March 11, 2020

Net Profits Interest Decision

By: Nigel Bankes

Case Commented On: *Hudson King v Lightstream Resources Ltd*, 2020 ABQB 149 (CanLII)

William Hudson (WH) of Texas discovered hydrocarbons in a reservoir near Rocanville, Saskatchewan. Lacking the resources to develop the discovery WH assigned the Rocanville properties to Triton (a Texas based corporation) in 1977 in return for $900,000 and a net profits interest (NPI). The NPI Agreement was executed in favour of a trust that WH and his wife had established for the benefit of their three children EHK, AH and CH. The trust was collapsed in 1986 when the youngest child reached 21 and the three children became the counterparties to the NPI Agreement. AH assigned his interest to ACH Holdings in 2009. I refer to EHK, AH, CH and ACH Holdings as the Hudson parties or as the plaintiffs. On the Triton side of the NPI Agreement the interests in the Rocanville properties passed through several hands including TriStar which continued as Petrobakken Energy which changed its name to Lightstream Resources. In September 2014 Lightstream sold and assigned its entire interest to Crescent Point. Lightstream, Crescent Point and the Hudson parties entered into an assignment and novation agreement (reproduced and discussed further below). In what follows, I sometimes refer for the sake of simplicity to the party from time to time holding the Triton interest in the NPI Agreement as the operator.

The NPI Agreement required Triton to drill two wells on the Rocanville properties within a year at its sole risk, cost and expense and, if the drilling was successful, to drill up to six additional wells so long as the wells that it had previously drilled were producing oil in commercial quantities. Triton agreed to indemnify the trust against any liability. Clause III of the NPI Agreement provided that:

> III A. If, as and when TRITON, and its successors and assigns, recover from the proceeds of production attributable to the properties and interests acquired by it pursuant to the Rocanville Agreement, or any renewals or extensions thereof, and from the income defined in Section D of this Paragraph III a sum equal to the total of:
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>> (a) all of the costs and expenses incurred by TRITON in the acquisition thereof, including the consideration paid to Rocanville Corporation therefor and interest paid by TRITON on loans and advances made to it by a lending institution for funds paid to Rocanville Corporation as such consideration, and
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>> (b) all of the costs and expenses of whatsoever nature incurred by TRITON and its successors and assigns in exploring, developing, drilling, testing, completing, equipping, operating and maintaining

such properties and interests and marketing the production, therefrom, and in conducting the business defined in Section D of this Paragraph III,

HUDSON shall be entitled to receive and TRITON will pay to HUDSON, an amount equal to one-half (1/2) of the net profits thereafter realized by TRITON, its successors and assigns, from the development and operation of such properties and interests and the conduct of such business.

B. "Net profits", as such term is used in this Paragraph III shall be the amount by which the total of:

1. Proceeds actually paid to TRITON, its successors and assigns, for oil, gas and other minerals produced, saved and sold from the attributable to the SUBJECT PROPERTIES (after deducting therefrom (i) all payments made on royalties, overriding royalties, and other payments out of production to which the same are presently subject, and (ii) all taxes thereon other than income taxes);

2. Consideration paid to TRITON, its successors and assigns, for personal property and equipment constituting a portion of the SUBJECT PROPERTIES (including equipment in or on the properties described in Part I of Exhibit "A" to the Rocanville Agreement, but excluding such oil[,] gas and mineral properties);

3. Sums paid in cash to TRITON, its successors and assigns, as dry hole or bottom hole contributions to the cost and expense of operations conducted on the SUBJECT PROPERTIES, to the extent such sums are paid by parties not owning an interest in or participating in such operations; and

4. Credits allowed or payments made to TRITON, its successors and assigns, by the Province of Saskatchewan, Canada, for operations conducted by TRITON, its successors and assigns, on the SUBJECT PROPERTIES if and to the extent that such credits or payments are funded from the production attributable to the properties and interests covered by this agreement.

exceeds the total of the costs and expenses incurred by TRITON, its successors and assigns, in exploring, developing, drilling, testing, completing, equipping, operating and maintaining the SUBJECT PROPERTIES.

All of such proceeds, costs and expenses shall be acculated [sic].

C. There shall be charged as cost and expense for the purposes hereof the sum of $1250 (Canadian) per month, in lieu of any other charge for administrative supervision and overhead. There shall not be considered a cost and expense incurred by TRITON and there shall not be charged as cost or expense for the purposes hereof (i) any other cost or expense incurred by TRITON in maintaining its corporate offices, or (ii) the salaries of any officers or employees for time not actually expended on the properties.

> …
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> E. Not less frequently than quarter-annually after the date of closing the purchase and sale provided by the Rocanville Agreement, TRITON will furnish to HUDSON a statement in detail setting forth the revenue received, the costs and expense incurred, and the status of such net profits account. Payment for such net profits realized during each particular quarter-annual period shall be made to HUDSON within 30 days after the expiration of the quarter-annual period during which the same were realized.

The NPI Agreement therefore created its own internal accounting rules for the net profits account. The Agreement did not incorporate a more detailed accounting procedure and in particular it did not incorporate the accounting guidelines of the Petroleum Accountants Society of Western Canada (PASWC).

Clause IV of the NPI Agreement extended the Agreement beyond the Rocanville properties to any additional lands acquired by Triton within two miles of the original properties (additional interest area (AIA)):

> IV If while there remains in force and effect any lease acquired by TRITON pursuant to the Rocanville Agreement TRITON acquired any additional interest in the oil, gas or other minerlas [sic] in and under lands within two (2) miles of any of the lands covered by and of the leases described in Part I of Exhibit "A" to the Rocanville Agreement, such additional interest shall constitute a part of the SUBJECT PROPERTIES for all purposes hereof, including the computation of net profits pursuant to Paragraph III hereof, and the cost and expense incurred by TRITON in the acquisition thereof shall constiture [sic] a cost and expense in the computation of net profits.

The Hudson parties received significant sums of money under the NPI Agreement although in some months (e.g. the end of 2006) there were no payments because of incremental exploration activities (seismic and drilling) on the original Rocanville lands or acquisitions within the AIA. This led the Hudson parties to make additional inquiries about the operation of the NPI account and to take some legal and accounting advice. Those inquiries did not initially lead the Hudson parties to pursue litigation although they did ultimately file the statement of claim in this action on August 6, 2010. The Hudson parties alleged that Lightstream had failed to properly account to them under the NPI and was in breach of its fiduciary obligations.

Justice Woolley concluded that the operator under the NPI Agreement did not owe the Hudson parties a fiduciary duty:

> The NPI Agreement contemplates that the Defendants' pursuit of their own self-interest in maximizing the profits earned at the Rocanville Properties will benefit the Plaintiffs; it does not contemplate the Defendants "renounc[ing] their own interests and those of all others in favour of those of the beneficiary", which is what the duty of loyalty requires … [at para 123]
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> ….

> The Defendants have power and authority that affects the Plaintiffs, but not in relation to the Plaintiffs' legal or substantial practical interests other than as created by the NPI Agreement itself.

The defendants did however owe the Hudson parties a duty of honest performance of the NPI Agreement (*Bhasin v Hrynew*, 2014 SCC 71 (CanLII), [2014] 3 SCR 494) and the defendants were in breach of that duty with respect to the allocation of costs to the NPI account with respect to the Arista acquisition (discussed below).

The Treatment of Overhead

There was a significant difference between the parties as to whether or not the defendants had improperly included some overhead expenses as operating expenses (and therefore charged to the NPI account) in addition to the $1250 per month expense provided for by clause III.C of the NPI Agreement and expressed to be "in lieu of any other charge for administrative supervision and overhead". In the end, Justice Woolley concluded that the Hudson parties had failed to "discharge the burden of showing that overhead expenses were improperly included in the NPI Agreement accounts" (at para 225). In the course of reaching that conclusion, Justice Woolley also concluded (at para 210) that she did "not have an evidentiary basis sufficient to allow me to infer that the PAWSC 1976 Accounting Procedure and the industry practices it reflects were known (or reasonably could have been known) to the original parties to the NPI Agreement, or that it was a custom of the market or industry in which the NPI Agreement was negotiated."

The Treatment of Amounts Payable Under Saskatchewan's *Corporation Capital Tax Act* and Associated Limitations Issues

The NPI Agreement allowed the operator to include in the expense column "(i) all payments made on royalties, overriding royalties, and other payments out of production to which the same are presently subject, and (ii) all taxes thereon other than income taxes)…". Successive operators had charged amounts payable under Saskatchewan's *Corporation Capital Tax Act* (CCTA) to the NPI account but Justice Woolley ruled that this practice was impermissible on the basis that the CCTA tax was not a production tax per se but was instead (at para 241) " a corporate tax determined by reference to the resource corporation's production". That led directly to the limitations issues and here Justice Woolley ruled that the claim was statute barred for the period prior to August 6, 2008. She reasoned as follows:

> [266] … The injury [that the plaintiffs] suffered was that the Defendants charged them for the CCTA Tax when doing so was not permitted by the terms of the NPI Agreement. All of the facts relevant to that injury were known to them at the time that it occurred – that the amounts were being charged, that they were arose from a surcharge imposed by the Saskatchewan government, and the terms of the NPI Agreement that governed whether those amounts were properly recoverable. The only thing that they did not know was a matter of contractual interpretation and the law – the proper interpretation of Clause III.B.1 of the NPI Agreement, and whether the CCTA Tax could properly be characterized as a tax on the proceeds. Those things were easily followed up on through consultation with a lawyer, and through legal research.
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> ….

> [268] The claimants in this case, while not immersed in the Canadian oil and gas industry, were sophisticated and educated, and one of them was a lawyer. They considered retaining legal counsel and decided not to do so largely because of cost. In my view once the Plaintiffs knew that a surcharge from the Saskatchewan government was being included on the NPI Agreement accounts they had the facts necessary to know that they had been injured, that the injury was by the Defendants and that it was worth pursuing in a proceeding. They could be expected at that point, as a matter of due diligence, to review the NPI Agreement and to investigate the Saskatchewan law, consulting with a lawyer if necessary, to decide whether to bring the claim.
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> [269] There are, however, multiple limitation periods for the purposes of the CCTA Tax. Every time the Defendants charged the Plaintiffs for the CCTA Tax contrary to the terms of Clause III.B.1, they committed a new legal wrong and inflicted a new injury on the Plaintiffs. As a result, and as acknowledged by the Defendants, the Plaintiffs claim is not statute barred in relation to any amounts deducted with respect to the CCTA Tax for the period after August 6, 2008. The CCTA Tax was not a one-time breach of the NPI Agreement, it was a recurring periodic breach, and each time it occurred a new limitation period began.

The Cherry Hill Wells

Justice Woolley concluded that another claim was also statute barred. This was a claim made in respect to some wells (the Cherry Hill wells) acquired in the area of the AIA. By mistake, the then operator failed to include the activities associated with these wells in the NPI account. When it did realize its mistake, the operator made one macro adjustment rather than adjusting the accounts for every production month in the intervening years. While Justice Woolley was by no means convinced that the operator could not use the macro adjustment option (at para 311) she found that any claim in respect of a material adverse difference in the two ways of calculating the account was statute barred by June 7, 2009:

> [318] The Plaintiffs had actual knowledge of the Cherry Hill adjustment, and in particular that the adjustment had been made on a cumulative basis, by June 2007 at the latest. I recognize that the Defendants never explicitly told the Plaintiffs that this was an adjustment to correct an error for wells that had not been included; however, the Plaintiffs knew that the Defendants issued corrections to the NPI Agreement accounts. They knew that the adjustment was for the 1999-2006 period. They knew the wells to which it applied, and they knew the revenues and expenses for each of those wells broken down on a month-by-month basis for the six-year period.

The conclusions on limitation issues (both with respect to the tax and the Cherry Hill Wells) seem appropriate but the suggestion month-by-month recalculation might not be required if Justice Woolley were wrong on the limitations issue for the Cherry Hill Wells is less convincing. Any recalculation must follow the terms of the contract, and, as Justice Woolley notes at para 49, the contract required cumulative accounting and that meant that "while any positive balance would be paid out on a 50% basis to the NPI Agreement holders in the month it was earned, any negative balance in one month was carried over to the next."

The Arista Allocation Issue

Perhaps the most interesting discussion in the case related to the accounting treatment of TriStar's acquisition of Arista an oil and gas company with assets in Saskatchewan including some assets (the Welwyn assets) that were within the AIA. Tri-Star ultimately acquired Arista for $212 million under an Arrangement Agreement. The acquisition gave rise to the need to allocate a portion of these acquisition costs to the cost side of the NPI account. To cut a long story short, TriStar had three different reserves evaluations available to it to assist it in making this allocation at the time of the acquisition: (1) reserve evaluation reports prepared by a third-party (the AJM\GLJ reports); (2) internal reserve evaluation reports (the Kimber reports of December 3, updated to December 11); and (3) information provided by Arista updating TriStar on its drilling and development activities, and its production results from those activities. These reports offered a range in values (and using different discount rates) for the Welwyn Assets of between a low of approximately $351,000 and a high of $5,796,000.

Subsequent to closing (January 2008), TriStar had Sproule prepare another reserves report. The Sproule report suggested a:

> [431] … net present value [of all of Arista's reserves] using forecast prices as $230,316,100 at a 5% discount rate and $194,922,100 at a 10% discount rate. Sproule evaluated the Welwyn assets as having a net present value of proved plus probable before tax as $14,363,100 based on a 5% discount rate and $12,569,500 based on a 10% discount rate.
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> [432] The Sproule Report assessed the Welwyn assets as representing 6.24% of the total value of the Arista assets at a 5% discount rate and 6.45% at a 10% discount rate.

Following all of this TriStar ultimately allocated $8,977,000 to the cost side of the NPI account in August 2008. However, even this allocation was based on a mistaken understanding that the Welwyn Assets included only four wells when in fact there were six. This mistake was caught by Petrobakken in 2010 at which time the cost was re-stated in the NPI account at $14,364,000 (based on a 5% discount rate) (at paras 460 – 462).

The question for present purposes was whether TriStar\Petrobakken had properly included this amount in the NPI account as "the cost and expense … in the acquisition" of the Welwyn Assets within the AIA under clause IV of the NPI Agreement. It appears that the plaintiffs argued that "'cost and expense incurred' means price, and that to comply with Clause IV the Defendants had to identify, using an appropriate price allocation methodology, the price paid for the Welwyn assets." The defendants in turn argued that Clause IV could be fulfilled by "a *bona fide* estimate of the value of the Welwyn assets – that is, that cost and expense can be equated to value."

Justice Woolley rejected both elements of the Defendants' argument. That is, she concluded that the defendants had not made a bona fide estimate of value (at para 502):

> Even if cost and expense means value, the most accurate evidence about the value of the Welwyn assets was the price paid for Arista. That is an actual market price, arising from negotiations between arm's length third parties. To ascertain the value of the Welwyn

assets without consideration of the purchase price could not create a *bona fide* estimate of value.

But she also rejected the defendants' efforts to conflate value with cost (at para 507):

> The words "cost and expense incurred" have an ordinary and grammatical meaning, and also one recognized in law, which is "what I had to spend to get something". If I ask you what something cost, or what your expenses were to get it, I am not asking what it is worth. I am not trying to ascertain its value; I am trying to find out what you had to give up to get it. If in response to the question, "what did that ring cost?" you answered "it was appraised at $5000" I would think you had misunderstood the question.

In sum (at para 536):

> Clause IV of the NPI Agreement required TriStar and Petrobakken to identify the amounts they paid to acquire the Welwyn assets. They did not do so. They extracted from the Sproule Report the fair market value of the Welwyn assets at a 5% discount rate and included that amount in the NPI Agreement account. They did not allocate, or even attempt to allocate, the cost expended by TriStar to acquire the Welwyn assets, which is what allocating the "cost and expense incurred" required them to do. By making an allocation without reference to the price paid for Arista they breached their obligations under the NPI Agreement.

That was enough to conclude that the defendants had included an inflated amount associated with the costs of acquisition of the Welwyn assets in the NPI accounts. However, Justice Woolley also went on to consider whether the allocation and the communications by TriStar and Petrobakken with the Hudson interests about that allocation was a breach of the duty of honest performance of the contract. She concluded that the defendants had breached this obligation:

> [539] …. They did not make a meaningful effort to identify what Clause IV of the NPI Agreement required, or to fulfill those requirements. They simply picked a number close to hand that advanced their own interests without regard to those of the Plaintiffs. Doing so did not pay appropriate regard to the interests of the NPI Agreement holders and undermined those interests.
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> [540] Further, the information they provided to the parties – saying in the first instance that this was "a reasonable allocation of the total purchase price for this corporate acquisition to the lands, production and reserves" and then later providing no information at all about how the allocation had been done – was neither honest nor candid. I have accepted that TriStar did not deliberately set out to deceive the Plaintiffs; however, they also made no effort to be honest or candid, and the information they provided was in fact inaccurate and misleading. By their actions they did deceive the Plaintiffs, and the evidence does not show that they took any meaningful steps to avoid that deception even though they could have done so.
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> [541] Because of the lack of effort to comply with Clause IV of the NPI Agreement, and the lack of honesty and candour in their communication with the Plaintiffs, I find that

TriStar and Petrobakken breached their duty of honest performance under the NPI Agreement.

That led Justice Woolley to assess how the defendants ought to have allocated the portion of the purchase price that should be included on the cost side of the NPI account. She suggested that while Tri-Star had some margin for manoeuvre it was also subject to three constraints (at para 556):

1. The goal of the allocation must be to identify what TriStar paid for the Welwyn assets.
2. The starting point must be the price paid for Arista and identifying which portion of that price could reasonably be allocated to the Welwyn assets.
3. The allocation must be based on the information available to and relied upon by Arista or TriStar at the time the purchase price was identified and negotiated.

The third constraint led Justice Woolley to reject the relevance of the Sproule reserves report not on its merits but on the basis that (at para 588) "on the evidence before me, it cannot be connected to the identification and negotiation of the price paid for Arista by TriStar." Instead, Justice Woolley preferred the AJM\GLJ report and the Kimber internal report updated to December 11 and that led her to average (at para 603) the proportion of the Welwyn assets relative to the Arista assets as a whole; and evidence of industry practice led her to adopt a 10% discount rate (at para 611). Justice Woolley also ruled on certain other matters associated with the cost allocation. Thus she concluded on the evidence that: there should be no allocation to the Welwyn assets for undeveloped land; that there should be no recognition of the value of tax pools or the particular value that TriStar attributed to other assets included in the transaction. The defendants were entitled to recover an amount for transaction costs but, in the absence of more specific evidence, this should be taken to be a percentage of total amounts allocated to transaction costs multiplied by the percentage of reserves allocated to Welwyn assets as above. Furthermore, in principle, the defendants might be able to include interest costs associated with the acquisition, not as a one-time cost but (at para 666) "charged as they are incurred, on a year to year basis, as a "cost and expense in the computation of net profits", as Clause IV expressly provides." This (at para 667) "leaves open the possibility that the Defendants could adjust the NPI Agreement accounts between 2008 and 2015 to recover the portion of interest expenses actually incurred during that time period. They can only do so, however, based on actual evidence that such expenses were incurred and arose as a result of the Arista acquisition."

Justice Woolley's overall conclusion was that TriStar and Petrobakken had "allocated $8,922,722 more to the NPI Agreement account than they ought to have allocated with respect to the acquisition of the Welwyn assets ($14,364,000 less $5,441,278)." The NPI accounts would have to be recalculated to remove this amount as well as the amount of the CCTA tax that had been improperly charged between August 2008 and 2015. This would serve to put the plaintiffs in the position that they would have been in had the contract been performed according to its terms.

The Arista part of the decision has some similarities with the decision in the Court of Appeal in *Mesa Operating Limited Partnership v Amoco Canada Resources Ltd.*, [1994 ABCA 94 (CanLII)](). In that case, the Court held that a working interest owner (Amoco) was not free to pool on an acreage basis rather than a reserves basis where the evidence suggested an uneven distribution of reserves and where the result of an acreage based pooling would prejudice the interests of a gross overriding royalty owner (GOR). The GOR contract afforded Amoco the unilateral power to enter into a pooling agreement but the court held that this power was qualified by the reasonable expectation of the original parties based on a practice in the industry that a working interest owner (at para 21) "would consider both areal and reserves-based pooling, and follow whichever route the facts justified." It is notable that *Mesa v Amoco* is one of the case canvassed by Justice Cromwell in his decision in *Bhasin v Hrynew*, [2014 SCC 71 (CanLII)](), [2014] 3 SCR 494 (at para 44).

That left the question of from whom recovery should occur. Justice Woolley concluded that the assignment and novation (A & N) agreement of 2014 allowed the plaintiffs to recover all of these amounts from Crescent Point. That conclusion requires an examination of the terms of the A & N Agreement. The key terms of that Agreement are reproduced in the introductory part of the judgment (at para 40):

> 2. Assignee herby accepts the assignment herein provided and covenants and agrees with Assignor and Third Party [the Hudson interests] to assume as of the Effective Date, and thereupon and thereafter to be bound by and observe, carry out and perform and fulfill all of the covenants, conditions, obligations and liabilities of Assignor under the Agreement, to the same extent and with the same force and effect as though Assignee had been named a party to the Agreement as of the Effective Date in the place and stead of Assignor.
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> 3. Third Party hereby consents to the assignment and accepts Assignee as a party to the Agreement, and hereby covenants and agrees that as of the Effective Date, Assignee shall be entitled to hold and enforce all of the benefits, rights and privileges of Assignor under the Agreement as if Assignee had been originally named as a party to the agreement, and from and after the Effective Date, the Agreement shall continue in full force and effect with Assignee substituted as a party thereto in the place and stead of Assignor.
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> 4. As of and from the Effective Date, Third Party hereby expressly releases, relieved and discharged Assignor from all its duties, obligations and liabilities arising out of or accruing under the Agreement; PROVIDED however that nothing herein contained shall be construed as a release of Assignor from any obligations or liability under the Agreement, which obligations or liability accrued prior to the Effective Date…
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> 6. for the benefit of Third Party only, Assignee expressly acknowledges that in all matters relating to the Agreement, subsequent to the Effective Date and prior to the delivery of a fully executed copy of this Agreement to Third Party, including but not limited to all accounting, conduct of operations and disposition of production thereunder, Assignor has been acting as trustee for and duly authorized agent of Assignee. For the benefit of Third Party only, Assignee expressly ratifies, adopts and confirms all acts or omissions of Assignor in its capacity as trustee and agent, to the end that all such acts or omissions shall be construed as having been made or done by Assignee

To reach the conclusion that Crescent Point is liable, Justice Woolley fastened on the language of paragraph 2 to the effect that Crescent Point assumes not only the *obligations* of Lightstream but also its *liabilities*. Lightstream was liable to the plaintiffs for these breaches of contract (at para 683): “The contract breaches had occurred. Lightstream or its predecessor corporations were responsible for them. The Plaintiffs had commenced their action for contract breach. Crescent Point knew that the Plaintiffs had done so. Other than awaiting final adjudication by this Court, by September 30, 2014 Lightstream’s liability for breach of contract had crystallized.” By entering into the A & N agreement, “Crescent Point expressly agreed to take on those liabilities, and I find that it has done so. It is liable to the Plaintiffs for the entirety of the remedy to which the Plaintiffs here have shown themselves to be entitled.”

It is not clear to me that this is the only or the best interpretation of the A & N agreement (and I must stress that it would be important to examine the entire agreement and not all of that agreement is reproduced in the judgment). I express reservations about Justice Woolley’s interpretation of the A & N agreement for three reasons. First, clause 2 is forward looking not backward looking; it speaks as of the effective date. Second, if Crescent Point were assuming all past liabilities under the NPI one would expect some more specific acknowledgement of that category of liability (i.e. pre-existing liability) than that one word. It may be the case here that Crescent Point was aware of a potential liability with respect to the NPI but that is not a condition of liability on Justice Woolley’s interpretation of the contract. Third, the interpretation ignores the proviso in paragraph 3. While it is true that this paragraph deals with the legal relationship between Lightstream and the Hudson parties, it expressly clarifies that the agreement does not release Lightstream “from any obligations or liability under the Agreement, which obligations or liability accrued prior to the Effective Date…”. These liabilities were, according to Justice Woolley, crystallized liabilities prior to the effective date. A contextualized interpretation of the agreement requires, as Justice Woolley notes at para 106, that the agreement be construed as a whole. It is hard to tell from the judgment how much argument was devoted to the allocation of liability. It is entirely possible that the answer may be very little if the defendants had already agreed as between themselves on that matter. The fact that Crescent Point does not seem to have been separately represented may speak to that point.

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