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WELCOME TO THE APOCALYPSE

(My Thoughts on Freehold Leases When the World Stops Moving)

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COVID-19

The COVID-19 Pandemic, and the resulting demand destruction for oil, is an apocalyptic, once in a lifetime occurrence. Our tiny question today is, how does the apocalypse impact freehold lease tenure?

To fully understand the issue we will:

(1) first review conventional oil and gas tenure law; and

(2) then consider the WTF potential legal interpretations.

DISCLAIMERS

The facts on the ground are what ultimately matter. These facts are fluid and changing. Currently, price, demand and storage matters appear to be dire and long term. But then I read about less than expected inventory builds. As facts change, the legal consequences for freehold lease tenure will change.

This is free information. Not advice.

PART 1 - CONVENTIONAL OIL & GAS TENURE LAW

The freehold mineral lease is the document which governs the relationship between the fee simple owner of mineral rights (the lessor) and the party (the lessee) contracting to exploit and develop the petroleum and natural gas and related substances owned by the fee simple owner.

It creates what Ballem calls "…**one of the most insecure tenures known to the common law**. The slightest misstep may detonate one of many booby-traps (all placed by the lessee) which will terminate the grant."

FREEHOLD LAND TENURE

Freehold land tenure is at significant risk of automatic termination if production is shut-in for prolonged periods due to pricing. General rule of thumb is that anything greater than:

- **90 days** for CAPL form leases; and
- **30 days** for old non-CAPL leases.

However, each freehold lease must be examined where all wells on the said lands are being shut-in.

Notification to lessor, if any, must be carefully considered and written. Letters can be useful to preserve lessor/lessee relationships and "set the tone". However, a factual statement that a lessee is shutting-in due to price may, in fact, be strong evidence of automatic lease termination.

NON-CAPL LEASES - NO STANDARD FORM

There is NO "standard form" freehold mineral lease. To analyze any issue arising out of a lease, the starting point must ALWAYS be to read the lease. The answer will be derived from (or based on) the specific wording of the lease and the application of current case law (if any) to such wording.

WHAT IS A FREEHOLD MINERAL LEASE

The Courts have gone to great pains to legally categorize the freehold mineral lease. Basically, they have said that a freehold mineral lease is a ***profit à prendre*** (a.k.a. the right to win, take and remove petroleum substances from the land of another person).

A freehold mineral lease is **not a lease**, like a typical office space lease with exclusive possession of a physical space for a fixed period of time. It is also **not a sale**, as there is a returning of the lands to the fee simple owner at the end of the lease (reversion).

As a freehold lessee, **you acquire only the contractual right to sever (produce)** leased substances from the lands through the constant exercise of the profit. The very limited nature of the grant of tenure by a *profit à prendre* is what makes freehold leases so fragile.

If and when you fail to meet the contractual provisions of the *profit à prendre*, your freehold mineral lease **AUTOMATICALLY TERMINATES**.

There is **no default** and NO requirement on the lessor to issue you a notice of default.

TYPICAL INGREDIENTS PERTAINING TO SHUTTING IN PRODUCTION

Granting clause - which:

- states which substances are leased substances (e.g. PNG);
- provides for continuation of the lease as a *profit à prendre*; and
- sets the primary term.

Habendum clause: which provides for continuation of the lease beyond the primary term based upon stated actions to meet the profit - "AND SO LONG THEREAFTER as …".

Proviso clause(s): which provide (limited) provisos to the requirements under the habendum.

Shut-in clause: which provides an alternate method of lease continuation based upon specific conditions with respect to a non-producing well and often periodic payments to the lessor.

Force Majeure clause: right to not produce in extraordinary circumstances.

Note: the **default** clause does NOT typically come into play as there is automatic termination, not a default. NO default notice is required for a freehold mineral lease to terminate. **Query** - do the new PrairieSky general terms and condition require lessor notice prior to termination?

LEASE CONTINUATION

During the primary term, you are GOLDEN.

After the primary term, you can continue a freehold lease in ONLY a maximum of two ways:

- under the h**abendum** clause; or
- by virtue of a **shut-in well** and the lease specific continuation mechanisms.

One of the two continuation conditions must be met at all times.

It is irrelevant if you:

- restart production, and pay big royalties, later; or
- make payments during the shut-in period.

The lease is said to "click" when the conditions are not met and cannot be revived by future conduct.

Note: Some leases have NO shut-in clause. These are SUPER CRITICAL leases that cannot be shut-in or they die.

THE HABENDUM

Most freehold leases provide that the grant shall subsist for a set number of years *(the primary term)* ***and for so long thereafter*** as production continues.

This portion of the grant clause is called the "**habendum"** (to have and to hold).

Variations in the wording of the habendum are critical. For example, consider the following variations on the wording from a variety of freehold leases, each embodying the concept that a lease will continue as long as it remains productive:

> so long thereafter as leased substances are **being produced in paying quantities**
>
> so long thereafter as leased substances are **being produced in commercial quantities**
>
> so long thereafter as leased substances **are (being) produced**
>
> so long thereafter as the leased substances are **capable of producing in paying quantities**
>
> so long thereafter as any of the leased substances is **being produced or is capable of producing in paying quantities**
>
> so long thereafter as the lands are **capable of producing** leased substances [**Note:** in light of *Omers*, this word "capable" may now be interpreted as "meaningful production", which makes this wording much less lessee friendly]
>
> so long thereafter as leased substances … **are being produced or are commercially producible**
>
> so long thereafter as leased substances are **producible**
>
> so long thereafter as leased substances **can be produced**

DRILLING OR WORKING OPERATIONS

Many leases do not require actual production to continue the lease under the habendum or provisos. Rather, the leases will continue for so long thereafter as "operations", or "drilling or working operations", or some variation of this wording, sufficient to continue the lease has occurred. What constitutes sufficient operations has been considered by the Courts.

See for example:

> so long thereafter as **Operations are conducted upon the Lands**, … with no cessation, in the case of each **cessation** of Operations, of more than **90 consecutive days** (M3794 and CAPL)

SHUT-IN ROYALTY CLAUSE

Most leases provide for an additional continuation mechanism beyond the habendum if there is a shut-in well on the said lands.

This clause normally has two purposes:

- to protect a lessee, where a successful well has been drilled but, for some reason, the well cannot be produced at the critical time; and
- to ensure, in the circumstances above, that the lessor receives some financial compensation during the non-producing periods.

Tends to be numerous provisos in the clause regarding what is required for the clause to apply, for example:

- Very often the payment of shut-in royalty in a timely fashion is a prerequisite for the clause to apply. If you pay late, or fail to pay each year, the clause does not apply and your lease automatically terminates.
- Often there are qualifiers on why the well is not producing which again limit its use, such as:
  - the well be shut-in due to the lack of a market; and
  - the well be shut-in due to a lack of an economical or profitable market.

Note: Only very rarely will the shut-in payment alone continue the lease. Generally, the shut-in payment is required IN ADDITION to other proviso(s) wording for the well to qualify under the shut-in clause.

ONUS ON LESSEE TO PROVE THE LEASE IS ALIVE

The legal onus is on the lessee to establish that the lease is valid and subsisting. Must be able to prove this at all times. Onus is on a balance of probabilities. Lack of any evidence to prove the tenure is subsisting results in lease termination.

MEASURE OF DAMAGES - SIGNIFICANT CHANGE IN 2015

BEFORE STEWART - BEST ROYALTY PLUS FRESH BONUS

Until the *Stewart Estate* 2015 ABCA 357 case, the general rule under Canadian law was that almost all production under dead leases is a "good faith trespass". This is crucial in that it sets your measure of damages at:

- compensatory damages; not
- punitive or full disgorgement damages.

In general this meant that your damages for producing after the lease had terminated were limited to:

- the market lessor royalty at the time of termination; plus
- a new bonus payment.

AFTER STEWART - NET REVENUE MEASURE OF DAMAGES

This concept was blown out of the water under *Stewart Estate.* A decision that radically changes the risk allocation for production under a dead lease.

The Court adopted a measure of damages called "mild disgorgement" based upon the concepts of trespass and wrongful conversion. One legal quote to end our legal overview:

> [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)

The new measure of damages is all **net revenue** from the well after lease termination. This radical change in the measure of damages changes the risk analysis for shutting in production under freehold mineral leases.

UNIT AGREEMENTS

A unit agreement is a magical document that unitizes and amends the terms of each unitized lease. Therefore, you look to the unit, not the lease as the first and best method for lease continuation. In general, the lease of each royalty owner is unitized under three typical clauses:

- 301 - leases unitized and combined such that operations anywhere under the unit are deemed to be operations under each lease.
- 302 - leases amended to conform with the terms of the unit agreement.
- 303 - defined or undefined *"unit operations "* conducted for the unit *"shall .. be considered as operations upon or production from each unit tract"*.

Clause 303 is the "unit operations" clause, which continues the unitized leases. No definition of unit operations. No wording regarding the requirement for continuous unit operations (e.g. 30/60/60 days).

Therefore, clause 303, combined with old form freehold leases, likely requires unit operations approximately every 30 days to ensure continuation of the unitized leases.

Note: The Unit Agreement and UOA reference termination of the agreement only after abandonment of all unit wells. Termination of the agreement **IS NOT** the same as lease continuation and termination under clause 303. Very often misunderstood.

Older Unit Agreements

Many old unit agreements provide that undefined *"unit operations"* will continue the lease. As the term is undefined, it is uncertain what period of cessation of operations would be permissible. However, 30 days is likely a reasonable gap in time between unit operations.

PJVA Form of Unit Agreement

The PJVA form of lease is much more forgiving with respect to lease continuation and it appears that the act of unitization continues the leases and the requirement of unit operations only occurs after a party has issued a notice to terminate (clause 1402 of the 2003 PJVA Unit Agreement). The operator then has 90 days from such notice to commence defined Unit Operations.

Clauses 301 and 302 unitize the leases and deem production from each lease and tract.

- Such unitization is in effect unless and until such unitization is terminated under clause 1401.
- Clause 1401 kicks you to clause 1402.
- Clause 1402 allows for a notice to terminate only if Unit Operations (as defined in clause 1402) are interrupted or suspended for a period in excess of 90 consecutive days.
- Therefore, unless and until a notice of termination is received, deemed production under the leases will continue.
- If a termination notice is received, the operator has 90 days to re-commence Unit Operations.
- The test for the *bona fides* of such Unit Operations is set out in clause 1402, such that if a notice is received, we need to reconsider the ability of a single money losing well to continue the Unit. It may be enough, or an operator may need to ramp up production at such point in time. But remember, nothing is triggered until a notice is received.

BEST PRACTISE

In price collapse scenarios, best practise is as follows:

- Try to produce just enough to keep the lease alive under the habendum.
- Shut-in clause may have some limited application where the proviso refers to a lack of market.
- If you cannot meet either continuation mechanism, try to get grace period letters BEFORE the lease expires and remember to caveat same.
- For CAPL leases, you could send out a form of letter advising that you are shutting in production but the leases are still capable of producing the leased substances. Tough test as "capable" now means "meaningful" under *OMERs*, but COVID-19's impact on price might be enough to meet the test, especially in the short run.
- If not, consider options over your leases.
- If not, remember that the post *Stewart Estate* measure of damages for turning the wells back on is net revenues.

PART 2 - WTF COVID-19 SCENARIO

The above legal summary of freehold tenure law has been applied innumerable times by Canadian Courts. We simply cannot ignore the fundamental premises of:

- the extremely limited nature of the tenure granted - *profit à prendre*;
- the result of such tenure - automatic termination; and
- the freakin' fact that industry has been fully aware of the above for at least 70 years and it never occurred to us to change the lessor/lessee relationship to a normal contractual relationship.

During other periods of crisis such as the collapse in NG prices, the 2008 financial collapse, and the collapse of heavy oil prices, I have been extremely reluctant to suggest that the old rules will not apply. Hard facts simply cannot change tenure.

Is COVID-19 different. Maybe. But it will be a tough sell.

CONTRACTUAL TERMS

It is possible that a Court will ultimately determine that the various habendum and shut-in terms discussed above:

- must be liberally interpreted during COVID-19, such that time periods or actions are, in some sense, stayed or not counted. Many forms of old freehold leases in fact include "not counted" provisos in the habendum for actions beyond the lessee's reasonable control or similar wording in the shut-in provisions;
- will simply not apply during COVID-19 based upon a fulsome equitable interpretation of the agreement considering the mutual expectations for the parties during the pandemic.

Such equitable remedies are uncertain and backward looking. That is to say, we will only get an answer years after the fact from a judge. Yuck and a Hail Mary pass. But who knows.

FORCE MAJEURE

The more certain answer is *force majeure*, which is a contractual legal doctrine that will apply only if the lease contains a force majeure clause.

Force majeure is a VERY specific and time limited exception to the profit à prendre. It is very common for a Court to find force majeure applied, but the lease died anyway as the event of force majeure ended and the lessee failed to immediately recommence required lease continuation actions.

Force majeure will almost certainly not apply to lack of finances by the lessee.

Force majeure may apply to a lack of an economic market, depends on the wording. Be cautious.

Without reference to a specific lease or unit agreement, my general answer regarding *force majeure* right now is as follows. I see two possible, and very different, scenarios for *force majeure*:

- Force majeure will likely apply: to a COVID-19 situation that makes it impossible to physically produce, transport or market production. This could occur where field employees are sent home for self-isolation. Or where limited field employees means it is unsafe go keep facilities or wells operating, or trucks running, etc. Or perhaps if the US or Alberta Government limits or ban imports or exports. Or a demand collapse means there is no market to sell into. Once the *force majeure* period ends, standard lease continuation provisions apply. Remember, the end of *force majeure* will be immediate and will occur without any requirement for notice. The grace period will be almost non-existent. Often it is the period immediately after the expiry of *force majeure* that results in lease termination.

- Force majeure will NOT apply: to the collapse in the oil price, so long as it is physically possible to produce, transport and market production. So, if the true reason you are shutting in is price, your leases are subject to automatic lease termination in accordance with the various lease terms. Units can bridge some of that gap ,as discussed above.

In a true *force majeure* scenario, your contract will typically require you to notify the lessor. Even where a notice requirement is not listed, it is very prudent to provide notice in order to have documentation on your files.

FRUSTRATION

Absent a *force majeure* clause, a lessee under a "normal" lease, i.e. not a *profit à prendre*, may look to the equitable doctrine of frustration as a method to either void the contract, or as a defense against a damage claim. Many folks are claiming frustration under commercial leases and contracts due to COVID-19. Unfortunately, arguing frustration of a *profit à prendre* is likely not useful to a lessee, as we are trying to keep our leases alive, not get out of the agreement or avoid damage claims.

GOVERNMENT DECREE

On April 22, 2020, the Oklahoma Corporation Commission approved an emergency order allowing freehold oil and gas lessees to shut-in or curtail oil production to prevent *"economic waste"*.

Could this happen in Alberta. Yup.

The Province has jurisdiction for *"property and civil rights"* under the Constitution. In fact, Canadian law generally provides Canadian Provinces with greater constitutional authority over property than US.

The AER, under the *Oil and Gas Conservation Act* has the legislative authority to *"conserve"* oil and gas production. This refers to economic conservation, and grants the AER the authority to regulate oil and gas companies' practices to ensure the greatest, and most economical, possible production of oil and gas. Therefore, a declaration of economic waste from the AER could likely be issued under its present legislative authority.

Whether such a declaration, as opposed to an outright prohibition of production, is sufficient to ensure freehold lease continuation, is a much more complicated question. But hey, it couldn't hurt.

Thanks for listening.

Enjoy the apocalypse.