled wells until Joffre had settled the accounts between the parties. The issue turned on the interpretation of a clause in the farmout agreement which provided that the farmee could only earn provided that it was not otherwise in default under the agreement. Justice Medhurst found that the "agreement" included not just the terms of the farmout agreement but also the attached operating agreement. Since Joffre was in breach of the terms of the operating agreement as noted above it had not completed earning and thus Pacific was entitled to hold Joffre's interest as security for Joffre's indebtedness. One of the issues that Justice Medhurst had to address was the question of whether the "no default" provision was a condition precedent to earning that covered all possible defaults even trivial default. As to which Justice Medhurst responded that the default was hardly trivial given the significant sums involved (over $100,000 in 1980s dollars).

But in all of this of course there is no suggestion that Joffre's default had cost it the right to earn; the case is merely authority for the proposition that a farmee must fulfill all the conditions precedent to earning and that some of those conditions precedent may be imported from attached agreement such as the CAPL operating procedure. In sum, *Joffre* case provides no support for UGR's argument and Master Hanebury was surely correct to observe (at para 35) that *Joffre* is inferentially also authority for the proposition that "a default could be remedied": quite the opposite of the result for which UGR was contending.

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