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Gross Negligence and Set-off Rights under the 2007 CAPL Operating Procedure

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Case Commented On: *Bernum Petroleum Ltd v Birch Lake Energy Inc.* 2014 ABQB 652; unreported transcript of reasons of Master Robertson, July 31, 2013

Bernum and Birch Lake held interests (60:40) in five sections of land (sections 3, 7, 8, 17 and 19) governed by the 2007 version of the CAPL operating procedure. Bernum was the operator. Birch Lake elected to participate in drilling two horizontal wells, the 4-3 well and the 6-19 well. The 4-3 well was a success and is still producing. The 6-19 failed and was subsequently abandoned. Birch Lake failed to meet cash calls under the authorizations for expenditure (AFEs) for the two wells; Bernum commenced an action and applied for summary judgement. Bernum also set off Birch Lake's share of production against Birch Lake's indebtedness.

Birch Lake defended Bernum's application for summary judgement on the basis that Bernum had been grossly negligent in drilling the two wells. The 2007 CAPL provides that:

> 4.02 The Operator … will not be liable to any of the Non-Operators for any Losses and Liabilities resulting from or in any way attributable to or arising out of any act, omission or failure to act, whether negligent or otherwise, of the Operator or its Affiliates and their respective directors, officers, agents, contractors or employees in the performance of the Operator's duties under this Agreement (including those in planning or conducting any Joint Operation), except insofar as: (a) those Losses and Liabilities are a direct result of, or are directly attributable to the Gross Negligence or Wilful Misconduct of the Operator …;

Unlike earlier versions of the CAPL operating procedure, the 2007 version provides a definition of Gross Negligence or Wilful Misconduct:

> .... any act, omission or failure to act (whether sole, joint or concurrent) by a person that was intended to cause, or was in reckless disregard of, or wanton indifference to, the harmful consequences to the safety or property of another person or to the environment which the person acting or failing to act knew (or should have known) would result from such act, omission or failure to act. However, Gross Negligence or Wilful Misconduct does not include any act, omission or failure to act insofar as it: (i) constituted mere ordinary negligence; or (ii) *was done or omitted in accordance with the express instructions or approval of all Parties, insofar as the act, omission or failure to act*

otherwise constituting Gross Negligence or Wilful Misconduct was inherent in those instructions or that approval. (emphasis added)

Birch Lake also counterclaimed with respect to sections 7, 8 and 17. The leases on these lands had been allowed to expire in accordance with their terms but Bernum then re-leased them in its own name and for its own account. Birch Lake argued that Bernum had failed in its obligations under the CAPL to maintain the co-owners' interest in the original leases and that the subsequent acquisition of new leases on these properties was subject to an area of mutual interest (AMI) obligation, or, that in acquiring these leases in its own name and for its own account, Bernum was in breach of a fiduciary obligation owed to Birch Lake. Bernum took the position that the AMI obligations had expired.

Master Robertson granted Bernum summary judgement on the amounts owing under the cash calls but stayed execution of that judgement for one year to allow the parties to proceed to trial on the AMI issue – apparently so as to allow Birch Lake to establish set-off. Master Robertson denied summary judgement on the AMI issue and the other issues relating to the section 7, 8 and 17 lands since while the AMI obligation on its face had expired, there was an argument that it had been extended by the conduct of the parties; and the agreement did not prescribe that any amendments had to be in writing.

Birch Lake appealed and Bernum cross appealed the stay. Both parties adduced additional evidence on the appeal.

Justice Pentelechuk agreed that Bernum was entitled to summary judgement on the cash calls with no further stay (at para 118). There was no evidentiary basis for the claims of gross negligence and in any event Birch Lake must be taken to have approved the mudding program proposed by Bernum in its AFE (see the italicized text in the definition of gross negligence, *supra*). The following paragraphs summarize her conclusions on these matters:

> [46] The determination of each case of gross negligence or wilful misconduct is not only fact- but context-specific. The oil and gas industry is a high risk, speculative business, particularly for junior participants who often operate on precarious financial foundations. As admitted by the parties, many things can go wrong during the course of drilling, resulting in unanticipated delays and cost overruns. Often, decisions in the course of drilling must be made quickly without time for extended consultation or analysis. A well may not produce as expected or may not produce at all.
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> [50] There is nothing in the record to suggest the 4-3 well would have produced at a higher rate had a different mud system been employed or that the difficulties with the 16-19 well would have been avoided if different drilling operations were employed. In other words, while there is criticism aimed primarily at the mud system utilized, it begs the question whether utilization of a different mud system would have led to a different result. With the benefit of hindsight and time, it may be established that utilization of a different mud system would have been preferable in the circumstances, but Birch Lake must put its "best foot" forward now.

> [51] Taking Birch Lake's evidence at its highest and ignoring the evidence put forward by Bernum, Birch Lake has failed to establish that its defence of gross negligence in relation to the operation of the wells is an issue of merit requiring a trial. The record does not disclose evidence showing a conscious wrongdoing or a very marked departure from the standard expected of an operator like Bernum. Part of the problem is Birch Lake's failure to lead evidence on industry standards by which the actions of Bernum could be compared. For example, Birch Lake points to Bernum's choice of mud programs, and its decision to use the same program on the 16-19 well, but provides no evidence to suggest the mud system utilized was contrary to industry standards. In contrast, Bernum led evidence that the mud program utilized is the standard program used by operators in the area.

Justice Pentelechuk also agreed that it would be inappropriate to grant summary judgement with respect to any of the matters in relation to the section 7, 8 and 17 leases. The provision in the 2007 CAPL to the effect that all amendments to the agreement must be in writing did not apply to the head agreement since in the event of a conflict between CAPL 2007 and the head agreement the head agreement must prevail. The head agreement as noted above did not require that amendments to the AMI agreement must be in writing. It is possible however that the *Statute of Frauds* may be relevant to the question of writing (at para 74).

Justice Pentelechuk appears to have given two types of reasons for denying any extension of the stay ordered by Master Robertson. As noted above, Master Roberston seems to have granted the stay so as to allow Birch Lake to establish a right of equitable set-off. Justice Pentelechuk however drew the attention of the parties to cl.5.05B(d) of the 2007 CAPL which provides that the operator may

> … maintain actions against that Non-Operator for all such unpaid amounts and interest thereon on a continuing basis, as if those payment obligations were liquidated demands payable on the date they were due to be paid, *without any right of that Non-Operator to set-off or counter-claim*. (emphasis added)

In her view this clause is one of a number of clauses which (at para 94) "provide an operator with expedited and enhanced remedies not available to an ordinary creditor."

> [95] These enhanced remedies reflect the high risk and high reward world of oil and gas exploration. These provisions discourage non-operators from delaying payment of their agreed upon share of operating costs because production is lower than expected.

As such, potential set-off claims (at para 104) "cannot be raised as a means to refuse or delay payment of operating costs due and owing."