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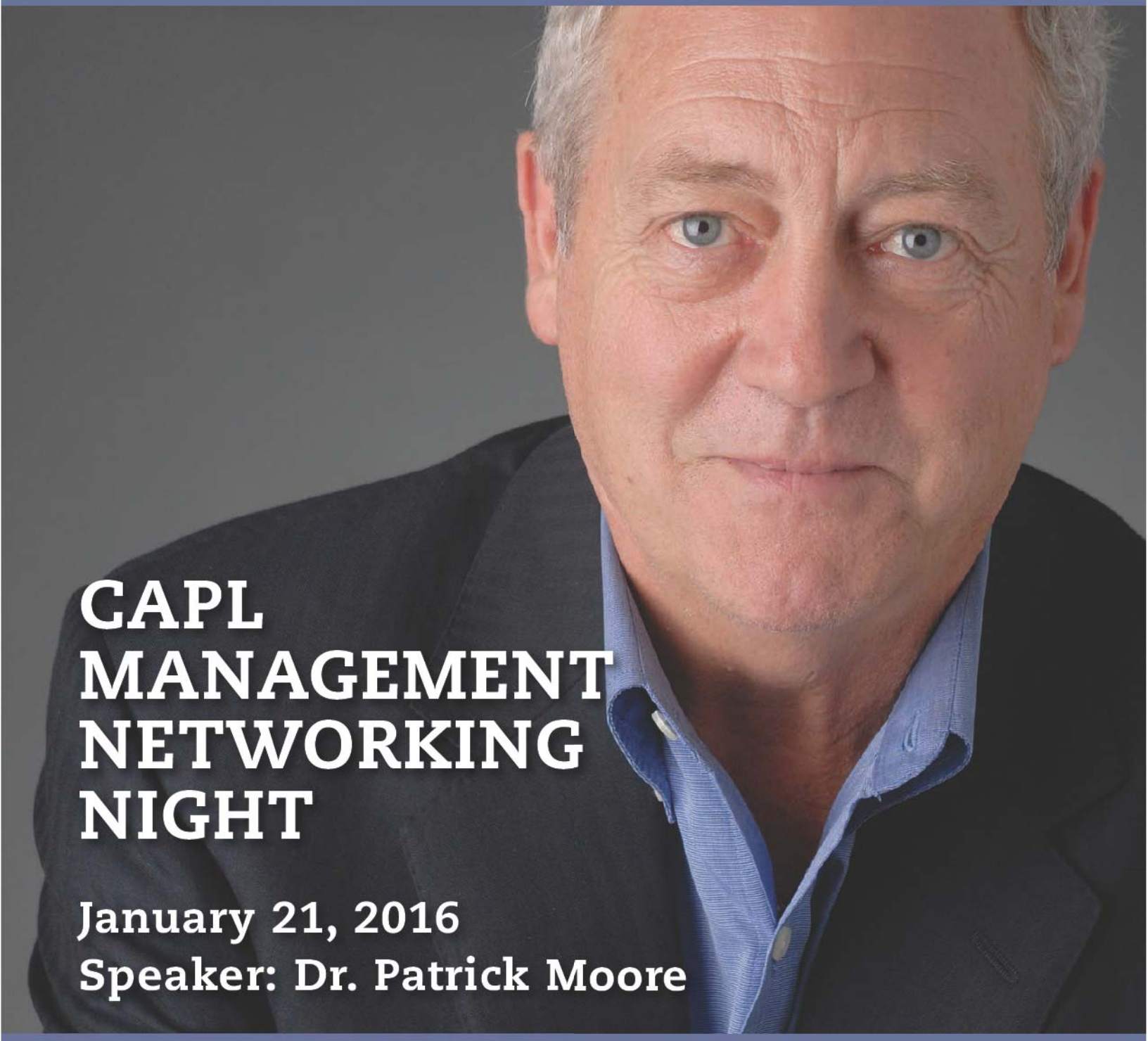

CAPL MANAGEMENT NETWORKING NIGHT

January 21, 2016
Speaker: Dr. Patrick Moore

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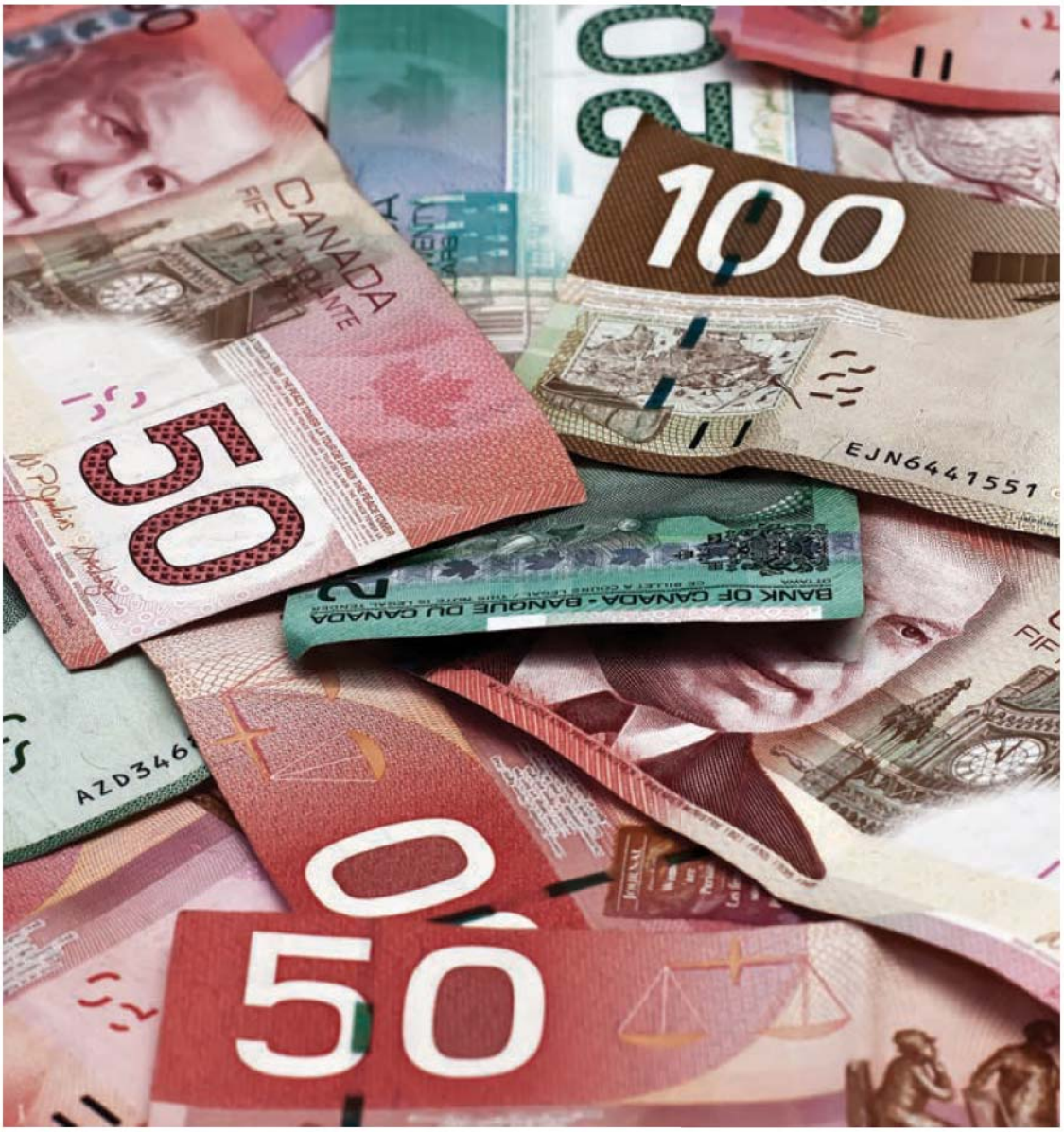

Speculation is Evil – and Costly

(*Stewart Estate v TAQA North Ltd*, 2015 ABCA 357)

"Disgorgement of net benefits" (*Stewart Estate*, par 417). Ouch. IF YOU ARE THINKING, "DISGORGEMENT" SOUNDS LIKE AN UNHAPPY WORD, YOU ARE CORRECT. To be clear, it is also a super cool word. It sounds like something you might do to a dragon. The wee little problem is that the dragon in the *Stewart Estate* case is us, lessees producing from dead freehold leases.

Facts

First, a quick summary of the facts:

- Non-CAPL freehold lease entered into in the 1960s. "Are produced" clause in habendum. "Lack of or intermittent market" or "any cause whatsoever beyond the lessee's reasonable control" not counted provision in the 4th proviso.

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- 7-25 gas well spud and produced during the primary term. No production from 1995 to 2001. Recommences production in 2001. Production suspended by ERCB (AER) in 2011 for other reasons. Sweet Basal Quartz and sour Wabamun production.

- Lessors, in concert with a top lessee Freehold Solutions, commence a Court action in 2005 seeking a declaration that the leases terminated in 1995 when the 7-25 well was shut-in. They also issued a Notice to Vacate at that time.

Decision – Dead Lease

Shockingly, the Court found the leases were dead. Of course, I jest. The leases are always dead.

Mr. Justice O'Ferrall sets out this principle problem with freehold leases quite succinctly:

> [347] Historically, in drafting the terms of petroleum and natural gas leases, oil companies wanted to be free to walk away from their leases. They wished to avoid being stuck with the obligations of a tenant under a conventional real property lease. So, oil companies drafted forms of leases which permitted them to unilaterally abandon their leases at any time. Hence the "unless" and "so long as" clauses in oil and gas leases. The problem presented by such clauses is that a lessee can unwittingly cause a lease to expire according to its terms. As John Ballem so aptly stated in the preface to the first edition of his book, the oil and gas lease contains "hazards to the lessee" because of the "dogged determination of oil companies to continue with the lethal 'unless' type of drilling clauses". *Ballem describes these clauses as being "explicable" only in terms of "a corporate death wish"*. The same could also be said of the "so long as" clauses in continued production provisos which are in issue in this case. (emphasis mine)

This of course is an issue larger than the Stewart Estate decision. The issue is the very nature of the oil and gas lease. An oil and gas lease "is not a traditional lease because it grants a *profit à prendre*, rights to minerals in situ below the surface." (*Stewart Estate*, par 162).

Unless and until we decide to fundamentally rewrite the terms of the freehold lease to make it into something more durable than a mere *profit à prendre* (the right to win, take and remove), we cannot expect to get better results from the Courts.

Speculation is Evil

Once the Court found the leases were dead, it next considered how to interpret the contract (the leases) as between the lessor and lessee, in respect of the nature of the wrong committed by the lessee. The Court relies heavily of the prior decisions of *Omers*

Of course, the elephant in the room is that the "royalty approach" means that an oil and gas company can quite easily decide to continue to produce a dead lease, because, well, honestly the measure of damages is pretty darn low.

Energy Inc v Alberta (Energy Resources Conservation Board), 2011 ABCA 251 and *Freyberg v Fletcher Challenge Oil & Gas Inc*, 2007 ABQB 353, 428 AR 102 in formulating its interpretive lens.

From *Omers* and *Freyberg* comes the unsurprising concept that the words of the lease must be interpreted by the Court by searching for the intention of the parties (the lessor and lessee).

More annoying is that the Court's search for the intention of the parties results in a finding that "speculation" by oil and gas companies is somehow evil:

> [73] As this court remarked in Freyberg, it *strains common sense to think that a lessor would tie up its land past the primary term for a lessee's speculative purposes and for a well that lacked commercial viability*: para 50. As reinforced in Omers, the third proviso was not intended to permit a lessee to hold a property for purely speculative purposes: para 95. *The common purpose and goal of parties entering into the lease is to develop the resource for the purpose of making a profit*: Omers at paras 77 and 95; Freyberg at paras 50-51. Any interpretation which defeats that purpose should be rejected in favour of one which promotes that purpose and a sensible commercial result: Omers at para 78. (emphasis mine)

This is the first major decision on remedies post *Omers*, and the Court relies heavily on the *Omers* interpretive lens to justify a greater measure of damages. Me thinks that all subsequent freehold lease decisions will be interpreted through this lens. Wind is blowing one way; we appear to be peeing against it.

...and Costly

Once the lease is dead, the issue is how much does it costs the oil and gas company (i.e. what are the damages payable by the lessee to the lessor). Damages are based upon two causes of action, trespass and conversion.

Best Royalty Plus Bonus Rejected

From the remedies decision in *Freyberg, Williston Wildcatters*, 2001 SKQB 360, aff'd 2002 SKCA 91, and the trial decision in Stewart Estate, many people, included myself, concluded that the proper measure of damages for trespass or conversion by a lessee under a dead lease was the "Royalty Method." Justice Rowbothem summarized the royalty method as follows:

> [196]... When neither party knew of the trespass and the property owner would have been unable to realize the benefit the trespasser obtained from the trespass, courts have permitted the trespasser to retain the benefit of the trespass and ordered the trespasser to *pay the property owner a reasonable fee for the use of the property*. This is known as the "royalty method". *The lessee pays the property owner contractually agreed royalties and any bonus associated with negotiating a new lease*. (emphasis mine)

This measure of damages is based upon the utterly common sense proposition that where the lessor is an individual not involved in the oil and gas business, it would never, ever, be in a realistic position to drill a well. Ergo, compensatory damages (to put the lessor in the same position as if the wrong had not occurred), means damages are limited to the best royalty and any fresh bonus the lessor could have negotiated at the date the lease terminated.

Many of us believed that to give the lessor more would be punitive, and punitive damages are generally not awarded in Canada, unlike the good ol' US of A, where you can get millions for spilling a coffee on your crotch.

Of course, the elephant in the room is that the "royalty approach" means that an oil and gas company can quite easily decide to continue to produce a dead lease, because, well, honestly the measure of damages is pretty darn low.

Notwithstanding the prior decisions that ignored the elephant, this Court was not amused:

> [209] First, and foremost, the royalty approach ignores the ownership of the gas after the termination of the lease. *It is the lessor and not the lessee who owns the gas*. Once a lease has terminated, "it is the lessor, not the lessee who owns the minerals. In the absence of bad faith on the part of the lessee, and following the [Sohio] approach, it would seem equitable to apply a form of restitution": Ballem at 388. *Moreover, the royalty approach used by the trial judge "could encourage the lessee to continue producing the well after the lease has been challenged, knowing that the financial consequences will not be severe*. Indeed, it would be very much to the lessee's advantage to do so, as the result could end up being almost the same as if the lease continued to be valid.... This, despite the fact that the lessee had enjoyed revenue

from the production of minerals to which it had no legal title": Ballem at 389. (emphasis mine)

Does anyone else smell elephant poo?

Disgorgement (Mild Rule)

Now we get to the crux of the matter. Speculation is evil. Best royalty plus bonus is unfair. So what then is the proper measure of damages? The answer is disgorgement:

> [213] ...but when circumstances call for a different measure, disgorgement of defendant's benefit is a potential remedy... [416] ... the court is not simply compensating for trespass. It is also compensating for a wrongful conversion. In other words, *the wrongdoers (the lessees) not only overheld, but they also damaged (depleted or wasted) the reversion while they overheld. An irreplaceable value was taken from the fee.* This was not simply a wrongful occupation of land for which compensation for use and occupation (e.g., rent) might be appropriate. *This was a wrongful failure to vacate accompanied by a wrongful conversion of personal property* (when the hydrocarbons were severed from the realty and produced by the lessees) for which the value of the goods wrongfully converted may be an appropriate measure of damages. (emphasis mine)

At law, disgorgement can be applied harshly or mildly. Two of the three judges choose the "mild rule" to calculate damages in this case:

> [1.d.i] Rowbotham JA and O'Ferrall JA direct the respondents to *disgorge revenues less production, gathering and processing, i.e., on a net basis*... (the so-called "mild rule"). (emphasis mine)

Ouch. The cost for producing a dead lease is now your total net revenue. It's not so easy anymore to simply ignore a dead lease and keep on pumping.

Disgorgement (Harsh Rule)

We should be happy that only one judge choose the "harsh rule" of disgorgement:

> [1.d.ii] McDonald JA would impose *disgorgement of the respondent's gross revenues* (the so-called-harsh rule). (emphasis mine)

Double ouch. Damages equal to gross revenues, with no allowance for cost and deductions.

I would like to say that the harsh rule will never be applicable in a dead lease trespass and conversion case, but it is tough to fight the logic of Justice McDonald:

> [313] *We are dealing with large, sophisticated and well-informed corporations on the one hand, and lay people, including the proverbial "little old lady in the nursing home" on the other.* The need for the former to act in good faith when discharging their contractual obligations to the latter has been highlighted with the recent Supreme Court of Canada decision in *Bhasin v Hrynew*, 2014 SCC 71, [2014] 3 SCR 494. See also Freyberg at para 82. (emphasis mine)

Once the genie is out of the bottle for a Court to do more than simply compensate a lessor, all the interpretive concepts discussed above seem to point to damages creeping closer and closer to the Harsh Rule. Who knows, I never thought the Mild Rule would be applied.

Limitation of Action – the Good News

Now for some good news: At least until lessors, or top lessee's like Freehold Solutions, get smart and start suing faster and more often.

Two of the three judges found that the two-year limitation in the Limitations Act applied to the lessors. The Court found that the lessors knew or ought to have known that the leases might have terminated once they stopped receiving royalties. Once that trigger starts, they need to sue or lose the right to sue for damages:

> [7] *However, the Limitations Act, RSA 2000, c L-12 is a complete defence to claims that arose before August 9, 2003, two years before the statement of claim was filed.*

Due to the breach (trespass and conversion) being continuous, a new cause of action accrues monthly. So the leases are dead in either 1995 (two judges) or 2000 (one judge), but the limitation period is a two-year look back from the statement of claim date due to the continuous breach.

This is again shocking to me. I swear I am really a lawyer, perhaps maybe just a dumb one. I had assumed that the two-year look back, which was applied to a sophisticated Landman in *Canadian Natural Resources Limited v Jensen Resources Ltd*, 2013 ABCA 399, would not apply to non-industry, unsophisticated lessors. I had assumed they would be provided with the ultimate 10-year look back period under the *Limitations Act*. You know what they say about assuming. So, two-year look back it is.

Note 1

The decision includes an excellent analysis of the measure of damages payable during the time period after the lease dies until the lessor demands that the lessee stop producing or files a statement of claim. Concepts of "consent to occupy" and "leave and license" are really fleshed out and are shown as a true limit on disgorgement damages. These concepts also provide some merit to the very annoying Landman lament that the lessor is still cashing the cheques. However, the reverse may also be true, such that a lessor could revoke you leave and license (like the Notice to Vacate issued in Stewart Estate), even before a statement of claim is filed and begin the clock on higher damages. Fascinating, but a discussion for another day.

Note 2

Stewart Estate is also extremely important in its discussion of the 4th proviso of the non-CAPL lease where the lessee is entitled to not produce due to a "lack of or intermittent market" or "any cause whatsoever beyond the lessee's reasonable control." Stunningly, the Court upheld the trial decision that the fourth proviso *allows a lessee to not produce where an objectively uneconomical market for production from the well exists*. Seems like a big win, but the Court's analysis, and the withering dissent, likely means the application of this clause will still be a Hail Mary pass for most lessees. Again, due to space, a discussion for another day.