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The False Security of Commingled Trust Accounts

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Case Commented On: *Alberta Treasury Branches v Exall Energy Corporation*, 2017 ABQB 602 (CanLII)

Working interest owners in the western sedimentary basin have long sought to have the best of both worlds: the convenience of allowing an operator to commingle joint account monies from multiple properties in a single general account, while offering (through the provisions of the Canadian Association of Petroleum Landmen (CAPL) operating procedures) the contractual assurance to non-operators that their funds were impressed with a trust while in that commingled account. The weakness of such an assurance is that its underlying premise is that the operator will always have a balance in that commingled general account equal to or greater than the amounts represented by the "monies of the joint operator", whether those monies are monies contributed by a joint operator to fund joint operations or whether they represent monies received by the operator on account of the sale of a joint operator's share of production. If that premise turns out not to be the case then a joint operator's proprietary claim evaporates. The premise of course is most likely to be false when the operator is in financial difficulty – the precise point in time when a joint operator would like to have access to a proprietary remedy.

Exall is in receivership. Most of its assets have been sold. This case involves competing claims with respect to approximately $1.2 million from the proceeds of sale held back from distribution to the secured creditor. Justice Blair Nixon describes three categories of claims: (1) claims by LMP Resources as a joint operator/working interest owner with Exall, (2) various lien claims, and (3) claims by Alberta Treasury Branch (ATB) as a secured lender. This post focuses on LMP's claims. I will try to address the lien claims (where the arguments and reasoning seem to me to be much more complex and convoluted) in a subsequent post but I understand that this part of the decision is under appeal.

The Claims of LMP Resources

LMP Resources claimed a share of the hold-back monies (to the extent of its share of production from jointly owned property) on the basis of: (1) an express declaration of trust, (2) a deemed trust under clause 507 of the 1990 CAPL Operating Procedure, and (3) an entitlement to take its share of production in kind.

Express Trust

It is somewhat difficult to figure out from the judgment the chain of title with respect to all of the co-owned properties, but the crucial point with respect to the express trust argument seems to be that Exall and LMP entered into a Declaration of Trust and Memorandum of Agreement in 2008

(at para 27). A schedule to the Declaration indicated that Exall held an interest in a property known as the LMP Marten Mountain Property in trust for LMP Resources. The Schedule did not reference any other properties (at para 46). The oil and gas lease underlying the LMP Marten Mountain Property expired in September 2013.

On these facts it was relatively clear that LMP Resources could have no claim. The subject matter of the trust was an interest in a lease on the LMP Marten Mountain Property. The trust died with the expiration of the lease. See the judgement at paras 49-51.

The CAPL Deemed Trust

The jointly owned properties subject to the claim of a deemed trust were all operated by Exall under the terms of the 1990 CAPL Operating Procedure. Exall paid production revenues from these properties into its general commingled account. Exall failed to account to LMP Resources for LMP's share of the net proceeds of production between July 2014 through January 2015 inclusive for a total of $314,747.36.

ATB was a secured creditor of Exall and put Exall into receivership on March 25, 2015. On March 24, Exall's general operating account was a negative $49,331.97; at the end of the day on March 25, 2015 it was a positive $493,772.83.

Clause 507 of CAPL 1990 provides that:

> 507 COMMINGLING OF FUNDS - The Operator may commingle with its own funds the moneys which it receives from or for the account of the Joint-Operators pursuant to this Operating Procedure. Notwithstanding that moneys of a Joint Operator have been commingled with the Operator's funds, the moneys of a Joint-Operator advanced or paid to the Operator, whether for the conduct of operations hereunder or as proceeds from the sale of production under this Operating Procedure, shall be deemed to be trust moneys, and shall be applied only to their intended use and shall in no way be deemed to be funds belonging to the Operator, other than in its capacity as the Joint-Operators' trustee.

The Alberta Courts have long held that the right to commingle is not inconsistent with a trust obligation (*Bank of Nova Scotia v Société general (Canada)*, 1988 CanLII 166 (AB CA), [1988] 4 WWR 232 (ABCA), *Brookfield Bridge Lending Fund Inc v Vanquish Oil & Gas Corp*, 2009 ABCA 99 (CanLII)) (and for my post on *Brookfield* see here) but the right to commingle does not authorize the trustee to breach the terms of the trust. In other words (and to focus only on proceeds of production), an operator/trustee has a duty at all times to keep a positive balance in its commingled account sufficient to cover all of its obligations owed to all joint operators with respect to proceeds of production that it holds for their account. If it fails to do so it is in breach of trust. But, as this case demonstrates, that may be an empty obligation, since, while a trustee is deemed to spend its own money first from a commingled account impressed with a trust (*Re Hallett's Estate* (1879), 13 Ch D 696), when those own monies are gone any further disbursements inevitably dip into the trust monies. As a consequence, the trust claim is then limited to the lowest balance in the account. In this case that lowest balance was negative. The joint operator cannot follow the disbursements of trust monies from the joint account because the

joint operator's claim to those monies sounds only in equity and the payee (absent some evidence to the contrary) is equity's darling, the equivalent of the bona fide purchaser of the legal estate for value without notice.

For Justice Nixon that negative balance was fatal to LMP's claim since (at para 69) "The funds which [LMP] was targeting had been released from that deemed trust." That conclusion seems inescapable. The fact that the account subsequently turned positive (and positive enough to cover all of the monies owed to LMP) as a result of a deposit from another party, Enerchem, was not relevant: "Absent any evidence to the contrary, I find that the Enerchem deposit was not traceable to any production that was attributable to LMP Resource" (at para 72).

The Implications of LMP's Right to Take in Kind

The facts necessary to understand this part of LMP's argument seem to be as follows. LMP and Exall had joint interests in a number of properties. Prior to the receivership LMP had elected to take 82% of its share of production in kind (subject to an obligation to reimburse Exall as Operator for its share of production costs). As of October 15, 2015 LMP owed Exall $43,504 as its share of those costs. Exall (and subsequently the receiver) was selling the balance of LMP's share of production (18%) which LMP had not elected to take in kind.

As part of this application, LMP sought a court order permitting it to take in kind that remaining 18% share of its production. Justice Nixon gave two reasons for not issuing the order. First, LMP already had the right to take in kind under clause 601 of CAPL 1990. Second, the fact that LMP was indebted to Exall in the amount indicated above suggested that the proceeds of sale of the 18% were inadequate to cover the production costs attributable to the 82% of its production. The implication of this seems to be that Justice Nixon was not prepared to exercise his judicial authority to better LMP's position in any way. It is not clear to me, however, why LMP felt that it needed a court order to exercise its right to take in kind (or indeed how that would give it a proprietary claim in relation to past production). As Justice Nixon notes (at para 82), LMP already had a contractual right to take in kind:

> 601 EACH PARTY TO OWN AND TAKE ITS SHARE - Each party shall own its proportionate share of the petroleum substances produced from wells operated for the joint account. The Operator shall measure and deliver into the possession of each party, as and when produced at the first point of measurement, the proportionate share of petroleum substances owned by that party, exclusive of production which has been unavoidably lost and production which may be used by the Operator in producing operations respecting the joint lands. Each party shall, at its own expense, have the right to take in kind and separately dispose its proportionate share of such production....

It is true that clause 9 of the receivership order (available here) stays the exercise of all rights and remedies (including rights of set-off) without leave of the Court, but it is not clear to me that exercising a right or option to take in kind would be caught by this provision.

In sum, and on all of the three arguments (express trust, CAPL 1990 deemed trust, and the right to take in kind) LMP was out of luck and had no claim on the holdback monies.

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