June 8, 2017

Party Principally Interested in Thermal Recovery Succeeds on Appeal

By: Nigel Bankes

Case Commented On: *IFP Technologies (Canada) Inc v EnCana Midstream and Marketing*, 2017 ABCA 157 (CanLII)

The Court of Appeal by a majority (Chief Justice Fraser, Justice Rowbotham concurring; Justice Watson dissenting) has concluded that a party (IFP Technologies) who acquired from PanCanadian Resources (PCR, now Encana) a 20% undivided interest in a set of oil and gas properties under the terms of a conveyancing document (denominated here as the Asset Exchange Agreement, AEA), retains a working interest in those properties even where other contemporaneous documents executed by the parties, including a joint operating agreement (JOA), purported to limit IFP's interest to an interest in the production that occurs as a result of *thermal processes* and not as a result of *primary production*. As a result of its interpretation of the AEA, the majority concluded that IFP was entitled to an accounting for its proportionate share of the net revenue realized from primary production from the relevant properties (now held by Wiser - and most recently Canadian Forest Oil - pursuant to a farmout from PCR to Wiser). The Court also held that IFP had reasonably withheld its consent to Wiser's acquisition of PCR's interest in the lands. In reaching these conclusions the majority overruled Chief Justice Wittmann's decision at trial (2014 ABQB 470 (CanLII)) acting in place of the Trial Judge, Justice Ron Stevens who (at para 48) died in spring 2014 without having been able to render judgement based on a trial which took place between January and June 2011.

The majority found less cause to dissent from the trial judge's findings with respect to the assessment of damages, principally because both the trial judge and the majority in the Court of Appeal considered that there was no chance that thermal operations would be undertaken within the relevant timeframe given oil prices at that time.

I commented on the trial decision here and that post also provides a summary of the relevant facts.

I think that there are two principal differences between this majority decision and the judgement at trial. The first main difference turns on the emphasis that the majority chose to place on the conveyancing language in the AEA rather than on the limiting language (i.e. the language apparently limiting IFP's rights to rights in relation to thermal production) found in the JOA. The second main difference turns on the majority's understanding of the agreement between the parties when the AEA was executed. In the opinion of the majority, both parties understood that primary production was coming to an end and that all future production would be thermal. In moving over to thermal production both parties agreed that IFP should be protected from the reclamation and abandonment costs associated with the wells that had been used for primary production. The majority therefore viewed the limiting language of the JOA as principally

serving a protective function rather than something that circumscribed IFP's interest. The majority's understanding of the factual matrix underpinning the agreements between the parties also influenced the majority's assessment of the reasonableness of IFP's decision to withhold consent to PCR's proposed farmout to Wiser.

My review of the Court of Appeal's decision is organized around the following headings: (1) standard of review; (2) principles of contractual interpretation; (3) errors in the interpretation of the AEA and the failure to accord a pre-eminent role to the AEA in the interpretation and application of the matrix of agreements between the parties; (4) errors in the interpretation of the JOA; (5) the misinterpretation or mis-application of article 2401 of the (CAPL) Operating Procedure with respect to the reasonableness of withholding consent; and (6) the assessment of damages. I also provide a brief summary of Justice Watson's dissenting opinion as well as some final commentary on the decision.

1. Standard of Review

There have been significant developments in contract law since Chief Justice Wittmann rendered his decision in 2014. Principal among these are the decisions of the Supreme Court of Canada in *Sattva Capital Corp. v Creston Moly Corp.*, 2014 SCC 53, [2014] 2 SCR 633 [*Sattva*] and *Bhasin v Hrynew*, 2014 SCC 71, [2014] 3 SCR 494 [*Bhasin*]. *Sattva* is directly relevant with respect to the preliminary question of the applicable standard of review that an appellate court must apply with respect to issues of contract interpretation. In general as the majority notes (at para 57), the current law "requires that appellate courts accord a high degree of deference to a trial judge's particular interpretation of a contract." However, an extricable question of law may be reviewed for correctness. In this particular case the majority concluded that the trial judge's failure to consider the surrounding circumstances in construing the agreements between the parties was such an extricable error. Correctness is also usually the applicable standard (at para. 60) for interpreting a standard form contract (such as the CAPL operating agreement) and the same standard applies "by analogy" (at para 61) to terms such as "working interest" "which have a common meaning to participants in a given industry". The majority did however reject (at paras 66-78) IFP's contention that correctness should be the standard for all issues given the circumstances of this case in which one judge conducted the trial but a second judge rendered judgement. Justice Watson in dissent broadly agrees (at paras 289-302) with all of the above while choosing to emphasise that specific findings of fact and the inference of fact, or mixed fact and law, deserve deference and should be assessed on a reasonableness standard which requires that an appellate court not interfere absent a palpable and overriding error.

2. Principles of Contractual Interpretation

The majority of the Court emphasised that the trial judge had a duty to consider the relevant contractual matrix for the contract even absent any ambiguity. This does not offend the parol evidence rule because the goal of considering the factual matrix is (at para 81) "to deepen the trial judge's understanding of the mutual and objective intentions of the parties as expressed in the words of the contract." Of particular relevance here were (at para 84) "the genesis and purpose of the Contract and the relevant background, including … (a)n antecedent agreement like the MOU [memorandum of understanding], which has been agreed to in writing by both PCR and IFP …".

3. Errors in the Interpretation of the AEA and the Failure to Accord a Pre-eminent Role to the AEA in the Interpretation and Application of the Matrix of Agreements Between the Parties

The majority chose to begin its analysis of the agreements between the parties by emphasising the pre-eminent or dominant role of the AEA within the various contracts between the parties. The principal reason for according it that pre-eminence (at para 92) was simply that this was what the agreement itself provided for. The key article (at para 106) of the AEA was Article 2.1:

> PCR hereby agrees to sell, assign, transfer, convey and set over to IFP, and IFP hereby agrees to purchase from PCR, *all of the right, title, estate and interest of PCR* (whether absolute or contingent, legal or beneficial) *in and to the PCR Assets* … all subject to and in accordance with the terms of this Agreement. [Emphasis added by the majority]

The relevant PCR Assets were defined as "an undivided interest equal to 20% of the working interest of PCR... in and to: (i) the PCR Eyehill Creek Petroleum and Natural Gas Rights; and (ii) the PCR Eyehill Creek Miscellaneous Interests" (at para 97).

The trial judge, noting that the parties had failed to define the term "working interest" in the AEA, had concluded that IFP's working interest was confined to an interest in thermal production. The majority decided that this was an error of law. The majority concluded that the trial judge had failed to recognize that the term working interest "is a legal term of art" (at para 98) but also concluded that the trial judge's characterization of PCR's interest as an interest in a resource limited by a method of extraction was fundamentally inconsistent with the idea of a working interest and ultimately unworkable (at paras 101-103). The majority acknowledged that parties are free to deviate from the meaning of a legal term of art (at paras 62 and 104) but emphasised in this case that there was nothing in the language of the AEA which even hinted at this (at para 104):

> To be absolutely precise, the AEA does not purport to limit the working interest that PCR conveys to IFP to oil and gas produced from thermal and other enhanced recovery methods. The word "thermal" is not even mentioned in the AEA, not once, not ever. Nor are the words "enhanced recovery methods". Finally, and tellingly, the working interest conveyed to IFP is defined as "20% of the working interest of PCR".

Hence, in the instant case (at para 109), the conveyancing language of the AEA was clear and admitted of no limitation by mode of recovery. By disregarding the conveyancing language of the AEA the trial judge committed (at para 109) a "fatal error". It was a further error (at paras 110-112) to rely on a preambular provision of the AEA that referenced operations to permit the operating agreement to qualify IFP's ownership interest. This was impermissible because the AEA dealt with ownership interests whereas the subject matter of the JOA was that of operations.

4. Errors in the Interpretation of the JOA

As noted above, the trial judge had concluded that IFP's working interest was limited to an interest in thermal production from the leased lands. While the AEA provided no support for this

conclusion there is support for this interpretation in clauses 4 and 5 of the JOA (quoted at para 151):

> 4. Operations
>
> (a) All operations conducted by the parties pursuant to this Agreement shall be at each party's sole risk and expense unless the contrary is specifically stated *and always in accordance with Clause 5 hereof.*
>
> ….
>
> (c) It is specifically agreed and understood by the parties that the working interests of the parties *as described in Clause 5 of this Agreement* relate exclusively to thermal or other enhanced recovery schemes and projects which may be applicable in respect of the petroleum substances found within or under the Joint Lands and the Title Documents. Unless specifically agreed to in writing, IFP will have no interest and will bear no cost and will derive no benefit from the recovery of petroleum substances by primary recovery methods from any of the rights otherwise described as part of the Joint Lands or the Title Documents.
>
> 5. Participating Interests
>
> Except as otherwise provided in this Agreement, as and from the Effective Date hereof, the parties hereto shall bear all royalties, costs, risks and expenses paid or incurred under this Agreement and the Operating Procedure and shall own the Title Documents, the Joint Lands, the petroleum substances and the operations to be carried out pursuant to this Agreement as follows:
>
> (a) That portion of the Joint Lands described in Schedule "Al":
> PCR - an undivided 80% working interest
> IFP - an undivided 20% working interest
> (b) That portion of the Joint Lands described in Schedule "A2":
> PCR - as described in Schedule "A2"
> IFP - as described in Schedule "A2"
>
> (i) In any event and at all times, unless otherwise specifically agreed in writing, the working interests of the parties will be in the proportions PCR 80%, IFP 20%;...
>
> (c) For greater clarity, there exist, in conjunction with the Joint Lands, numerous wells, flowlines, processing facilities and other similar and related surface and underground installations which have been or are being used in the primary production of petroleum substances and which are owned, at least partially, by PCR. The parties do not intend that IFP will, pursuant to this Agreement, acquire any interest in such wells, flowlines, facilities or installations. Unless otherwise specifically agreed in writing, the only circumstance in which IFP will come into possession of a proportionate 20% working interest share in any of the aforementioned wells, flowlines, facilities or installations is in the

> event such wells, flowlines, facilities, or installations are included within the definition of a thermal or other enhanced recovery project. At such time as the parties agree to the inclusion of any such well, flowline, facility or installation in a thermal or other enhanced recovery scheme or project, IFP will forthwith become the owner of a proportionate 20% working interest in any such well, flowline, facility or installation without further consideration paid by IFP to PCR. In such circumstance, IFP will assume its proportionate share of all future costs, liabilities and benefits derived from or associated with its ownership of such well, flowline, facility or installation. Any interest so acquired will become subject to the Operating Procedure without further action by the parties. [Emphasis added by the majority]

The trial judge relied in particular on the language of paragraph 4(c) to support his conclusion that PCR's interest in the joint lands was limited to thermal production. The majority however held that this interpretation was untenable, not least because if it applied to constrain IFP's interest it must similarly constrain PCR's working interest (at para 154):

> This interpretation is unreasonable. The parties did not agree under the JOA to limit their own ownership interests to thermal or enhanced production only. This would lead to the absurd result that neither IFP nor PCR had any interest in Eyehill Creek beyond oil and gas produced through thermal or enhanced recovery methods. This cannot be.

In the opinion of the majority (and bearing in mind that in the majority's view (at para 155) the JOA deals with operations and not ownership), Clause 4 (at paras 159-160) dealt with the terms and conditions under which the parties would pursue a thermal recovery project and thus dealt with their interests in the thermal project and not more generally with respect to their working interests in the co-owned assets. Read in this manner (at paras 165-166) Clause 4 provided an option which allowed IFP to opt in to primary production operations. Another purpose of these two clauses was to protect IFP from the liabilities associated with the existing facilities and in particular the wells which had been put in place for the purposes of primary production. In the opinion of the majority, PCR was impermissibly using the protective role of these provisions to limit IFP's rights. The majority put it this way (at para 171):

> A Clause intended to protect IFP cannot now be turned on its head and used for another purpose entirely. And yet, that is what PCR is trying to do. It is attempting to use Clause 4(c), designed to protect IFP from liability for abandonment costs of existing infrastructure unless and until IFP agreed otherwise, to support its claimed rights to (1) engage in unrestricted new primary production at Eyehill Creek, rather than simply phasing out primary production; and (2) cut IFP out of any benefits from primary production. This unreasonable interpretation, which is inconsistent with both the commercial context and factual matrix, is without merit. A Clause designed as a shield to protect IFP cannot be used as a sword to benefit PCR.

It is apparent that in reaching this conclusion the majority draws heavily on the factual matrix of the relationship between the two parties. Examination of that matrix convinced the majority that both PCR and IFP were of the view (at para 139) that primary production at the relevant property

"was finished and all that remained was to phase out existing production." Any future production would be thermal production.

The majority buttressed its conclusion by referring back to the hierarchical relationship between the AEA and the JOA. If the preferred interpretation of the trial judge were to be accepted (i.e. a conclusion that the JOA limited IFP's ownership interest) the result would be a conflict between the terms of the AEA and the terms of the JOA. If that were the case, the AEA stipulated that the terms of the AEA should prevail.

The majority concluded this part of its judgement as follows:

> [178] For these reasons, IFP's working interest in Eyehill Creek is, and remains, an undivided interest as a tenant in common equal to 20% of PGR's working interest in the PGR Eyehill Creek Petroleum and Natural Gas Rights (which included Crown leases) and in the PGR Eyehill Creek Miscellaneous Interests, as both terms are defined in the AEA.
>
> [179] Accordingly, IFP is entitled to an accounting for its proportionate share of the net revenue realized from primary production at Eyehill Creek.

5. The Misinterpretation or Mis-application of Article 2401 of the (CAPL) Operating Procedure with Respect to the Reasonableness of Withholding Consent

The majority concluded that the trial judge also erred in finding that IFP acted unreasonably in withholding consent to the farmout to Wiser. I think that there are perhaps three parts to this conclusion. The first part, following *Bhasin* and also *Mesa Operating Limited Partnership v Amoco Canada Resources Ltd.* (1994), 1994 ABCA 94 (CanLII), is that a good faith implementation of the contractual arrangement between the parties precluded some types of operations. In particular, since the agreements between the parties were premised on the shared assumption that primary production was petering out and that future production would be thermal, PCR could not itself revert to primary production, nor could it transfer its interest to a party (Wiser) who had that objective. The majority put it this way (at para 194):

> … in keeping with *Mesa* and *Bhasin*, PCR was, at a minimum, under a duty of good faith not to engage in primary production in a manner which would undermine or substantially nullify IFP's ability to pursue a thermal project. This obligation necessarily precluded farming out its interest to a third party who would do the same. This good faith requirement is not inconsistent with the Contract. While there was no guarantee in the Contract that a thermal project would ever proceed at Eyehill Creek, even if PCR had the "right" to engage in new primary production using existing or new wells – which I have rejected for reasons explained earlier – it did not in any event have the right to engage in unconstrained primary production. The contrary is so. In keeping with the parties' reasonable expectations, PCR had a minimum good faith obligation under the Contract not to engage in primary production at Eyehill Creek in a manner which would substantially harm IFP's interests in pursuing a thermal project contrary to the original objective of the Contract.

Second, it followed from this that it was entirely reasonable for IFP to seek to protect the shared vision of a thermal recovery operation for the joint lands by withholding consent to a transfer to party that was only interested in primary production (see at para 203).
The third part of the conclusion (actually referenced in the section on damages) is that (at para 205) since "it was reasonable for IFP to refuse to consent to the disposition to Wiser, PCR breached the Contract in proceeding as it did."

Given the focus of the discussion at trial (see my earlier post), it bears emphasising that the majority decision does not reference in any way the landlord and tenant case law on the unreasonable withholding of consent that constituted the body of relevant law for Chief Justice Wittmann. By contrast, Justice Watson's dissent does engage with this body of law (at paras 308-320) and in doing so reviews Chief Justice Wittmann's assessment of the reasonableness of IFP's conduct according to the palpable error test applicable to findings of fact or mixed findings of fact and law. And as a consequence Justice Watson found no cause for appellate intervention.

6. The Assessment of Damages

While the majority concluded that PCR had breached the operating agreement by proceeding with the farmout agreement, no damages flowed from that breach since (at para 210) "there was zero chance that a thermal project would have proceeded at Eyehill Creek." Justice Watson, although dissenting on the main issues indicated (at para 362) that if he "were with the majority" he would concur in how the majority dealt with the issue of damages.

As a result, all that IFP was entitled to was an accounting (at para 216) for its proportionate share of the primary production "on both existing and new wells". The premise for the accounting is not breach of contract but simply IFP's co-ownership position (which must also mean that the contractual limitation in liability in AEA – discussed at para 217 - is inapplicable). The additional premise for the accounting seems to be that the JOA was only ever intended to deal with thermal production and not primary production. Thus the accounting must be in accordance with the common law of co-ownership as modified by the *Law of Property Act*, RSA 2000, c. L - 7 (LPA) (and not the JOA). The majority reaches no conclusion as to how the accounting is to be conducted (and indeed the reference to the LPA is mine and not the Court's) but instead refers these issues to the Queen's Bench for determination with the following "guidance" (at para 218):

> In addition to the obvious [issues as to how to calculate net revenue] there is a question of whether and to what extent, if any, IFP should be responsible for abandonment costs of existing infrastructure. To take a few examples only, there may be wells that were not reactivated at all and have now been formally abandoned. Whether IFP is responsible for what would otherwise be its proportionate share of those costs remains another open issue. Also, there might be certain abandonment costs that were already required to be paid when existing wells were reactivated. In other words, those costs might have been baked in, with or without reactivating them for primary production. Again, is IFP responsible for those costs or only the incremental costs of abandoning the wells associated with their reactivation for primary production? And is it, in any event, open to IFP to opt in to existing wells on an individual basis? Again, we heard no argument on these or related points dealing with how to determine the "net revenue" realized from primary production at Eyehill Creek.

I don't envy the trial judge who receives this assignment and I suspect that it may be in the interests of both parties to seek further guidance from this panel of the Court perhaps as part of finalizing the judgment role, much as in *Stewart Estate v TAQA North Ltd*, 2016 ABCA 143 (CanLII) (and for comment see here).

The Dissent

As noted in the introduction, Justice Watson dissented finding no cause for appellate intervention. I have indicated in several places above those issues on which Justice Watson concurred with the majority and it remains to emphasise some of the key points of difference. Justice Watson characterizes IFP's claim as a claim to veto PCR's further primary production from the property (at para 238) "until PanCanadian either commenced thermal production as per the Joint Operating Agreement (with IFP's right to participate) or, presumably, until PanCanadian acquired IFP's working interest." Ultimately Justice Watson found no support for this interpretation of the contractual arrangements between the parties. In his view the veto was a one-sided expectation of IFP and (at para 332) it was not the role of the principle of good faith or the duty of honest contractual performance to reframe the contract to reflect the expectations of a single party. In particular (at para 332) "The law will not amend this sort of a contract merely because the interests of IFP did not turn out to be beneficial, advantageous or profitable, let alone because the Deal turned out to be improvident …". Justice Watson conceded at several points that the majority's interpretation is possible and indeed plausible (see for example at paras 333, 337 and 354) but in the end he emphasises that the applicable standard of review for what he mostly characterizes as mixed questions of fact and law (triggering review only for palpable and overriding error) preclude appellate intervention. More fundamentally however I think Justice Watson believes that the majority is engaged in re-writing the bargain between the parties to reflect IFP's interests.

Commentary

I will confine my comments to two points of agreement with the majority and one point of disagreement.

I think that the majority is correct to question Chief Justice Wittmann's characterization of IFP's interests. In effect, Chief Justice Wittmann created a new form of property interest that purported to be distinguishable from other interests on the basis of the mode of production. I agree with the majority (see especially at paras 101-103) (and see my post on the trial decision) that there would be significant practical difficulties and uncertainties associated with such a view of property.

I also agree that PCR breached its duty of good faith implementation of its contractual obligations (based on *Bhasin* and *Mesa*) when it reverted through Wiser to a primary production model of extraction. PCR did not have a duty to implement a thermal recovery operation (and it did not owe the fiduciary's duty of undivided loyalty to IFP) but it did have a duty not to undermine IFP's expectations based on the shared premise that primary production was petering out. It follows that IFP was entitled to withhold its consent to the farmout and thus has a cause of action against PCR for wrongfully assigning the property to Wiser. There might be some difficulty making this stick against Wiser (and Canadian Forest) absent privity, but IFP should have a good claim against PCR subject to the problem of establishing damages.

However, I do think that the parties are free to modify the implications of the common law property position through their contractual agreements. While I agree that it would have been cleaner had the parties chosen to do that in the AEA rather than in the JOA, the provisions of clauses 4 and 5 of the JOA make it clear that the parties did intend to modify the default rules of the common law dealing with the rights of a working interest owner. That modification was intended to protect IFP from any claim to liabilities associated with existing primary production operations but it was also intended to deny IFP rights in relation to primary production. After all IFP's interest and expertise (what it brought to the table) focused on thermal production not primary production. The majority decision effectively ignores the language of the JOA which denies IFP's rights with respect to primary production while emphasising the protections offered by the JOA. The difficulties entailed in doing so are only too obviously revealed in the "guidance" offered to the trial judge for the accounting (quoted above). In reaching this conclusion the majority relies heavily on the hierarchical position of the AEA and indeed accords it quasi-constitutional status by denying that the JOA can derogate from the common law rights accorded by the conveyancing language of the JOA.

But like the majority I too am concerned that IFP got shafted (as I put it in my post on the trial decision) and so I wonder if there is an alternative path that would afford IFP a real remedy which avoids an accounting based on a common law ownership position. As noted above, I agree with the majority that PCR breached its obligations to IFP in proceeding with the Wiser farmout. But I also agree that it cannot really show that it suffered damages as a result of this breach. Is there a way out of this conundrum? One possibility would be to seek damages on a restitutionary basis, that is to say a disgorgement of the benefits received by PCR (see *AG v Blake*, 2000 UKHL 45 (BaiLII)). Such a remedy would be based on an accounting of net benefits, much as an accounting based on co-ownership but with one modification insofar as the accounting would be limited to the new primary production operations which resulted from the transfer to Wiser. I admit that this approach is hardly free from difficulty (not least of which is making this remedy run against Wiser and Canadian Forest as well as PCR) but it does less violence to the obvious intent of the parties to modify the common law rules with respect to co-ownership in relation to primary production from existing wells.

This post may be cited as: Nigel Bankes "Party Principally Interested in Thermal Recovery Succeeds on Appeal" (8 June, 2017), online: ABlawg, http://ablawg.ca/wp-content/uploads/2017/06/Blog_NB_IFP_v_Encana.pdf