RECENT JUDICIAL DECISIONS OF INTEREST TO OIL AND GAS LAWYERS

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This paper summarizes a number of recent Canadian judicial decisions which are of interest to Canadian lawyers practicing law in the oil and gas industry.

I. CONTRACTS

A. NORCEN INTERNATIONAL LTD. v. SUNCOR INC.[1]

This case considered whether royalties reserved under a bituminous sands sublease should be calculated on gross production or on net production after deduction of Crown royalties. The material provisions of the sublease are:

(e) GCOS shall pay to Sun and Abasand a minimum royalty . . . of ten cents (10 cts) per barrel of bitumen extracted or recovered from bituminous sands from the leased lands and charged to the coker as determined under clause 4.1 hereof. . . .

(f) GCOS shall pay to Sun and Abasand an additional royalty . . . per barrel of desulphurized crude oil sold by GCOS and attributable to the bitumen referred to in clause 3.1(e) hereof of the amount, if any, by which the price received by GCOS for such barrel of desulphurized crude oil exceeds

(i) until the cumulative total of the cash flow (as defined in clause 3.2(iii) hereof), . . . shall have equalled 60 percent (60%) of the total initial investment (as defined in clause 3.2(vi) hereof), the sum of two dollars and seventy-five cents ($2.75) per barrel; and

(ii) thereafter, the sum of two dollars and sixty cents ($2.60) per barrel.

The sublease is in respect of a Bituminous Sands Lease granted by the Crown in Right of Alberta. The sublease had been granted by Sun Oil Company Limited and Abasand Oils Ltd. to Great Canadian Oil Sands Limited ("GCOS"). Abasand's interests were subsequently acquired by Norcen and the interests of Sun and GCOS were subsequently acquired by Suncor (with the result that Suncor became both a sublessor and the sole sublessee).

Suncor argued that the royalties payable to the Crown under the Bituminous Sands Lease constitute an interest reserved to the Crown such that the production attributable to Crown royalties was retained by the Crown and never demised pursuant to the lease. Suncor further argued that the royalties payable under the sublease are only payable on the production from the leased lands. Since the Crown royalty share of production did not form part of the leased lands, no royalties should be payable under the sublease on the Crown's royalty share of production.

The minimum royalty payable under the sublease is calculated on production from the "leased lands". The term "leased lands" is defined in the sublease as being "the lands comprised in and demised by Bituminous Sands Lease No. 4".

In his judgement, the trial judge carefully reviewed the terms of Bituminous Sands Lease No. 4 and the provisions of the statutes and regulations under which the lease was granted and governed. He concluded that the royalty clause in the Crown lease is of the type which provides for the payment of money measured by the sale value of production. The reservation to the Crown created only a contractual right to payment and did not except a portion of lands from the lease. The lease was granted in 1949. It was governed by and subject to government regulation. The regulations governing computation of Crown royalty in effect in 1965 when the sublease

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1. (1988), 89 A.R. 200 (Q.B.).

was granted provided that the Crown royalty would be a percentage of the number of barrels produced from the lands. Subsequent statutory and regulatory provisions provided that the Crown had the right to take its royalty share of production in kind, failing which the lessee would be required to market the Crown's royalty share on behalf of the Crown. Such provisions suggest that the Crown royalty entitles the Crown to a share of production rather than contractually entitling the Crown to a money payment, as the terms of the lease state. In this context, the trial judge noted that the parties to the sublease must be taken to have contracted on the basis of the law in effect at the time that the sublease was granted.

Regardless of the nature of the Crown royalty from time to time, the issue was determined on an interpretation of the provisions of the sublease. The trial judge found that these provisions were unambiguous. The minimum royalty payable was calculated on the production extracted "from the leased lands". That term referred to a geographical area and not to the rights granted under the lease. If the leased lands did not include all of the lands, the lessee would not have the right to extract bitumen from any of the lands. The trial judge also noted that specific provision was made in the sublease for the deduction of Crown royalty in the determination of "cash flow". Such a provision would not have been necessary if Suncor's argument was correct.

The additional royalty payable under the sublease is payable in respect of production sold by Suncor, rather than production from the leased lands. The trial judge held that the royalty was payable on the production sold by Suncor on behalf of the Crown, as well as the production beneficially owned by Suncor, since there was no provision in the sublease to the contrary. The judgment does not consider the effect on the additional royalty if the Crown had taken its royalty share of production in kind and disposed of it itself. In any event, the trial judge specifically stated that the legislation granting the Crown a notional right to take its royalty in kind (which was enacted after the sublease was granted) should be interpreted so as not to interfere with the pre-existing vested rights of the parties under the sublease.

The trial judge concluded that the Crown's royalty interest is in the sales value of the products or in the production itself, rather than being an exception to the lands demised under the lease. The royalty does not constitute an exception to the grant, but rather is a reservation of a right not previously in existence. The royalty is "reserved" rather than "excepted".

The trial judge also distinguished the case from *Imperial Oil Ltd.* v. *Placid Oil Company*[2] on the grounds that the royalties provided for in the sublease are not payable on "leased substances" but on production from the "leased lands".

B. NORCEN INTERNATIONAL LTD. v. SUNCOR INC.[3]

This decision deals with the same Bituminous Oil Sands Sublease considered in the case reviewed immediately above. Advanced royalties ceased to be payable under the sublease when the cumulative total of bitumen in respect of which such royalties had been paid equalled the economically recoverable bitumen remaining in the leased lands. In addition, at that time the sublessee had the right to terminate the sublease. If the sublessors and the sublessee could not agree on

2. [1963] S.C.R. 333.
3. (12 October 1988), Calgary 8701-10656 (Alta. Q.B.).

the amount of remaining economically recoverable bitumen, the dispute could be referred to arbitration by any party. Suncor wished to refer the determination of unrecoverable reserves to arbitration and Norcen contended that Suncor did not have the right to do so.

As a result of various corporate reorganizations, Suncor is one of two sublessors and also the sole sublessee. Norcen is the other sublessor. This case considers whether Suncor had the right to an arbitration to determine the remaining economically recoverable bitumen. Since Suncor is both a sublessor and the sole sublessee, it would be in Suncor's best interests to terminate the sublease and eliminate its obligation to pay royalties thereunder to Norcen.

The original parties to the sublease were Sun Oil Company and Abasand Oils Ltd. as sublessors, and Great Canadian Oil Sands Limited ("GCOS"), as sublessee. Sun Oil Company assigned all of its rights to Sun Oil Company Limited. That company subsequently amalgamated with GCOS to form Suncor. The trial judge found that as a result of the amalgamation, the property, rights, powers, obligations and duties of both GCOS and Sun Oil Company Limited had been vested in Suncor. He also concluded, as both Norcen and Suncor submitted, that the amalgamation did not result in a merger of the interests of Sun Oil Company Limited, as sublessor, and GCOS, as sublessee. He stated that for the doctrine of merger to operate, a right and an obligation must come to rest in the same legal entity. Because of the presence of the other sublessor, that had not occurred. Nevertheless, he concluded that the obligation of GCOS to pay royalties to Sun Oil Company Limited had been eliminated, since Suncor could not be obligated to pay a royalty to itself.

Norcen (the successor to Abasand) argued that Suncor could not refer the determination of remaining reserves to arbitration unless Suncor intended to cease mining operations, because the ultimate purpose of the arbitration was to terminate the sublease. Suncor intended to continue mining, but wished to do so free of the obligation to pay royalties under the sublease. Norcen argued that the parties to the sublease must have intended that arbitration would not be available so long as mining operations continued.

The provision in the sublease permitting arbitration was as follows:

> . . . if at any time the parties hereto cannot agree on the amount of the economically extractable or recoverable bitumen remaining in the bituminous sands in the leased lands, then any party hereto shall be at liberty to refer the matter to arbitration. . . .

The trial judge noted that the determination of economically recoverable bitumen had two purposes, one was to terminate the sublessee's obligation to pay advanced royalties and the other was to permit termination of the sublease. The former provision was necessary because the advanced royalties are paid on estimated future production. In order to protect itself, the sublessee required the right to eliminate its obligation to pay advanced royalties when the economically recoverable reserves equalled the estimated future production upon which royalties had been paid. Most probably, the sublessee would still intend to continue mining operations. This interpretation of the sublease is not incompatible with the sublessee having the right to terminate the sublease when there were no further economically recoverable reserves. Even though advanced royalties may have been paid on the remaining reserves, the sublessee would want the right to eliminate its obligation to continue mining operations if it were uneconomic to continue operations even without the requirement to pay further advanced royalties.

In any event, the provisions of the sublease were clear and unequivocal that any party could refer the determination to arbitration at any time. Intention to continue operations was not stated to be a condition precedent to arbitration.

Norcen also argued that it is a precondition of arbitration that the parties are unable to agree. Norcen argued that Suncor, by its intention to continue operations, acknowledged that there were economically recoverable reserves remaining and since Norcen did not dispute this fact, there was no disagreement. The court rejected that argument, since arbitration was available if the parties could not agree on the amount of the economically recoverable reserves and there was no evidence that there was agreement on that issue.

There is also a discussion in the case concerning Suncor's intention to continue mining being *qua* GCOS or *qua* Sun Oil Company Limited. If its intention is in the latter capacity, then Norcen's major argument would be undermined. The trial judge found that Suncor was one entity and it could not have separate intentions *qua* GCOS and *qua* Sun Oil Company Limited.

The arbitration clause in the sublease provided as follows:

> The arbitration board shall consist of three arbitrators, one of whom shall be chosen by GCOS, one by Abasand [predecessor to Norcen] alone, if at such time Sun or Sun U.S., either alone or together and/or with other companies controlled by them, owns beneficially more than fifty percent (50%) of the outstanding voting shares of GCOS and in any other event by Abasand and Sun jointly, and the third arbitrator shall be chosen by the first two arbitrators so chosen. . . .

Suncor argued that since the capital stock of GCOS ceased to exist upon its amalgamation with Sun Oil Company Limited, the only condition under which Norcen had the sole right to choose one of the arbitrators did not exist. The trial judge held that the literal interpretation of the contract urged by Suncor led to an absurd result, which the parties could not have intended, given the object of an arbitration, since it would allow one side of the dispute to control the members of the board of arbitration.

The trial judge was satisfied that the intention of the parties, as expressed in the sublease, was that the board of arbitration be comprised of three members, one of whom is to be appointed by the "Sun Companies" and one by Norcen. The sublease was to be so construed, even if such a construction was at odds with the literal meaning of the words in the agreement.

C. PETROGAS PROCESSING LTD. v. WESTCOAST TRANSMISSION COMPANY LIMITED[4]

This is an appeal of a decision which considered the effect of regulated natural gas prices on take or pay obligations. Westcoast purchased natural gas from "Petrogas" under a gas purchase agreement dated May 15, 1959. The agreement contained a take or pay clause under which Westcoast agreed to pay for a minimum annual quantity of gas regardless of whether it requested delivery of that volume. In 1975, the Governments of Canada and Alberta enacted legislation providing that the price to be paid for natural gas in Canada would be the price stipulated by the Governments, regardless of the provisions of private contractors. Westcoast contended that these regulations relieved Westcoast from its obligations to pay for minimum annual quantities.

4. [1989] 4 W.W.R. 272, 66 Alta. L.R. (2d) 254, 95 A.R. 112, 58 D.L.R. 156 (Alta. C.A.).

In his reasons for judgment,[5] the trial judge held that the contract had been frustrated by supervening illegality brought about by government regulation and because the regulation made performance of the contract a fundamentally different thing than that which was originally agreed upon. As a result of the frustration, the contract terminated upon the occurrence of the frustrating event, the enactment of the legislation, and Westcoast was relieved of its obligations to make take or pay payments thereafter.

The Alberta Court of Appeal dismissed "Petrogas"' appeal but on the grounds of force majeure, rather than frustration. Having decided the issue on that basis, the Court of Appeal did not receive submissions on the frustration issue and did not comment on that issue in its reasons for judgment.

The relevant provisions of the gas purchase agreement were as follows:

1. *Export Contract Volumes*:

   Subject to the other provisions of this Article V, Seller agrees to sell and deliver to Buyer, and Buyer agrees to purchase and receive, or pay for whether taken or not, the average daily volumes hereinafter set out . . .

   PROVIDED that Buyer's obligation to purchase and receive, or pay for whether taken or not, shall in no event exceed the volume determined as follows: . . .

4. *Make-up of Deficiencies in Gas Volumes Taken*:

   Buyer agrees that, beginning on January 1 of each year, in the event the total volume of pipeline gas purchased by Buyer from Seller hereunder during any prior calendar year shall, through no fault of Seller or limitation imposed by law, be less than a volume equal to the minimum annual contract volume required to be purchased by Buyer as herein provided, the volume of pipeline gas not so purchased by Buyer during any such calendar year shall be accepted and purchased by Buyer hereunder during the succeeding calendar year, and paid for at the price or prices applicable to the date or dates when such pipeline gas shall be delivered; and any such deficiency volumes of pipeline gas not so accepted and purchased during such succeeding calendar year shall be paid for by Buyer at the end of such succeeding calendar year. . . .

The gas which Westcoast purchased from "Petrogas" was sold to Northwest Pipeline Corporation. The price payable by Northwest to Westcoast was based on a "cost of service" which included the price paid by Westcoast for the gas sold thereunder, including take or pay payments. The statutory enactments in 1975 regulated the prices payable by Westcoast to "Petrogas" and the price payable by Northwest to Westcoast. Northwest resold the gas in the United States. Because the regulated prices were relatively high, Northwest reduced the quantity of gas which it purchased from Westcoast, presumably in favour of non-Canadian sources of gas. As a result, Westcoast purchased less than the minimum volumes from Petrogas.

The Court of Appeal, *per* Mr. Justice Belzil, ruled that the deficiencies resulted "through limitation imposed by law" such that, under clause 4 of article V of the contract as quoted above, Westcoast was not obligated to make take or pay payments.

The Court of Appeal distinguished the word "through" from the word "by". It stated that "through", in this context, means "in consequence of", or "by reason of". There did not need to be a direct relationship between the cause and the effect, as might have been the case if "by" had been used. The narrower interpretation would ignore the commercial reality of the contract which the parties had in contemplation when entering into it. At that time, it was intended that all the gas purchased by Westcoast would be sold to Northwest. Any limitation on the quantity

5. [1988] 4 W.W.R. 699, 59 Alta. L.R. (2d) 118, 89 A.R. 321 (Q.B.).

of gas which Westcoast could sell to Northwest was a limitation on the volume of gas which it could purchase from "Petrogas."

The provision in the contract with Northwest which required Northwest to purchase all of the gas which Westcoast was obligated to purchase from "Petrogas" was not relevant because the arbitrary pricing regulations had likely relieved Northwest from that obligation.

The Court also rejected "Petrogas'" argument that clause 4 of article V of the contract was an extension of clause 3 of that article and, therefore, dealt with legal limits on "Petrogas'" ability to produce gas, rather than limitations on Westcoast's ability to purchase gas. Clause 3 provided as follows:

> The volumes of pipeline gas which Seller shall be obligated to deliver to Buyer hereunder shall be limited to volumes of pipeline gas which may legally be produced from the wells. . . .

The Court of Appeal rejected "Petrogas'" argument that the words "limitation imposed by law" in clause 4 referred only to limitations imposed upon the Seller's ability to produce. Such a narrow construction would be inconsistent with the obvious intention of clauses 3 and 4. Clause 3 was intended to relieve the Seller from its obligations to deliver in certain circumstances. Clause 4 was intended to relieve the Buyer of its obligations to pay for gas in certain circumstances.

D. HAMILTON BROTHERS CORPORATION v. CARTER OIL AND GAS LTD.[6]

In 1979, Hamilton Brothers sold Canadian oil and gas properties to Carter, subject to payment of a royalty to Hamilton Brothers. The royalty is a stated percentage of the value of the petroleum substances produced from the land to which the royalty relates. The value of production is defined as the proceeds from the sale thereof less burdens. Burdens include "deductions, taxes (excluding income taxes) charges and payments payable to the Crown in Right of Canada or any of its provinces in respect of the ownership, production or sale of petroleum substances". Sometime after the royalty agreement was entered into, the Petroleum Gas Revenue Tax ("PGRT") was introduced. It was, basically, a tax on oil and gas well production. A working interest owner paid the tax on gross production revenues from each well less operating costs and royalties. A royalty owner paid the tax on gross royalty income. There was a $250,000 exemption for a taxpayer in respect of the tax.

Carter had sold the properties subject to the royalty to ten companies ("Tencos"). Each of the Tencos qualified for the $250,000 PGRT exemption.

This case is an appeal of a decision of the Alberta Court of Queen's Bench[7] which held that PGRT is a burden for purposes of the royalty calculation which should be deducted from gross sale proceeds prior to computing the royalty. Only the actual amount paid in respect of PGRT, net of the exemptions, should be taken into account. The effect of the decision was that Hamilton Brothers obtained the benefit of some of the Tencos' exemptions. Since the rate of the royalty varies from 60% to 70%, Hamilton Brothers obtained the lion's share of the Tencos' exemptions.

Under the arrangement between Hamilton Brothers and Carter, all production revenues are paid to a trustee. Hamilton Brothers computes the amount of its royalty

6. (1988), 60 Alta. L.R. (2d) 247, 91 A.R. 251 (C.A.).

7. (1987), 54 Alta. L.R. (2d) 330 (Q.B.).

and provides directions to the trustee as to the disbursement of the production revenues. Immediately after the PGRT was implemented, Hamilton Brothers calculated the royalty without reference to the exemptions, with the result that it understated its royalty share of the production revenues in its disbursing instructions to the trustee. Subsequently, it claimed that it had been underpaid and demanded that the Tencos refund the shortfall.

The Court of Appeal upheld the trial decision, holding as follows:

1. The royalty agreement is plain and unambiguous requiring no interpretive aids or rules. Hamilton Brothers' claim is an action for the balance owing on account of the royalty and not restitutionary or an action for money paid under mistake.
2. The royalty does not comprise a precise share of production, with the Tencos having no financial responsibility for payment of the royalty. The arrangement with the trustee was intended to ensure collection of the royalty payments and does not relieve the Tencos from the obligation to pay the royalty.
3. The Tencos and Carter are jointly and severally liable for the shortfalls in the royalty payments.
4. Hamilton Brothers is not estopped from making its claim by the disbursing instructions it gave to the trustee. The instructions were not a representation, they were not intended to induce the Tencos to act to their detriment and in fact the Tencos have not acted to their detriment by having received a larger share of the production revenues than they should have and then subsequently spending the same. None of the three requirements of promissory estoppel were present.

E. HAMILTON BROTHERS CORPORATION v. CARTER OIL AND GAS LTD.[8]

This case deals with the same royalty agreement considered in the case described immediately above. The royalty applied to interests in the Nipisi Gas unit. After the royalty was created, the operator of the unit commenced an enhanced recovery program. The payors of the royalty (the Tencos) did not pay their shares of the costs of the program so that the operator of the unit set off their shares of production revenues against such costs. Because such production revenues were not received, there were insufficient revenues to pay the royalty to Hamilton Brothers. Hamilton Brothers brought this action to recover the shortfall.

The trial judge ruled that the issues of joint and several liability of the Tencos and Carter and whether the claim was a simple action in debt or a claim that could be exerted only against a particular fund (i.e. production revenues) were *res judicata*, having been decided in the earlier litigation. In any event, he found that there was nothing in the documents restricting the Tencos' liability to a particular fund, which would have been a simple matter to provide for if the parties had so intended.

The royalty was a percentage of the gross proceeds from the sale of production less amounts paid on account of burdens. "Burdens" were defined in the royalty agreement as follows:

> all deductions, taxes (excluding income taxes) charges and payments payable to the Crown in right of Canada or any of its provinces in respect of the ownership, production or sale of petroleum substances and shall include all rentals and royalties payable pursuant to the said leases, field mineral taxes, and any overriding royalties that exist at the closing date as shown on schedule "A" to the said agreement, but shall not include overriding royalties, production payments or similar interests created on or after the closing date.

The trial judge found that operating and development costs, including the costs of the enhanced recovery program, were not "burdens".

8. (25 November 1988), Calgary 8601-15147 (Alta. Q.B.).

The trial judge also rejected the Tencos' argument that they had no obligation to pay the costs of the enhanced recovery program. The Nipisi unit operating agreement under which the enhanced recovery program was conducted was in effect at the time Carter purchased the interests of Hamilton Brothers and agreed to pay the royalty. The unit operating agreement provided that if a sufficient percentage of the parties thereto voted in favour of a development scheme, then all parties were bound to pay their shares of the costs thereof. Thus, the Tencos (the successors to Carter) were obligated under the unit operating agreement to pay their shares of the costs of the enhanced recovery program.

The royalty agreement contained the following provisions:

> 11. *COVENANTS OF PURCHASER*
>
> (a) Subject to paragraph 12, Purchaser shall, so long as the Vendors' royalty is in force and effect, . . .
>
> (ii) perform all obligations of operating agreements, . . . affecting said lands; . . .
>
> (iv) punctually pay all rentals . . . and other payments required by contracts affecting said lands; . . .
>
> 12. *ABSENCE OF OBLIGATION TO DEVELOP OR PRODUCE*
>
> Notwithstanding any provision herein contained, Purchaser shall be under no obligation to Vendor to develop the said lands. . . .

The Tencos contended that paragraph 12 relieved them of any obligation to pay operating and development costs and that, because of its introductory words, paragraph 11 is subservient to paragraph 12. The trial judge held that there is no conflict between clauses 11 and 12. Hamilton Brothers did not seek to hold the purchaser responsible for any failure to develop or produce. The obligation to pay the development costs is owed to the operator of the unit, not to Hamilton Brothers.

It was also held that an assignment of the royalty from Hamilton Brothers to Bank of Montreal did not affect the Tencos' liabilities.

The Tencos unsuccessfully argued that Hamilton Brothers' claim should have been raised in the earlier litigation to the extent of shortfalls in existence at that time. They argued that the doctrine of *res judicata* prevented Hamilton Brothers from raising the claim in this action. The trial judge ruled that it would have been unreasonable to join the two actions because that would have resulted in a substantial delay to the first action.

F. ALPINE RESOURCES LTD. v. BOWTEX RESOURCES LTD.[9]

This decision of the Alberta Court of Queen's Bench examines a payout account in a gross overriding royalty agreement. The account determines when the royalty can be converted to a working interest.

Alpine had sold oil and gas interests in lands in Saskatchewan to Atlantic Energy (predecessor to Bowtex), reserving a gross overriding royalty. The royalty agreement provided that when payout occurred, Alpine could convert the royalty to a working interest. In order to determine when payout occurred, a payout account was established to which the costs of the project were to be credited and the production revenues from the project were to be debited. Payout would occur when the credits and debits were equal. A number of issues concerning the amounts to be entered into this account were raised in the case.

9. (1989), 66 Alta. L.R. (2d) 144 (Q.B.).

"Equipping costs" were to be credited to the account. Equipping costs were defined as follows:

> All costs incurred in equipping a well at the wellhead and beyond the well head to the lease valve including, without limiting the generality of the foregoing, the tubing, pump and rods, the acquisition and installation of flow-lines, separator and production tankage and, in the case of a gas well, a heater or dehydrator or other hydrate control facility.

Bowtex contended that the costs of the gathering system, central dehydrator and central compressor servicing the wells located on the lands were equipping costs. Alpine argued that equipping costs were confined to costs of equipment installed within each individual well site. The trial judge found in favour of Bowtex on this issue. Alpine contended that the "lease valve" is a valve situated on the well-site. However, there was other expert evidence to the effect that the term has no special meaning. In any event, the trial judge found that the parties intended that Atlantic Energy should recover all costs incurred in developing the field to the point where production could be delivered in a marketable state, to a purchaser thereof. This intention was taken from the circumstances in which the contract was entered into, as well as the general terms of the contract. Since costs beyond the well-site had to be incurred before production could be marketed, it must have been intended that such costs be recovered prior to payout. Alpine had admitted that it expected such costs to be included in the payout account. In considering this issue, the trial judge refused to have regard to the definitions of equipping costs in the operating procedure attached to the royalty agreement and in a subsequent farmout agreement entered into by Atlantic Energy with a third party, because the definition contained in the royalty agreement was capable of reasonable interpretation in accordance with the intention of the parties.

The payout account provisions required that "[a]ll amounts received by Atlantic . . . in payment upon marketing of Atlantic's share of Petroleum Substances produced from the Royalty Lands" be debited to the payout account and that certain costs "paid or incurred by Atlantic with respect to the Royalty Lands" be credited to the account. In fact, Atlantic entered into a farmout agreement pursuant to which a third party paid some of the costs of developing the royalty lands and became entitled to an interest therein. Alpine questioned whether the costs incurred by the third party farmee and the revenues received by him should be credited and debited to the payout account. The trial judge, for reasons that are not entirely clear, found that Alpine concurred in and consented to the farmout. Alpine contended that only gross revenues, net of expenses, should be entered in the account. The trial judge found that the use of the words "received by Atlantic" and "Atlantic's share" made it clear that only Atlantic's share of revenues, exclusive of the farmee's share, were to be entered in the account.

The royalty agreement provided that overhead should be credited to the payout account, as follows:

> All amounts paid or incurred by Atlantic . . . on account of overhead and administration and any similar accounts pursuant to agreements relating to the Royalty lands.

In fact, Atlantic credited between 60% and 100% of the costs of its Calgary office to the payout account and, in addition, $200 per month per well. Alpine argued that only the amounts chargeable to the joint account on account of overhead and administrative costs pursuant to the accounting procedure forming part of the operating procedure attached to the royalty agreement should be entered into the payout account. The trial judge held that the operating procedure and the accounting

procedure had no application to the payout account. Those procedures deal with the assigning of costs incurred by an operator appointed by working interest owners. He ruled that the actual overhead and administrative costs incurred by Atlantic and Bowtex should be entered in the payout account. In that regard, it should be recognized that Atlantic was involved in other projects and not all of its office expenses were attributable to the royalty lands. Bowtex must prove, by a preponderance of evidence, the amounts actually expended by Atlantic and Bowtex in respect of overhead and administration. The parties agreed that such determination would be made by an independent auditor after the trial.

Alpine took the position that only operating costs incurred at wellsites should be charged to the payout account so that costs of renting and operating compressors should be excluded. Since the compressors were required to make the production marketable, the trial judge concluded that the parties intended that the costs of operating them be charged to the payout account in order to achieve the object of the payout account, namely recovery of all costs.

Atlantic had entered into a facilities agreement with the third party farmee governing gathering, compression and transmission facilities. Atlantic agreed to operate those facilities for the use of the third party farmee and other parties for a fee based on the amount of product serviced by the facilities. Bowtex contended that it was entitled to charge a fee to the payout account for servicing the production from the royalty lands in such facilities arguing that such fee is an "operating cost". The trial judge disagreed. The fee contained a component for return on capital investment. However, the capital costs are charged to the payout account elsewhere. To charge the fee as an operating cost would result in double recovery of such capital costs. He ruled that only the direct day to day expenses of operating the facilities should be charged to the account.

The payout account provided for Atlantic to recover interest on costs incurred by it. The date from which such interest was to accrue was unclear. The royalty agreement had an effective date of December 1, 1982. Some costs had been incurred prior to that date and the agreement specifically provided that such costs were to be charged to the payout account. The trial judge found that, having regard to the object of the agreement (namely to provide for recovery of all cost incurred by Atlantic) and since the parties had specifically provided for recovery of costs incurred before the effective date, they must have intended that interest would accrue before the effective date. Furthermore, it was clear that the effective date was only applicable for certain purposes of the agreement.

Alpine had provided transfers of interest in the royalty lands to Atlantic, which were lost. When Atlantic requested new transfers, Alpine refused to provide them due to the dispute over the payout account. Then Atlantic ceased paying production revenues to Alpine. When Alpine finally provided the transfers, Atlantic placed the withheld revenues in a trust account. Alpine argued that it was entitled to interest on the withheld amounts. The trial judge found that the revenues were withheld by Atlantic to force Alpine to deliver the new transfers. However, Alpine's refusal to provide the new transfers did not entitle Atlantic to withhold the revenues. The revenues were unjustly withheld within the meaning of the Alberta Judicature Act.[10] Interest was awarded on the withheld revenues at the rate of interest applicable to the payout account.

10. R.S.A. 1980, c. J-1, as am.

Alpine also sought damages for the failure by Atlantic and Bowtex to provide payout statements. Bowtex submitted that it was unable to provide the statements because the farmee did not provide adequate information about its activities. The trial judge stated that, although that may be true, it did not discharge Atlantic and Bowtex from their obligation to provide the statements. However, Alpine did not prove that it had sustained any damage as a result thereof which could not be remedied by an accounting.

The trial judge rejected Alpine's claim for punitive damages since there did not exist the type of high-handed, wilful or malicious conduct required to support such an award. In fact, Atlantic engaged chartered accountants to reconstruct the farmee's records, which did not indicate a callous lack of regard for its obligations. In any event, the trial judge stated that in his view punitive damages do not lie in an action for breach of contract since the existence of misconduct cannot alter the basic premise that the purpose to be served by damage awards in contract actions is to provide compensation for losses suffered. This statement of the law may not be correct.[11]

The final issue concerned the costs of the independent audit. The royalty agreement provides that Alpine may audit the payout account at its cost. The trial judge stated that that provision contemplated an audit of an existing account, rather than an assignment of costs and revenues. Accordingly, he ruled that the costs of the independent audit should be borne by Bowtex.

G. B.P. RESOURCES CANADA LIMITED v. GENERAL AMERICAN OILS LTD.[12]

A letter farmout agreement reserved an overriding royalty to the farmors. The letter agreement was silent on conversion of the royalty to a working interest. Several years after the letter agreement was signed, a more formal royalty agreement was prepared and executed. The formal agreement contained a right to convert the royalty to a working interest at payout. The farmee contended that the right of conversion was inserted in the formal agreement in error and sought to have the formal agreement rectified by eliminating the conversion clause. The request for rectification was denied and the farmors were held to be entitled to convert their royalty interests to working interests.

The letter farmout agreement was entered into in July, 1973. In November, 1973 the farmee wrote to one of the two farmors advising that it had drilled the earning well as required under the farmout agreement and requested that an overriding royalty agreement be prepared. Murphy Oil Company, one of the farmors, prepared a draft agreement which was discussed between January and July, 1974. That agreement was not executed. In 1977, Murphy circulated a new form of royalty agreement. The other farmor, B.P. Resources, provided a list of seven requested changes in the draft royalty agreement (which did not include provision for conversion of the royalty) and provided Murphy with a form of royalty agreement acceptable to B.P. (which did include a right of conversion). Murphy then prepared another royalty agreement in the B.P. form. This agreement was executed in late 1977 and early 1978. It contained a right to convert the royalty to a working interest.

11. See *Vorvis* v. *I.C.B.C.*, [1989] 4 W.W.R. 218 (S.C.C.).

12. (1989), 66 Alta. L.R. (2d) 82, 95 A.R. 121 (Q.B.).

It provided that following conversion, the working interests would be operated pursuant to an existing operating agreement. Shortly after its execution, the royalty agreement was recirculated to initial a change in the conversion clause in the description of the operating agreement to be effective after conversion.

Late in 1982 General American, successor to the farmee, requested B.P. and Murphy to acknowledge that they did not have a right to convert the royalty. Murphy executed the acknowledgement but B.P. did not.

The trial judge reviewed the law relating to rectification and concluded that it is only available if there is an agreement among the parties which has been incorrectly recorded in a written document. The court must be satisfied by at least convincing proof and possibly more, that the error has occurred. The requisite standard of proof was not met in this case.

The trial judge stated that the original letter agreement was merely an outline. It contained only one sentence describing the royalty. The vast majority of the terms which appeared in the various drafts of the formal royalty agreement were not present in the letter agreement nor could they be inferred from it. It was clear from the correspondence among the parties relating to the formal royalty agreement that at the time the letter agreement was entered into, the parties had not reached agreement on the terms of the royalty. It was only the final agreement, which contains the conversion clause, that was accepted by all of the parties. The fact that the formal agreement was recirculated for initialing of a change in the conversion clause made it difficult to accept that the clause was inadvertently included in the royalty agreement. Furthermore, there was evidence that B.P.'s standard form royalty agreement contained a conversion right. The farmee did not have a standard form royalty agreement.

Murphy was not estopped by the acknowledgement letter from exercising its right of conversion. The farmee did not act or fail to act as a result of the acknowledgement and had suffered no detriment as a result of it. Both of those facts would have to exist in order for promissory estoppel to apply.

It is submitted that the decision in this case is somewhat harsh. A right of conversion is such an essential term that it would have been included in the original letter agreement if the original parties to the farmout had intended it to apply.

H. ITCO PROPERTIES LTD. v. MOHAWK OIL CO.[13]

The Alberta Court of Appeal held that an assignee of a contract is not disentitled from requesting rectification of the contract solely because it is not an original party to the contract. If the right to seek rectification has also been assigned, then the assignee has the status to make the request.

I. GUARANTY TRUST COMPANY OF ALBERTA v. HETHERINGTON[14]

This case concerns royalty trust agreements. It is an appeal of the 1987 decision of Mr. Justice O'Leary.[15] The Court of Appeal decided the case on the basis of the specific terms of the royalty trust agreement rather than ruling on the nature of the

13. [1988] 6 W.W.R. 704, 91 A.R. 76, 62 Alta. L.R. (2d) 42 (Q.B.).
14. (1989), 67 Alta. L.R. (2d) 290 (C.A.).
15. [1987] 3 W.W.R. 316 (Alta. Q.B.).

interests created thereby. As a result, the case will only be applicable to the royalty trust agreement considered in this case. It does not create a precedent of broad application to royalty trust agreements.

Royalty trust agreements are agreements between the owner of fee simple mineral rights and a trustee pursuant to which the owner assigns its right to lessor royalty payments under petroleum and natural gas leases in respect of such mineral rights. Fractional or percentage interests in the trust are then sold.

This case involved two royalty trust agreements entered into by Prudential Trust Limited, predecessor of Guaranty Trust Company of Alberta. The royalty trust agreements were identical in all material respects. In one case, the grantors of the royalty trust were a brother and sister by the name of Alden and in the other case the grantor was a woman named Pedersen. In each case, there was a petroleum and natural gas lease in existence at the time that the royalty trust was created which covered the lands to which the royalty trust applied. The primary terms of the leases subsequently expired without any drilling having taken place. Prudential Trust Company registered caveats in respect of its interests under the two royalty trust agreements.

Subsequent to the trust agreements being made, the Aldens sold their interests in the lands covered by the Alden royalty trust to a bona fide purchaser for value. Thereafter, a new petroleum and natural gas lease was granted to an oil company who drilled a successful well on the Alden lands.

At the time of trial, the Pedersen lands were held in the name of Mrs. Pedersen's executrix. The executrix had granted a petroleum and natural gas lease covering the Pedersen lands to an oil company who had drilled a successful well thereon.

The trial judge held that, by their terms, the royalty trust agreements applied to the new leases. Furthermore, the royalty trust agreements did not create an interest in land and were not capable of being protected by caveats. Accordingly, he held that the bona fide purchaser for value from the Aldens acquired the Alden lands free and clear of the Alden royalty trust agreement. However, since the executrix of Mrs. Pedersen was a volunteer and could acquire no better interest than Mrs. Pedersen had, the interest of the executrix was subject to the royalty trust agreement.

The Alberta Court of Appeal held that, by their terms, the royalty trust agreements applied only to the leases that were in existence when the royalty trust agreements were made and did not apply to the new leases. Accordingly, the royalties reserved under the new leases were not subject to the royalty trust agreement and the interests of the bona fide purchaser for value and the executrix of Mrs. Pedersen were not subject to the royalty trust agreement. Having decided the issue on that basis, the Alberta Court of Appeal declined to consider whether the royalty trust agreements created interests in land.

The recitals to the royalty trust agreements described the leases which were then in existence and the lessor royalties reserved thereunder and stated that the grantor of the royalty trust wished to assign such royalty to the trustee. In each case, the habendum or granting clause of the lease provided as follows:

> 2. The Owner herein doth hereby grant, bargain, sell, assign, transfer and set over unto the Trustee, its successors and assigns forever, all the estate, right, title, interest, claim and demand whatsoever both at law and in equity of the Owner in and to the above-mentioned 12 and 1/2 percentum gross royalty . . . to have and to hold the same. . . .

A subsequent clause in the royalty trust agreement provided as follows:

> 25. The Owner hereby covenants and agrees with the Trustee that, in the event that any lease that may be in existence as at the date of this Agreement is cancelled for any reason or in any event that no lease is in existence as at the date of this Trust Agreement, he shall and will in negotiating any lease or other instrument for developing the said lands, reserve unto the Trustee the full 12 1/2% Gross Royalty hereby assigned to the Trustee.

The trial judge had found that but for Clause 25, the royalty trust agreements would have applied only to the leases in existence at the time that the royalty trusts were created. However, to restrict the granting clause to the royalties reserved in the existing lease would render Clause 25 nugatory and therefore, he concluded that the royalty trust agreements assigned royalties reserved in future leases, even though not specifically covered by the granting clause of the agreements. The trial judge attached some weight to the common industry understanding that royalty trust agreements apply to future leases.

The Alberta Court of Appeal agreed that the habendum or granting clause in the royalty trusts did not cover future leases. However, they narrowly construed Clause 25 as applying only if an existing lease is cancelled or void *ab initio* and not to the circumstances in which the existing lease expires by its terms. Since, in the situations in issue, the existing leases had expired by their terms, Clause 25 was not applicable and the royalty trust agreements did not apply to the new leases.

The Court of Appeal stated that the understanding of the industry that royalty trust agreements apply to new leases could not be considered unless the agreements were ambiguous. In the view of the Court of Appeal, the agreements were not ambiguous.

It is understood that leave to appeal this decision to the Supreme Court of Canada is being sought.

II. FREEHOLD LEASES

A. DURISH v. WHITE RESOURCE MGMT. LTD.[16]

In this decision, the Alberta Court of Appeal agreed with the reasons of the trial judge in holding that a freehold petroleum and natural gas lease had terminated.[17]

The lease in question was an "unless" type lease which provided that it would subsist for a primary term of 5 years and "so long thereafter as the leased substances or any of them are produced from the said lands", subject to the proviso that "if any well on the said lands . . . is shut-in, suspended or otherwise not produced for any cause whatsoever which is in accordance with good oil-field practice, the time of such interruption or suspension or non-production shall not be counted against the Lessee." The lease contained a shut-in well clause which provided, in part, that "if all wells on the said lands as (sic) shut-in . . . during any year ending on an anniversary date, the Lessee shall pay to the Lessor at the expiration of each such year, a sum equal to the delay rental herein set forth and each such well shall be deemed to be a producing well hereunder. . . ." The lease also contained a default clause under which the lessor could give notice of a default to the lessee and providing that if the default was not rectified, the lease would terminate.

16. (1988), 63 Alta. L.R. (2d) 265 (C.A.).
17. (1987), 55 Alta. L.R. (2d) 47, 82 A.R. 66 (Q.B.).

The leased lands were pooled and a gas well drilled on the pooled lands. In November, 1985, after the end of the primary term of the lease, Gulf Resources shut-in the well due to a dispute over processing fees. In January, 1987, 8 months after the anniversary date of the lease, the lessee purported to make a shut-in royalty payment.

The Court of Appeal held that the shut-in royalty clause in the lease granted an option to the lessee to make a payment if the lessee wished to continue the lease. It did not impose an obligation to make such payment. The default clause has no application because it applies only when there has been a default in an obligation. In fact, the shut-in royalty clause provides that, if it is applicable, the lessee "shall" make a shut-in royalty payment, which suggests an obligation, not an option.

The lessee had argued that the shut-in royalty payment had been made by a set-off through an internal bookkeeping entry in its records. It was conceded that there could not be set-off without an agreement to set-off. Even if there was such an agreement, there was no evidence that the agreement permitted set-off without notification.

The lessee argued that the pooling agreement altered the lease. The Court of Appeal held that even if that were the case, the amendment was not binding upon Durish. Durish had purchased the lessor's interest in the leased lands after the lease was granted. The transfer was registered under the Land Titles Act.[18] Since no caveat was registered in respect of the amendment to the lease effected by the pooling agreement, it was not binding on Durish, even if he had actual knowledge of it.

The acceptance of royalties by Durish did not constitute an acquiescence in the continuation of the lease, having regard to the disputes and litigation between Durish and the lessee which had been raised prior to the payments being made.

There is an interesting case comment on this decision in the Alberta Law Reports.[19]

B. CANADIAN SUPERIOR OIL LTD. v. WORLD WIDE OIL AND GAS (WESTERN)[20]

This case concerns the effect of registration of a unit agreement on the priorities between two freehold oil and gas leases. The case is similar to *Esso Resources Canada Ltd.* v. *Pacific Cassier Ltd.*[21]

Canadian Superior had obtained a freehold lease covering a quarter section. It farmed out the lease. Legal subdivision 9, which was comprised in the quarter section, was unitized in 1959. The lessor executed the unit agreement. In 1960, the Registrar of the North Alberta Land Registration District filed a memorandum in respect of the unit agreement, which only stated that the unit agreement affected Lsd. 9. In 1961, title to the mines and minerals was transferred to World Wide, for value.

It was held that World Wide had priority over Canadian Superior to all of the quarter section, except Lsd. 9. Canadian Superior argued that at the time World Wide acquired the mineral rights, there was notice on title of the unit agreement

18. R.S.A. 1980, c. L-5, as am.
19. (1988), 63 Alta. L.R. (2d) 269.
20. (9 January 1989), Edmonton 8703-16431, 8401-23668 (Alta Q.B.).
21. [1986] 4 W.W.R. 385, 45 Alta. L.R. (2d) 1 (C.A.).

and of the prior lease. Had World Wide read the unit agreement and the prior lease, it would have realized that the unitization of Lsd. 9 had the effect, under the terms of the lease, of continuing the lease as to all of the lands covered thereby.

The trial judge stated that the Registrar's memorandum has an effect similar to a caveat. Since the memorandum was restricted to Lsd. 9, its registration only gives priority with respect to Lsd. 9. Accordingly, World Wide's interest in the balance of the quarter section was free and clear of the lease to Canadian Superior.

III. GOVERNMENT REGULATION

A. VANDERGRIFT ET AL. v. COSEKA RESOURCES LIMITED ET AL.[22]

The principal issue in this case is the effect of the formation of a gas block pursuant to the Alberta Oil and Gas Conservation Act[23] on the calculation of a gross overriding royalty. The case also considers whether the royalty is an interest in land.

A gross overriding royalty was granted in 1971. At that time, the grantor of the royalty had the right, under a farmout agreement, to earn an undivided interest in an Alberta Crown petroleum and natural gas lease covering the Royalty Lands and held a Crown Reserve Natural Gas Licence covering the Royalty Lands. In 1973, a well was drilled on the Royalty Lands as a result of which the grantor earned an interest in a Crown petroleum and natural gas lease pursuant to the farmout agreement and acquired a Crown natural gas lease pursuant to the licence. In 1978, on the application of the successors-in-interest to the grantors of the royalty, the Energy Resources Conservation Board of Alberta issued an order establishing a gas block covering the Royalty Lands and lands adjacent thereto (the "Non-Royalty Lands"). In 1973, after the well was drilled, the Royalty Lands and the Non-Royalty Lands were pooled. The plaintiffs were not a party to the pooling agreement. At all material times, there was one well located on the Royalty Lands and five wells on the Non-Royalty Lands.

The royalty owners claimed that the gas block order resulted in a pooling or unitization, such that the royalty should be calculated on all of the production from the block, including production from the Non-Royalty Lands. In his reasons for judgment, Mr. Justice Virtue stated that there are two critical elements required for unitization, being:

1. a compulsory allocation of a percentage of total production from the unit to individual tracts in the unit; and
2. a deemed amendment of existing contracts whereby the production allocated to a tract under the unitization scheme is substituted in contracts pertaining to such tract for the actual production from such tract.

The gas block order did not meet either of those requirements. Rather, it suspended the application of Part 4 of the Oil and Gas Conservation Regulations[24] in respect of wells drilled on the gas block and it imposed a special spacing arrangement prescribing the distance between wells located on the gas block. Part 4 of the Oil and Gas Conservation Regulations[25] prescribes production penalties for off-target

22. (1989), 67 Alta. L.R. (2d) 17, 95 A.R. 372 (Q.B.).
23. R.S.A. 1980, c. O-5, as am.
24. Alta. Reg. 151/71, as am.
25. *Ibid.*

wells, being wells not located in the location prescribed by the Regulations. The well located on the Royalty Lands was an off-target well and was subject to the penalty. The trial judge found that the principal reason for the gas block order was to avoid the penalty in respect of that well. As a result, the gas block order benefited the royalty owners. The trial judge stated that a gas block order permits the Energy Resources Conservation Board to determine the production which will be allowed, on an aggregate basis, from the block. However, there was nothing in the order or the legislation requiring that the total production be allocated among the various tracts in the block nor any formula setting out the basis on which such an allocation could be made. The trial judge contrasted the legislation pertaining to gas block orders with the legislation pertaining to compulsory pooling and unitization[26] which provides for an allocation and which provides that compulsory pooling and unitization orders are binding upon each owner or anyone entitled to a contractual benefit through an owner. There are no similar provisions in the legislation pertaining to gas block orders.

Since there is nothing in the legislation or the order prescribing the calculation of the royalty, it is to be calculated in accordance with the terms of the agreement under which it was created. The Court refused to imply any term into the royalty agreement to the effect that the royalty should be calculated on an allocated share of the production from the whole of the gas block. The royalty owners have no right, contractual or otherwise, to control the manner in which the working interest owners take production from the Royalty Lands. The royalty agreement specifically relieved the working interest owners from any obligation to conduct exploratory operations or drill wells on the Royalty Lands. The judgment sought by the plaintiffs would modify the bargain which the grantors and grantees of the royalty had reached.

The plaintiffs also alleged that the defendants had acted unfairly in taking production from the Non-Royalty Lands rather than the Royalty Lands. The trial judge found that the claim was not substantiated by the evidence. He noted that the royalties burdening the Non-Royalty Lands exceeded those burdening the Royalty Lands, so that there was an incentive for Coseka to favour the Royalty Lands. He found that there was no drainage because the evidence before him indicated that, in this field, drainage was limited to one-half section from a well-site. He found that more wells were drilled on the Non-Royalty Lands than the Royalty Lands for valid geological reasons.

The trial judge also considered whether the royalty is an interest in land. The exact relevance of this issue is not clear. In the reasons for judgment, it is stated that the issue is pertinent to the determination of whether the gas block order resulted in a *de facto* unitization. However, whether the royalty is an interest in land does not seem relevant to that issue. It also appears that when Coseka applied for the gas block order, it represented to the Energy Resources Conservation Board that ownership was uniform throughout the whole gas block. If the royalties are interests in land, that would not be true. It is not clear, however, that such a misrepresentation would found a cause of action in the royalty owners.

The trial judge stated that an overriding royalty can be an interest in land if two requirements are satisfied:

26. *Supra*, note 23, ss. 72 and 76.

1. the grantor and grantee of the royalty intended that the royalty be an interest in land rather than a contractual right to a share of production; and
2. the royalty is carved out of an interest which is, itself, an interest in land.

In considering the first point the trial judge placed particular emphasis on the fact that the royalty does not relate to petroleum substances within, under or upon the lands, but refers to petroleum substances "recovered" or "found" and is described in the agreement as "a share of production", "petroleum substances sold", and "petroleum substances produced". The result is that the royalty is in respect of production after it has been removed, rather than being an interest in land. Based upon prior judicial authority,[27] he held that where a royalty relates to a share of production which has been removed from the land, it is not an interest in land. He stated that if the royalty did create an interest in land, then one would expect the royalty owner to have the right to enter upon the lands to explore for and extract petroleum substances. This royalty agreement specifically provided to the contrary, since it expressly stated that the grantor was under no obligation to develop the lands. Since the grantor and the royalty owner were, effectively, the same people when the royalty agreement was prepared, it would have been easy for them to have created an interest in land. Furthermore, since those people now comprise the plaintiffs, it would be unfair to impose obligations on the defendants, who were not involved in the preparation of the agreement (but have succeeded to the position of the grantor) unless the agreement is very clear.

The trial judge also found that the royalty could not be an interest in land because the interest from which the royalty was carved was not itself an interest in land. When the royalty was granted, the grantor had the right under the farmout agreement to acquire an interest in a Crown petroleum and natural gas lease and the right under the licence to acquire a Crown natural gas lease. It did not then hold any interests in any leases relating to the Royalty Lands. The farmout agreement specifically stated that only upon the grantor drilling a well in accordance therewith would it acquire an interest pursuant thereto. It also stated that if the grantor failed to complete the well, it would have no interest whatsoever in the lands covered by the farmout agreement. The Crown Natural Gas Licence was governed by the Alberta Natural Gas Licence Regulation, Section 14 of which provided as follows:[28]

> A licence conveys the right to drill a well or wells for natural gas that is the property of the Crown . . . and the right to produce the same. . . .

The trial judge held that neither the farmout agreement nor the Crown Natural Gas Licence created an interest in land. Thus, the second requirement for the creation of a royalty, namely that it be carved out of an interest which is itself an interest in land, was not satisfied in this case.

The trial judge suggests that in order for the royalty to be an interest in land, the royalty owner must have the right to enter upon the lands and extract petroleum substances therefrom. If that is the case, then it is submitted that an overriding royalty interest will never be an interest in land because that right is inconsistent with the passive nature of a royalty interest. A lessor's royalty which carries with

27. *Vanguard Petroleum Ltd.* v. *Vermont Oil and Gas Ltd.*, [1977] 2 W.W.R. 66 (Alta. S.C.); *Emerald Resources Ltd.* v. *Sterling Oil Properties Management Ltd.* (1969), 3 D.L.R. (3d) 630 (Alta. S.C.A.D.) aff'd 15 D.L.R. (3d) 256 (S.C.C.).

28. Alta. Reg. 297/62.

it the right to re-enter the land upon non-payment, may be an exception, not because the owner of the royalty has a right to enter the lands and take production therefrom, but because it has a right of re-entry on termination of the lease.

It is submitted that the trial judge was in error in finding that the farmout agreement and the Crown Natural Gas Licence do not create interests in land. Both the farmout agreement and the licence gave the grantor of the royalty the right to acquire an interest in a Crown lease. If the Crown lease is an interest in land (the trial judge seems to have assumed that this is the case, and, in any event, the author believes that it is), then the rights under the farmout agreement and the licence are in the nature of an option. An option to acquire an interest in land is itself an interest in land.[29] It would seem that this issue was not fully explored by the litigants or the trial judge, probably because the real issue in the case relates to the nature of a gas block order.

Even if the grantor's rights under the farmout agreement and the Crown Natural Gas Licence were not interests in land, the finding of the trial judge that the royalty is not an interest in land because it is not carved out of an interest in land is probably incorrect. The parties to the royalty agreement did not intend that the royalty would be carved out of the interests then held by the grantor. Rather, the parties must have intended that as and when the grantor had the right to take production from the Royalty Lands (which would presumably happen when the grantor had an interest in land), the grantees would be entitled to a royalty interest thereon. Thus, the royalty agreement could be construed as an agreement to grant a royalty as and when the grantor acquired a working interest.

Apparently, this decision has been appealed.

B. SASKATCHEWAN POWER CORP. v. TRANSCAN PIPELINES LTD.[30]

In this case the constitutional validity of the Petroleum Administration Act[31] ("PAA") and its applicability to contracts entered into prior to its enactment were considered by the Saskatchewan Court of Appeal. The PAA is an act of the federal Parliament. It prescribes the price to be paid for natural gas produced in one province and sold in another, when there is an agreement between the federal government and the government of the producing province in respect of natural gas prices. Saskatchewan Power Corp. ("Sask Power") and TransCanada Pipelines Limited ("TCPL") entered into a gas purchase contract in 1969 pursuant to which Sask Power sold volumes of gas to TCPL between 1969 and 1975 and TCPL was to deliver volumes of gas to Sask Power after 1975. The relevant provisions of the PAA were proclaimed in 1975. The prescribed price under the PAA far exceeded the price which had been paid by Sask Power to TCPL. Thus, if the PAA applied to the volumes redelivered by TCPL to Sask Power, Sask Power would pay far more for the gas redelivered to it than it received for the gas which it had delivered to TCPL.

The contract provided that Sask Power would make annual nominations of the volume of gas it required to be delivered to it in a contract year. The nominations

29. *Frobisher Ltd.* v. *Cdn. Pipelines & Petroleums Ltd.* (1957), 23 W.W.R. 241, 10 D.L.R. (2d) 338 (Sask. C.A.); aff'd [1960] S.C.R. 126.

30. [1989] 2 W.W.R. 385 (Sask. C.A.).

31. S.C. 1974-75-76, c. 47.

for 1976 deliveries were made prior to the PAA being proclaimed. However, the 1976 contract year commenced after it was proclaimed.

The gas redelivered by TCPL to Sask Power pursuant to the contract was produced in Alberta. The Alberta government and the federal government had entered into an agreement regarding prices as contemplated by the PAA.

Sask Power contended that the prices prescribed by the PAA did not apply to the gas redelivered by TCPL because the contract had been entered into prior to the PAA being proclaimed. In addition, Sask Power contended that the PAA was constitutionally invalid because it was ultra vires the federal Parliament. Sask Power further contended that, in any event, the prescribed prices did not apply to the 1976 deliveries because that gas was sold prior to the PAA being proclaimed since the nomination therefor was made before the proclamation.

The trial judge ruled against Sask Power.[32]

The Saskatchewan Court of Appeal dismissed Sask Power's appeal and sustained the decision of the trial judge.

Section 51(1) of the PAA, which is the key provision, provides as follows:

> 51.(1) Where an agreement is entered into with a producer-province under section 50, the governor-in-council may, by regulation, prescribe prices at which the various kinds of gas to which this Part applies that are produced, extracted, recovered or manufactured in that province are to be sold on or for delivery in any areas or zones in Canada and outside that province or to any points on the international boundary of Canada.

Sask Power contended that s. 51(1) did not apply to gas sold pursuant to contracts entered into before s. 51(1) was proclaimed. Sask Power argued that the words "are to be sold on or for delivery" in section 51(1) should be interpreted to mean that the section applies only to contracts entered into after the section was proclaimed, since that is the meaning of those words and since any other interpretation would give the section retrospective effect and would interfere with rights which were vested when the section was proclaimed in force. The Saskatchewan Court of Appeal agreed with the trial judge that the interpretation advanced by Sask Power would frustrate the purpose of the Act because most gas sold in Canada is sold under long-term contracts. Sask Power's interpretation would result in the Act applying only to a very small fraction of the gas sold in Canada during the first decade or so after the section was proclaimed.

A statute can interfere with vested rights, without express provision in the statute to that effect, if it is necessary in order to accomplish the regulatory purpose of the statute.

Section 51(1) does not have a retrospective effect because it applies only to gas delivered after the section was proclaimed.

The words "are to be" are used in the imperative sense in section 51(1) and may be read as "shall". The ordinary meaning of the word "sold" is "disposed of by sale" so that s. 51(1) applies to gas that is disposed of by sale after the enactment becomes effective, including gas that is the subject of an existing agreement for sale and including the 1976 deliveries.

The legislation is constitutionally valid. Mr. Justice Sherstobitoff, speaking for the Court, states:[33]

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32. [1985] 5 W.W.R. 391, 42 Sask. R. 127 (Q.B.).

33. *Supra*, note 30 at 414.

> The legislation itself, as well as the excerpt from Hansard makes it clear that the purpose of the legislation was to fix the price of natural gas in interprovincial trade in order to keep stable the national energy economy, strike a balance between the competing interests of the producing and consuming provinces, and to enhance self-sufficiency in energy. It was deemed necessary by Parliament in reaction to the international economic crisis created by the sudden multiplication of the international price of crude oil and the resulting national tension between producing provinces which felt the need to obtain the highest price possible for their oil and natural gas and the consuming provinces which were faced with severe economic distress as a result of the increasing prices of those products. The need to protect the national interest in becoming or remaining self-sufficient in petroleum and natural products was also a factor. Stability of the national economy was also important. Each of these factors is a matter of general interest to the whole country, not just to individual provinces and regions.

This analysis makes it clear that the legislation was something more than an attempt by Parliament to interfere with the provincial right to regulate discovery, development and production of natural resources or protect consumer rights. These effects were incidental to the larger purpose referred to above. The Court of Appeal stated that the constitutional validity of the legislation must be determined from the circumstances existing when the legislation was enacted. Thus, the changes in the energy industry in the 1980's were not relevant. Furthermore, s. 92(A) of the Constitution Act,[34] which provides for provincial control over its resources, was not applicable, apparently because it was enacted after the PAA.

The Saskatchewan Court of Appeal sustained the constitutional validity of s. 51(1) of the PAA under the federal power to regulate trade and commerce contained in s. 91(2) of the Constitution Act. The Court stated that *Citizens Ins. Co. of Can.* v. *Parsons*[35] established three principles with respect to the federal trade and commerce power: that it included regulation of international and interprovincial trade, that it may include general regulation of trade affecting the whole of Canada and that it does not include the power to regulate the contracts of a particular business or trade.

The Court reviewed a number of cases[36] which the Court stated established the constitutional power of Parliament to regulate interprovincial and international trade of natural resources produced in Western Canada. Section 48 of the PAA restricts the application of the PAA to gas that enters into interprovincial or international trade. The fact that s. 51(1) of the PAA deals solely with the fixing of prices does not mean that the Act does not "regulate" trade. The fixing of a price is one of the most direct and forceful methods of regulation. As noted in *Re Exported Natural Gas Tax*,[37] the fixing of the price of natural gas in interprovincial trade is part of a larger regulatory scheme governing natural gas and other petroleum products. As recognized in *Caloil Inc.* v. *A.G. Can.*,[38] Parliament has the authority under the trade and commerce power to regulate the interprovincial trade of petroleum

34. Constitution Act, 1982.
35. (1881), 7 App. Cas. 96 (P.C.).
36. *Murphy* v. *C.P.R.*, [1958] S.C.R. 626, 77 C.R.T.C. 322, 15 D.L.R. (2d) 145 (Man.); *Caloil Inc.* v. *A.G. Can.*, [1971] S.C.R. 543, [1971] 4 W.W.R. 37, 20 D.L.R. (3d) 472 (Ex.); *Can. Indust. Gas & Oil Ltd.* v. *Sask.*, [1978] 2 S.C.R. 545, [1977] 6 W.W.R. 607, 80 D.L.R. (3d) 449, 18 N.R. 107; *Central Can. Potash Co.* v. *Sask.*, [1979] 1 S.C.R. 42, [1978] 6 W.W.R. 400, 6 C.C.L.T. 265, 88 D.L.R. (3d) 609, 23 N.R. 481; *Reference Re Exported Natural Gas Tax*, [1982] 1 S.C.R. 1004, (sub. nom. *Reference Re Proposed Fed. Tax on Exported Natural Gas*) 136 D.L.R. (3d) 385, [1982] 5 W.W.R. 577, 21 Alta. L.R. (2d) 193, (sub. nom. *Reference Re Alta. Natural Gas Tax*) 42 N.R. 361, 37 A.R. 541.
37. *Ibid.*
38. *Ibid.*

products in order to resolve differences in regional interests between producing and consuming provinces.

Section 51(1) of the PAA also satisfies the second principle enunciated in *Parsons*[39] because it is aimed at the national economy. As Mr. Justice Sherstobitoff stated:[40]

> . . . the Petroleum Administration Act is general legislation aimed at the economy as a single integrated national unit rather than as a collection of separate local enterprises. Although the regulation is of a particular trade, and a narrow segment of that trade, the purpose of the legislation was to deal with the matter of not only national, but international, scope. The economy was in a crisis situation because of international events: the actions of the OPEC countries. The cost of petroleum and natural gas affected not only the cost of fuel, but indirectly affected the cost of almost everything in our economy. Regional conflicts between producing and consuming provinces were involved. There can be no question that the matter at issue was legislation aimed at the economy as a single integrated national unit. . . . Furthermore, the provinces jointly or severally would be constitutionally incapable of passing such an enactment . . . finally, failure to include one or more provinces or localities would jeopardize successful operation in other parts of the country.

The Saskatchewan Court of Appeal rejected Sask Power's argument that the legislation was invalid because it infringed the provincial right to legislate in relation to lands belonging to the province. The Court of Appeal distinguished the cases of *Smylie* v. *R*[41] and *Brooks-Bidlake & Whittall Ltd.* v. *A.G.B.C.*[42] on grounds that those cases dealt with the provinces' rights to make private contracts rather than their rights to legislate. In those two cases, provisions contained in provincially granted timber licences which conflicted with federal legislation were held to be valid. In any event, the Court stated that those two cases may have been implicitly overruled by *Can. Indust. Oil & Gas.*[43]

The last argument advanced by Sask Power was that s. 51(1) of the PAA was intended only to apply to contracts regulated in accordance with Part IV of the National Energy Board Act.[44] The grounds for this argument seem to be that the National Energy Board had made recommendations to the Governor in Council respecting the prices prescribed under s. 51(1) of the PAA and, in addition, the regulations passed under the PAA which prescribed prices had been, at the material times, identical to the orders issued by the National Energy Board prescribing prices payable in respect of gas sold by TCPL. The Court of Appeal rejected this argument. There was nothing in the PAA or the regulations thereunder limiting their application to contracts which are subject to conditions established by the National Energy Board. The prices prescribed by the regulations under the PAA were very similar to the prices prescribed by the National Energy Board in respect of TCPL contracts because the Governor in Council had relied upon advice from the National Energy Board as it was entitled, though not obligated, to do.

Chief Justice Bayda also provided reasons for judgment in respect of the issue relating to the meaning of the term "sold" in s. 51(1) of the PAA. He found that the gas purchase contract gave Sask Power an option to purchase gas from TCPL. This option was exercisable by the making of a nomination. Once the option was exercised, an agreement to sell gas, but not a sale thereof, came into existence.

39. *Supra*, note 35.

40. *Supra*, note 30 at 424-5.

41. (1900), 27 O.A.R. 172 (C.A.).

42. [1923] A.C. 450, [1923] 1 W.W.R. 1150, [1923] 2 D.L.R. 189 (J.C.P.C.).

43. *Supra*, note 36.

44. R.S.C. 1970, c. N-6.

Sales of gas only take place when there is delivery. The gas purchase contract specifically provided that title and risk of gas sold thereunder passed from TCPL to Sask Power upon delivery. Having regard to the ordinary meaning of the term "sold", especially as used in sale of goods legislation, and the provision of the contract noted above, sales took place when deliveries occurred. Section 51(1) of the PAA applied to gas sold after that section was proclaimed. Accordingly, it applied to gas delivered to Sask Power pursuant to the contract after that date.

It is interesting to compare the result in this case to that in the *Petrogas* case[45] where governmental regulation of natural gas prices was considered to be a force majeure.

C. WESTCOAST TRANSMISSION COMPANY LIMITED v. HUSKY OIL OPERATIONS LTD.[46]

For a time prior to deregulation of the natural gas industry in 1985, the price paid to producers of natural gas produced in Alberta and destined for removal from that province was prescribed under the Natural Gas Pricing Agreement Act[47] and the Natural Gas Price Administration Act[48] as the Alberta border price less the applicable cost of service. The cost of service was the cost to the buyer of buying and moving the gas to the Alberta border, as determined by the Alberta Petroleum Marketing Commission. Westcoast purchased natural gas from Husky and the other defendants. Westcoast removed sulphur from the gas in order to make it marketable. The cost of removing the sulphur was included in Westcoast's cost of service. When the price regulation scheme first came into effect, the sulphur had no commercial value. However, world sulphur markets later improved so that Westcoast was able to obtain revenue from the sale of sulphur. The defendants contended that sulphur revenues should be taken into account in Westcoast's cost of service, thereby reducing them. Westcoast contended that sulphur was a part of the gas which it had purchased and that, in any event, only costs, and not revenues, were to be included in the cost of service. The Alberta Petroleum Marketing Commission agreed with Westcoast. The Alberta Public Utilities Board (to whom appeals of the Commission's rulings lie) overturned the Commission's ruling. In this decision, the Court of Appeal sustained the ruling of the Public Utilities Board that sulphur revenues should reduce the cost of service. Because the sulphur is a part of the gas, its value is a factor in the calculation of costs and charges of processing and transportation. The legislation deals with total cost, rather than individual items of expense, so that revenues as well as costs should be taken into account in determining total cost. The object of the legislation is to assure a fair price.

The Commission established a cost of service each month. Husky appealed the February, 1980 ruling by the Commission. Husky did not object to the costs of service for subsequent months in which sulphur revenues were ignored. The Court of Appeal stated that it was not necessary for Husky to object to each and every monthly cost of service, since the first objection placed the matter in issue. Further,

45. *Supra*, note 4.
46. (5 January 1989), Calgary 19754 (Alta. C.A.).
47. R.S.A. 1980, c. N-4.
48. R.S.A. 1980, c. N-3.

the Public Utilities Board has wide power under s. 53 of the Public Utilities Board Act[49] to grant "other relief in addition to . . . that applied for".

D. KHAZANA RESOURCES INC. v. NEIL WEBBER, MINISTER OF ENERGY[50]

Khazana appealed a denial of its application for incentives ("PIP's") under the Petroleum Incentives Program Act.[51] That Act provides for the payment of incentives by the Alberta Government in respect of eligible expenditures incurred in the exploration and development of oil and gas deposits. The incentives equal a portion of eligible expenditures. Section 9(2)(b) of the Petroleum Incentives Program Regulation provides as follows:

> An eligible cost or expense shall be reduced to the extent that any of the following apply to the cost or expense:
>
> (b) it is incurred to earn a working interest or an operating interest and reimburses all or part of a cost or expense previously incurred by the person from whom the interest is earned.

By a letter agreement, Khazana agreed to participate in a joint exploration program formed by two other parties which had been in existence for eighteen months. Khazana agreed to reimburse the other parties for certain of the costs and expenses incurred by them in respect of the program and agreed to participate with them as to a 50% working interest in all projects to which the other parties were then committed. The letter agreement further provided that, by virtue of its commitments thereunder, Khazana was deemed to own and to be entitled to 50% of the other parties' interests in certain lands and in the data from a seismic program previously conducted by the other parties.

Khazana applied for PIP's in respect of the costs of the seismic program. It contended that s. 9(2)(b) quoted above related only to costs incurred to earn a working interest in lands. Khazana argued that the costs of the seismic program reimbursed by Khazana under the letter agreement only earned Khazana an interest in the seismic data. According to Khazana, reimbursement of other costs earned Khazana's interest in the lands.

The Alberta Court of Queen's Bench upheld the decision of the Minister denying Khazana's application for PIP's. The Court noted that under the letter agreement, Khazana acquired an interest in the "entire program". The fact that Khazana was not required to reimburse the other parties for any share of certain drilling costs was irrelevant to the interests acquired by Khazana. The reimbursed costs and the earned interests could not be segregated.

E. THE MINISTER OF ENERGY v. REDEARTH-BISTCHO EXPLORATION PARTNERSHIP[52]

The Minister had refused to grant an extension of time for making applications under the Petroleum Incentives Program Act.[53] The Alberta Court of Queen's Bench overturned that decision. The Minister appealed.

49. R.S.A. 1980, c. P-37, as am.
50. (20 June 1988), Calgary 8701-20839 (Alta. Q.B.).
51. S.A. 1981, c. P-4.1.
52. (27 October 1988), Calgary 10332 (Alta. C.A.).
53. *Supra*, note 51.

In May, 1985, the government agency responsible for administration of the PIP program had disallowed the Partnership's application for PIP's in respect of expenditures incurred in 1983 and 1984 because of inadequate responses to the agency's requests for information. The Partnership sought a clarification. The agency responded in July, 1985, suggesting that the appropriate proceeding would be a ministerial review under s. 25(2) of the Petroleum Incentives Program Regulation.[54] The Partnership did not follow that course. In 1987, Clarkson Gordon Inc., as agent for a creditor of the Partnership, pursued the matter further, which resulted in advice that the agency would accept a resubmission for part of 1983, but not 1984. The applicant requested an extension from the Minister of the time within which to make the applications. As had been recommended by the agency, the Minister granted the extension in respect of a portion of 1983 and refused the extension in respect of 1984.

The respondent argued that since the Minister had allowed information to be provided, it could not rely on the earlier delay in the provision of such information. The Court of Appeal rejected that argument on the basis that the agency did not engage in an exchange of information relating to the rejected applications but only with respect to the portion of the 1983 application for which an extension of time was granted. The Partnership had not taken the steps which the agency had advised it to take. The fact that there was not a published form for the application for ministerial review was not shown to play any part in the Partnership's failure and was irrelevant. In any event, there were no grounds for concluding that the agency would not have made a form available. There was no requirement that it be published. It was also irrelevant that the Minister's decision insulated the agency's legal determination from review. It was open for the Minister to conclude that the Partnership had been guilty of inexcusable delay with respect to the extensions which were not granted.

In the result the Minister's appeal was allowed and his earlier ruling reinstated.

IV. LAND TITLES

A. A.G. CAN. (DIRECTOR OF SOLDIER SETTLEMENT) v. SNIDER ESTATE[55]

This decision of the Alberta Court of Appeal appears to eliminate the interest of the Soldier Settlement Board of Canada as an exception to the indefeasibility of a certificate of title to mines and minerals under the Alberta Land Titles Act.[56]

The Soldier Settlement Board was established by the federal government for the purpose of providing land to soldiers returning from World War I. Section 57 of the Soldier Settlement Act of 1919[57] provides that "[f]rom all sales and grants of land made by the Board, all mines and minerals shall be and shall be deemed to have been reserved, whether or not the instrument of sale or grant so specifies." Thus, it had been thought that if the Soldier Settlement Board obtained title to surface and mines and minerals and then purported to transfer the same, the mines

54. Alta. Reg. 220/82, as am.

55. [1988] 6 W.W.R. 360, 61 Alta. L.R. (2d) 246, 88 A.R. 385 (C.A.).

56. *Supra*, note 18.

57. S.C. 1919, c. 71.

and minerals remained vested in the Board, even if a certificate of title covering mines and minerals was issued to the transferee. It was also thought that a subsequent purchaser for value of the mines and minerals from the transferee would not obtain good title since the provisions of the Soldier Settlement Act[58] would prevail over the provisions of the Alberta Land Titles Act.[59]

This case involved just such a situation. The trial decision[60] ordered cancellation of a certificate of title standing in the name of a *bona fide* purchaser for value of mines and minerals from a transferee of the Soldier Settlement Board.

The Alberta Court of Appeal held that the Alberta Land Titles Act[61] was binding upon the Crown in right of Canada in this case. The Court of Appeal stated that immunity of the Crown in right of one government from the legislation of another government depends on the following two questions:

1. Was the statute intended to bind the other Crown?
2. In the circumstances, can the statute bind the other Crown?

The answer to the first question in this case was affirmative because the relevant provision of the Land Titles Act[62] purports, expressly, to bind the Crown. The answer to the second question is also affirmative because when the federal Crown chooses to shelter itself under provincial land legislation (as it did by registering a transfer), and a prerogative right is not directly affected, the federal Crown must accept the burdens of that legislation. The Soldier Settlement Board was not obligated to register its transfer when it acquired the land. Section 13 of the Soldier Settlement Act[63] stated that no registration of a conveyance to the Board was required in order to preserve its rights, but the conveyance may be registered "if the Board deems it advisable".

The Court of Appeal ordered that the certificate of title of the bona fide purchaser for value be reinstated.

B. A.G. CAN. v. A.G. SASK.[64]

The Saskatchewan Court of Appeal dismissed an appeal of a decision of a judge in chambers, without reasons. The decision of the judge in chambers is reported.

In 1931, the Crown in right of Saskatchewan acquired title to surface and mines and minerals in respect of a section of lands located in Saskatchewan. A certificate of title was issued in the name of the province.

In 1935, the province transferred the surface of the southwest quarter of the section to an individual, specifically excluding mines and minerals. The title which issued to the transferee included mines and minerals.

In 1947, the transferee transferred title to the southwest quarter, including minerals, to the Crown in right of Canada.

58. *Ibid.*
59. *Supra*, note 18.
60. [1985] 2 W.W.R. 149, 34 Alta. L.R. (2d) 314, 35 R.P.R. 192 (Alta. Q.B.).
61. *Supra*, note 18.
62. *Ibid.*
63. *Supra*, note 57.
64. [1988] 5 W.W.R. 706 (Sask. C.A.).

On the face of the province's title, the word "cancelled" appears with the word "error" pencilled through it and the words "alive as to minerals" written above it. None of the entries are dated or signed.

The second encumbrance box on the back of the province's title records the cancellation of the certificate as to the southwest quarter as well as the number of the new certificate of title issued to the transferee. In the upper right hand corner of this box the words "minerals reserved" are stamped.

Section 213 of the Saskatchewan Land Titles Act[65] provides as follows:

> 213.(1) Every certificate of title . . . granted under this Act shall . . . be conclusive evidence, so long as the same remains in force and uncancelled, in all courts, as against Her Majesty and all persons whomsoever, that the person named therein is entitled to the land included in the same. . . .
>
> (2) If more than one certificate of title has been granted in respect of any particular estate or interest in land, the person claiming under the prior certificate shall be entitled to the estate or interest. . . .

The judge in chambers held that, although it was improbable that the registrar would have simultaneously issued a title to the transferee covering mines and minerals and reserved the minerals in the provincial title, in the absence of any evidence to show that the registrar added the words "minerals reserved" at some time following the issuance of title to the transferee, he could not find that the registrar had improperly attempted to rectify an earlier error. He held that he was precluded from questioning the correctness of the province's title since to hold otherwise would be contrary to the intent and purpose of the Land Titles Act[66] and would destroy the conclusive nature of the records in the land titles office. He held that he must assume that the notation reserving minerals was in place when the certificate of title issued to the transferee. He could not find that the province's title had ever been cancelled. In fact, there was an affidavit of the registrar that the province's title had, to the best of his knowledge, at all times been treated as a subsisting title and never cancelled. Accordingly, the province was found to have title to the mines and minerals in question.

V. CREDITORS' RIGHTS

A. NORCEN ENERGY RESOURCES LTD. v. OAKWOOD PETROLEUMS LTD.[67]

Norcen sought to have Oakwood removed as operator of certain oil and gas properties jointly owned by Oakwood and Norcen as a consequence of Oakwood's insolvency. Operation of the jointly owned properties was governed by two operating procedures, one a 1974 form of operating procedure published by the Canadian Association of Petroleum Landmen (CAPL) and the other a 1981 CAPL form of operating procedure. The forms were substantially similar with respect to the matters material to this case. Oakwood had been appointed operator of the properties under the two operating procedures. Clause 202 of the 1981 agreement provided, in part, as follows:

> (a) The Operator shall be replaced immediately and another Operator appointed pursuant to Clause 206, in any one of the following circumstances:
>
> (i) if the Operator becomes bankrupt or insolvent or commits or suffers any act of bankruptcy or insolvency.

65. R.S.S. 1978, c. L-5.

66. *Ibid.*

67. (1988), 63 Alta. L.R. (2d) 361, 92 A.R. 81 (Q.B.).

An order had been issued in respect of Oakwood under the Companies' Creditors Arrangement Act[68] ("C.C.A.A.").

The trial judge found that Oakwood was insolvent. An affidavit filed in connection with the application for the C.C.A.A. order by an executive vice-president of Oakwood contained numerous admissions that Oakwood was unable to pay its debts. In addition, the C.C.A.A. applies only to a "debtor company" which is defined in the C.C.A.A. as any company "that is bankrupt or insolvent or has committed an act of bankruptcy within the meaning of the Bankruptcy Act or is deemed insolvent within the meaning of the Winding-Up Act . . .". The fact that Oakwood was meeting its financial commitments as operator as they became due was not relevant. Insolvency for purposes of the CAPL has its normal meaning and is not restricted to payment of debts pertaining to the operating agreement. If insolvency has a special meaning in the CAPL, restricted to obligations in relation thereto, then the provisions of the CAPL providing for removal of the operator for default of its specific obligations under the CAPL, such as the obligation to pay amounts as they become due, would not be necessary.

The trial judge ruled that Oakwood's insolvency did not result in an automatic ejection of Oakwood as operator. Clause 206 of the CAPL deals with the appointment of a new operator and states:

> (a) if an Operator resigns or is to be replaced, an Operator shall be appointed by the affirmative vote of two (2) or more parties representing a majority of the participating interests, provided if there are only two (2) Joint-Operators to this Operating Procedure and the Operator that resigned or is to be replaced is one (1) of the Joint-Operators, then, notwithstanding the foregoing, the other Joint-Operator shall have the right to become the Operator.

The trial judge ruled that the use of the future tense in clause 206(a) suggests that another party may become the operator only if appropriate steps are taken. Some positive election is required on Norcen's part exercising its right to become the operator. It could not be said that Oakwood ceased to be operator upon becoming insolvent for that would be contrary to what in fact occurred. Oakwood continued to act as operator after it had become insolvent.

Oakwood and certain of its creditors argued that the order made under s. 11 of the C.C.A.A. in respect of Oakwood prohibited Norcen from taking proceedings to remove Oakwood as operator. That order stated in part:

> (c) that no proceeding shall be proceeded with or commenced against Oakwood, its assets, property and undertaking except with leave of this Court with notice to Oakwood and subject to such terms as this Court may impose, and without limitation to any of the foregoing, . . .
>
> (ii) all persons, having rights under the terms of any operating agreements with Oakwood are enjoined and restrained from taking proceedings to remove Oakwood as operator of such petroleum and natural gas properties and facilities, notwithstanding any provision contained in the said Agreements to the contrary, until further order of this Court.

Section 11 of the C.C.A.A., under which the order was made, provides as follows:

> 11. Notwithstanding anything in the Bankruptcy Act or the Winding-Up Act, whenever an application has been made under this Act in respect of any company, the Court, on the application of any person interested in the matter, may, on such notice to any other person, or without notice as it may see fit, make an order staying until such time as the Court may prescribe or until further order all proceedings taken or that might be taken in respect of such company under the Bankruptcy Act and the Winding-Up Act or either of them, and the Court may restrain further proceedings and any action, suit or proceeding against the company upon such terms as the Court sees fit, and the Court may also make an order that no suit, action or other proceeding shall be proceeded with or commenced against the company except with the leave of the Court and subject to such terms as the Court imposes.

68. R.S.C. 1970, c. C-25.

The Court found that the C.C.A.A. is designed to continue, rather than liquidate, companies. The C.C.A.A. is constitutionally valid federal legislation under the jurisdiction of the federal government with respect to bankruptcy and insolvency. An order under the C.C.A.A. which affects some non-creditors in pursuit of the objects of the C.C.A.A. is valid. Surely a necessary part of promoting the continuance of a company is to give the company time to gather its faculties without interference from affected parties. Continuance of a company involves more than a consideration of creditor claims. There is obviously a clear connection between permitting Oakwood to remain as operator and its continuance. There was evidence before the Court that removal of Oakwood as operator would likely be fatal to attempts to restructure Oakwood.

Although the broad interpretation of the C.C.A.A. adopted by the Court may interfere with property and civil rights, matters of provincial jurisdiction, that does not render the interpretation constitutionally invalid since it is necessarily incidental to the purpose of the valid federal legislation to interfere with property and civil rights to a certain extent.

Accordingly, Norcen's application was dismissed and Oakwood was not removed as operator.

B. LEBLANC ESTATE v. BANK OF MONTREAL[69]

This case considered the effect of the Saskatchewan Exemptions Act[70] on the enforcement of security granted pursuant to s. 178 of the Bank Act.[71] The decision is of interest by inference, because in many cases, oil and gas companies grant security to Canadian charter banks pursuant to s. 177 of the Bank Act,[72] which is similar, in many respects, to s. 178 security.

An issue has arisen in many cases whether, for constitutional reasons, valid provincial legislation is applicable in regard to security granted under the Bank Act.[73] In *Bank of Montreal* v. *Hall*,[74] the Saskatchewan Court of Appeal held that s. 178 security was subject to the Saskatchewan Limitation of Civil Rights Act.[75] That case was distinguished in this decision.

Section 173 of the Bank Act[76] provides, in part, as follows:

> 173.(1) A bank may engage in and carry on such business generally as appertains to the business of banking and, without limiting the generality of the foregoing, may . . .
>
> (d) subject to s. 176, lend money and make advances on the security of, and take as security for any loan or advance . . . but no such security is effective in respect of any personal property that at the time the security is taken is, by any statutory law then in force,
>
> (i) exempt from seizure under writs of execution. . . .

Section 178 of the Bank Act[77] permits a bank to lend money to a farmer on a security of various types of personal property. With respect to certain of such property,

69. [1989] 1 W.W.R. 49, 69 Sask. R. 81 (C.A.).
70. R.S.S. 1978, c. E-14.
71. S.C. 1980-81-82-83, c. 40.
72. *Ibid.*
73. *Ibid.*
74. [1987] 3 W.W.R. 525, 7 P.P.S.A.C. 197, 36 D.L.R. (4th) 523, 54 Sask. R. 30 (C.A.).
75. R.S.S. 1978, c. L-16.
76. *Supra*, note 71.
77. *Ibid.*

s. 178 specifically provides that security can only be taken on the property which is exempt from seizure. No such provision is made with respect to other types of property upon which security can be taken under s. 178.

The Saskatchewan Court of Appeal held that s. 173 relates to provincial security interests that could be taken by any lender and s. 178 relates to the special form of security available only to Canadian chartered banks under the Bank Act.[78] This determination was made on the basis of an historical examination of the provisions of the Bank Act. The Court found further support for its conclusion in the fact that s. 178 specifically precludes banks from taking security thereunder with respect to some types of property which are exempt from execution under provincial legislation but not with respect to other types of property which are exempt from execution. Such specific provisions must override the general provision contained in s. 173.

The Court held that the Saskatchewan Exemptions Act[79] is constitutionally invalid to the extent that it prevents the operation of valid federal legislation. The Court distinguished the *Hall* case[80] on the basis that the provincial legislation considered in that case did not prevent the operation of the federal legislation but only delayed the operation of the federal legislation by requiring the bank to give a notice to the debtor before realizing on the security. Since the Exemptions Act[81] prevents realization on security, it was invalid to the extent that it prohibited the bank from realizing on its s. 178 security.

C. BIRCH HILLS CREDIT UNION LTD. v. C.I.B.C.[82]

This case considers the effect of registering security granted under s. 178 of the Bank Act[83] pursuant to provincial personal property security laws. The Saskatchewan Court of Appeal held that the bank's priority under a personal property security registration is not excluded or impaired by its security under s. 178. The existence of rights under both the Bank Act[84] and the Saskatchewan Personal Property Security Act[85] do not involve any inconsistency or clash. The bank is not put to an election in regard to which security it wishes to realize under. Its priority under the Personal Property Security Act[86] entitles it to priority over subsequently registered security interests.

D. LLOYDS BANK OF CAN. v. LUMBERTON MILLS LTD.[87]

In this case, the British Columbia Court of Appeal ruled that because of a negative pledge a floating charge had priority over a lien created after the floating charge

78. *Ibid.*
79. *Supra*, note 70.
80. *Supra*, note 74.
81. *Supra*, note 70.
82. [1988] 5 W.W.R. 592 (Sask. C.A.).
83. *Supra*, note 71.
84. *Ibid.*
85. S.S. 1979-80, c. P-6.1.
86. *Ibid.*
87. [1989] 2 W.W.R. 360, 32 B.C.L.R. (2d) 67 (C.A.).

but prior to its crystallization. Lumberton Mills was created for the purpose of salvaging a mining operation on Vancouver Island. It financed the operation through a loan from the Continental Bank (now Lloyds Bank). Lumberton granted a fixed and floating charge debenture to the bank. The debenture specifically provided that Lumberton "shall not have power without the prior written consent of [the bank] to create . . . any . . . lien . . .". Lumberton entered into a contract with a shipper for the dismantling of equipment salvaged from the mining operation and the transportation of the dismantled equipment to Vancouver. The shipping contract granted a lien on the equipment in favour of the shipper. Subsequently, a default occurred and the floating charge was crystallized.

The Court of Appeal held that the lien granted to the shipper contravened the negative covenant contained in the debenture. The Court rejected the argument that because the bank knew that a shipper would have to be engaged and knew or should have known that such engagement was of the kind that could give rise to liens, the bank should be taken as having acknowledged or accepted the priority of such liens. The Court stated that in view of the clear prohibition contained in the debenture, there was no basis for finding that the bank authorized the creation of the shipper's lien. The Court stated that if the shipper had knowledge of the prohibition on the creation of liens contained in the debenture, effect would be given to the prohibition so as to defeat the shipper's lien. It was clear that the shipper did not have actual notice of the debenture. However, the debenture was registered with the office of the Registrar of Companies prior to the shipping contract being made. It was therefore available for inspection by the shipper. The Court of Appeal held that mere registration of the debenture did not create constructive notice of the terms thereof. However, there is an equitable doctrine whereby a person cannot claim lack of notice of a registered document where it should have made inquiry. The Court found that the shipper should have made inquiry.

It should be noted that the implications of this case may be affected by statutory provisions regarding the effect of registration.

VI. TAX

A. ESSO RESOURCES CANADA LTD. v. R.[88]

This case considered whether the repeal of the Natural Gas and Gas Liquids Tax terminated Esso's entitlement to a refund of such taxes to which it would otherwise have been entitled.

The tax was levied under the Excise Tax Act[89] on natural gas liquids produced at gas processing plants. Section 34(2) of that Act provided that "no tax is payable under this section in respect of . . . (b) natural gas liquids injected as miscible flood material into a natural reservoir in Canada for the enhanced recovery of oil from that reservoir . . .". The Act prescribed that the tax was to be collected at the outlet of the processing plant and, if the natural gas liquids in respect of which the tax was paid were exempt from the tax, then the person who used the liquids for enhanced recovery could obtain a refund of the tax.

88. 88 DTC 6469, [1988] 2 C.T.C. 312 (F.C.T.D.).

89. R.S.C. 1985, c. E-15.

In March, 1986, the Natural Gas and Gas Liquids Tax was repealed.[90] The repeal extended to s. 68(1)(g) which provided for refunds of the tax paid on natural gas liquids which were exempt from the tax. On December 1, 1986, after the repeal, Esso applied for a refund of the tax to which it would clearly have been entitled if s. 68(1)(g) had not been repealed.

The tax was payable by the person who owned the liquids at the outlet of the gas plant. The refund was available to the person who used the liquids for enhanced recovery of oil, regardless of whether that person had paid the tax. In fact, Esso had purchased a large portion of the liquids from the person who had paid the tax and had used them for enhanced recovery of oil after the effective date of the repeal of the tax.

Section 43(c) of the Interpretation Act[91] provides that, unless there is a contrary intention:

> . . . where an enactment is repealed in whole or in part, the repeal does not . . .
>
> (c) affect any right, privilege, obligation or liability acquired, accrued or accruing or incurred under the enactment so repealed.

In *Gustavson Drilling (1964) Ltd.* v. *M.N.R.*,[92] Dickson J., as he then was, when considering that section, stated as follows:[93]

> No one has a vested right to continuance of the law as it stood in the past. . . . The mere right existing in the members of the community or any class of them at the date of the repeal of a statute to take advantage of the repealed statute is not a right accrued.

That case dealt with items which were deductible in computing income tax. The statute in question had been amended so that the taxpayer could no longer deduct such items. It was held that, even though the items had been incurred prior to the statute being amended, they could not be deducted in computing the tax after the statute had been amended.

Nevertheless, the Court in this case concluded that Esso had a right which had accrued at the time the tax was repealed. No tax was payable in respect of the natural gas liquids because they were exempt from the tax. The fact that it was not possible to ascertain that the liquids were exempt from the tax until after the repeal became effective does not alter the fact that the liquids were exempt from the tax. Although it might be necessary to take steps to enforce a right, the right may nevertheless exist prior to such steps having been taken. This fact situation is in contrast to the situation where a person has an expectation of a right or a potential to have a right. In *Gustavson*,[94] the taxpayer was complaining of its inability to use the deductions to avoid paying taxes which would otherwise be payable after the repeal. The right to avoid paying such taxes did not exist at the time of the repeal since those taxes had not then accrued. In this case, the right to the refund existed when the legislation was repealed.

It was also argued that the repeal of the provisions containing the mechanics whereby a refund could be obtained necessarily implied a contrary intention to the presumption contained in s. 43(c) of the Interpretation Act.[95] However,

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90. An Act to Amend the Excise Tax Act and the Excise Act and to Amend Other Acts in Consequence Thereof, S.C. 1986, c. 9.

91. R.S.C. 1985, c. I-21.

92. [1977] 1 S.C.R. 271, 7 N.R., 401.

93. *Ibid*, at 282-3.

94. *Ibid*.

95. *Supra*, note 91.

s. 68(1)(a) of the Excise Tax Act[96] (which was not repealed) provided for a refund of taxes imposed by that Act "where an overpayment has been made by the taxpayer". The Court construed this provision as being broad enough to permit a refund to Esso even though Esso wasn't the person who paid the tax.

B. HUSKY OIL OPERATIONS LTD. v. SASKATCHEWAN (MINISTER OF ENERGY AND MINES)[97]

The Saskatchewan Oilwell Income Tax Act[98] imposed a tax on oilwell income. In computing its oilwell income, a taxpayer was entitled to deduct certain costs and expenses from its gross oilwell income. The amount of the costs which could be deducted was to be reduced by the amount of government incentives received by the taxpayer in respect of the costs. The tax was repealed. Husky did not reduce the amount of costs incurred prior to the repeal by the amount of incentives in respect of such costs received after the repeal.

The case turned on an interpretation of ss. 503(2) and 601(3) of the Oilwell Income Tax Regulations, 1981, which are identical for all material purposes. The pertinent provisions of s. 503(2) providing that the deduction on account of the costs of acquiring oilfield assets is to be reduced by incentives are the following:

> Less that portion of any amount:
>
> (a) credited to the approved expenditure credit bank account of the taxpayer . . .;
>
> that may reasonably be regarded as having been so credited . . . in respect of or as a consequence of the acquisition of such qualified oilwell asset by the taxpayer.

The Saskatchewan Court of Appeal held that the incentives must satisfy two requirements before they will reduce the costs: they must have been credited and they must be in respect of the acquisition of the asset. The incentives should not be taken into account until both of those requirements have been satisfied. Since that did not occur until after the tax had been repealed, the incentives need never be taken into account in computing Husky's liability for the tax.

There were two types of incentives involved. One incentive reduced one kind of deduction and the other incentive reduced another kind of deduction. It was not possible to determine with certainty which deduction an incentive would reduce until the incentive had been credited to the taxpayer's account. Accordingly, the Court of Appeal found that its interpretation was in harmony with the scheme of the Act. The Court of Appeal further held that the application of the so-called "matching principle" was not warranted in this case. The "matching principle" is a principle of tax law under which revenues and related costs should be applied against each other.

C. CARSON v. THE MINISTER OF NATIONAL REVENUE[99]

This is a transcript of an oral judgment in which a limited partnership arrangement was held not to have any commercial purpose but to have been established solely for the purpose of obtaining tax deductions, with the result that the deduc-

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96. *Supra*, note 89.
97. (1988), 66 Sask. R. 161 (C.A.).
98. R.S.S. 1978, (Supp.) c. 0-3.1, as am.
99. 88 D.T.C. 1249 (T.C.).

tions claimed by the limited partners were disallowed. The judgment is not entirely clear. However, it appears that the limited partnership entered into a drilling contract under which the partnership agreed to pay $44,100,000 to a company called Ganders Petroleum Inc. in consideration of that company agreeing to drill wells on certain lands in the United States in respect of which the partnership purported to have options. The partnership issued promissory notes to cover the payment of this sum. The partnership then transferred all of its rights under the drilling contract to another partnership on a roll-over basis pursuant to s. 97(2) of the Income Tax Act[100] for deemed consideration of one dollar. The first partnership retained the liability under the drilling contract. There was no evidence that Ganders had the expertise or assets to cause the wells to be drilled. Although the option was described in a prospectus, no option agreement was drafted. No title review was made of the option lands. It would appear that none of the wells was ever drilled. After the drilling contract was entered into, units in the partnership had been sold to investors. The investors gave cash and a promissory note to the partnership to pay for their investment. The promissory notes totalled $41,100,000. It is not clear what happened to those notes, although it would appear that no demand was ever made for payment.

D. TEXACO CANADA RESOURCES LTD. v. ALBERTA ASSESSMENT APPEAL BOARD[101]

The Alberta Municipal Taxation Act[102] provides a special rule for the assessment of land which is occupied for the following purposes:

(a) working any mines or minerals in or under that land or in or under land in the vicinity of it,
(b) drilling for oil, salt or natural gas, or
(c) operating a well for oil, salt or natural gas.

It was argued that since paragraphs (b) and (c) specifically referred to oil and natural gas, paragraph (a) must only apply to mines and minerals other than oil and natural gas. It was also argued that since paragraphs (b) and (c) referred only to wells, land occupied for the purpose of operating pumping, processing or storage facilities were not subject to the special rule. The Alberta Court of Appeal rejected that argument. There is no logical reason why the narrow language in paragraphs (b) and (c) should affect the meaning of paragraph (a). Mines and minerals include petroleum and natural gas. The operation of a well includes storage, production and processing facilities. Whichever of these items do not fall within paragraph (c) fall within paragraph (a).

E. NOVA, AN ALBERTA CORPORATION v. MINISTER OF NATIONAL REVENUE[103]

The issue in this case was the proper classification, for capital cost allowance purposes, of the valves and pipelines used in connection with the movement of natural gas from Nova's main pipeline into compressors and meters and then back

100. S.C. 1970-71-72, c. 63, as am.
101. (1988), 64 Alta. L.R. (2d) 37 (C.A.).
102. R.S.A. 1980, c. M-31.
103. (1988), 87 N.R. 101 (F.C.A.).

into the main pipeline. The equipment comes within either class 2(b) or (d) or class 8(d) of Schedule B of the Income Tax Regulations. The material provisions of class 2(b) and (d) are:

> (b) a pipeline, other than gas or oilwell equipment, . . .
>
> (d) manufacturing and distributing equipment and plant (including structures) acquired primarily for the production or distribution of gas . . . .

The material part of clause 8(d) is as follows:

> (d) a tangible capital asset that is not included in another class in this Schedule . . . .

The majority of the Federal Court of Appeal sustained the decision of the Trial Division[104] and held that the equipment fell within class 8(d). The term "pipeline" in class 2(b) refers to the main pipeline and all equipment integral to the main pipeline. The valves and pipelines in question were integral to the compression and metering stations and not the main line. The term "pipeline" has the meaning used in the natural gas industry rather than its ordinary meaning, since its ordinary meaning is equivocal and since the capital costs allowance schedules are used with regard to specific industries, although it was acknowledged that class 2(d) applied to all pipelines and not just those used to carry natural gas. The generally accepted meaning of the term "pipeline" in the industry includes only the main pipe and equipment necessarily incidental thereto. This was evidenced by the definitions in the Canadian Standards Association Z-18Y Code and by oral testimony.

The equipment was not "distributing equipment" for the purposes of class 2(d) since Nova was not in the distribution business. The ordinary meaning of "distribution" implies an allocation or allotment. Nova merely carried natural gas owned by other parties from the field to the facilities of other common carriers. It made no allotment or allocation. Further, distribution is a separate part of the natural gas business from transmission. Distributors deliver natural gas to end-users. Those in the transmission business carry natural gas from the producer to a distributor or to another person in the transmission business.

The majority distinguished the case from *Northern and Central Gas Corporation Limited* v. *Minister of National Revenue*[105] in which a liquified natural gas plant used mainly for storing natural gas in liquid form was held to be distribution equipment on the basis that the taxpayer in that case was a distributor.

Mr. Justice Pratte dissented, on the ground that the *Northern and Central* case held that distribution equipment in class 2 includes equipment used in both transmission and distribution.[106]

F. NOWSCO WELL SERVICE LTD. v. MINISTER OF NATIONAL REVENUE[107]

In this case, it was held that Nowsco's business involved the manufacturing or processing of goods for sale for the purposes of the Income Tax Act.[108] Nowsco's business involved treating wells for the purpose of facilitating the taking of production of oil and gas therefrom. The treatment involved pumping various mixtures

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104. (1987), 9 F.T.R. 277 (F.C.T.D.).
105. [1987] 2 C.T.C. 241, 80 N.R. 383 (F.C.A.).
106. *Ibid.*
107. 88 D.T.C. 6300, 60 Alta. L.R. (2d) 423 (F.C.T.D.).
108. *Supra*, note 100.

into wells, often under pressure, for purposes of cementing the casing or fracing, acidizing or otherwise stimulating the producing formation in order to increase the flow of oil and gas through the formation into the wellbore. The mixtures pumped into the well were designed by Nowsco (usually in consultation with the owner/ operator of the well) and prepared by Nowsco, usually at the wellsite. Nowsco provided the pumps and other equipment required for such services. The services were implemented by its personnel. Nowsco was paid a fee for these services.

The Court ruled that the functions performed by Nowsco involved a processing operation because the mixtures pumped into the well were prepared by Nowsco. Nowsco could not merely purchase the products to be pumped into the well since the mixtures were complex and required preparation, usually at the wellsite, to meet the specific needs of Nowsco's customer. The wellsite equipment used by Nowsco was a mobile factory. It was held that this mobility should not disentitle Nowsco to the tax benefits enjoyed by a processing plant. The mixing and blending functions need not be separated from the pumping and pressurizing functions, since they form part of one continuous process. The mobile units should not be treated as automobiles, either in whole or in part, since their primary function is not transportation but processing. The decision in *Haliburton Services Limited* v. *Her Majesty the Queen*[109] was not followed.

G. MARKIN v. M.N.R.[110]

This case considered the tax implications of a net profits interest granted to an employee of an oil company.

Markin was a senior employee and officer of Merland Explorations Limited. He was granted net profits interests as part of Merland's incentive program for its senior employees. Net profits interest agreements were entered into in 1979, 1980 and 1981. Each agreement granted Markin a share of the net profits from the oil and gas properties acquired by Merland during the year to which the agreement related. Late in 1981, the agreements were amended to provide that if Markin's employment with Merland terminated, Markin would have the right to cause Merland to purchase the net profits interests. Subsequently, Markin's employment with Merland was terminated and Markin exercised his rights to put the net profits interests to Merland.

Markin filed his income tax return on the basis that the proceeds from the disposition of the net profits interests constituted a capital gain.

The Minister of National Revenue contended that the payment made to Markin upon exercise of the put was employment income. Section 6 of the Income Tax Act[111] provides, in part, as follows:

> 6(1) There shall be included in computing the income of a taxpayer for a taxation year as income from . . . such of the following amounts as are applicable:
>
> (a) the value of board, lodging and other benefits of any kind whatsoever received or enjoyed by him in the year in respect of . . . employment . . .

109. 85 D.T.C. 5336.
110. 88 D.T.C. 2454 (T.C.C.).
111. *Supra*, note 100.

> 6(3) An amount received by one person from another . . .
>
> (b) on account . . . of . . . an obligation arising out of an agreement made by the payor with the payee immediately . . . after a period that the payee was . . . in the employment of . . . the payor
>
> shall be deemed, for the purposes of Section 5, to be remuneration for the payee's services rendered . . . during the period of employment, unless it is established that . . . it cannot reasonably be regarded as having been received
>
> (c) as consideration . . . for entering into the contract of employment,
>
> (d) as remuneration . . . under the contract of employment, or
>
> (e) in consideration . . . for a covenant with reference to what the . . . employee is, or is not, to do before or after the termination of the employment.

The Minister of National Revenue contended that the payment made upon exercise of the put fell within paragraph 6(3)(e). Markin contended that, at worst, the payment fell within paragraph 6(1)(a) with the result that an amount equal to the value of a net profits interest should have been included in Markin's income from employment in the year in which the interest was granted, the interest is a capital asset and, upon disposition, the proceeds in excess of the value of the interest when it was first granted is a capital gain.

The Tax Court found that the payment was a payment in respect of employment. The recitals to the net profits interests agreement stated that the interests were "an incentive to the employee". Paragraph 7 of the agreement stated that the interest was "a discretionary payment only and not to be treated as salary, wage or other regular employment income". The Tax Court stated that even if the payment was not regular employment income, it was still income from employment.

The Tax Court found that it was up to Merland to decide when to make payments in respect of the net profits interest and therefore concluded that the net profits interest was not a right because Merland had no obligation to make any net profits payments to Markin. The Court referred to paragraph 3(e) of the net profits interests agreement in this regard. Yet that paragraph states that if there is a positive net profits at the end of a calendar month, Merland "shall pay" the appropriate percentage of the net profits to the employee within 45 days of the end of the calendar month. It would seem that, in fact, no payments on account of the net profits were paid to Markin. It is not clear whether there were any net profits.

The Tax Court concluded that it was only when the agreements were amended in 1981 to provide for the put that Markin had any right to receive any payments.

The Tax Court found that Markin could not be taxed on an employment benefit until he received it. It would seem (though it is not totally clear from the judgment) that since Markin had no right to receive any payments in respect of the net profits interest until the 1981 amendment and in fact had not received any payments, Markin could not be taxed until either his right to receive payment vested (i.e. when the put was exercised) or the payment was received, both of which occurred in 1982.

If the case turns on Markin not being entitled to receive net profits payments from Merland unless Merland chose to make the payments, then the decision may be wrong. Subclause 3(e) of the net profits interest agreement clearly states that Merland is obligated to make the payment, if there are net profits. It might be argued that because the net profits interest is stated to be discretionary and not to be employment income, there is no consideration flowing from Markin so that the agreement is not enforceable because of a lack of consideration. However, that reasoning is not apparent in the decision.

The Minister argued, in the alternative, that the net profits interest was a Canadian resource property. If that were so, the proceeds from the disposition thereof upon exercise of the put would be taxed as income. A Canadian resource property is defined in paragraph 66(15)(c) of the Income Tax Act,[112] the relevant provisions of which are as follows:

> 66.(15) . . .
>
> (c) Canadian resource property . . . means any property . . . that is . . .
>
> (iv) any rental or royalty computed by reference to the amount or value of production from an oil or gas well in Canada, . . .
>
> (vii) any right to or interest in any property (other than property of a trust) described in any of subparagraphs (i) to (vi) (including a right to receive proceeds of disposition in respect of a disposition thereof);

The Court stated:[113]

> . . . it is obvious that one of the main elements of the royalty in reference to mines and wells is that the person who receives the royalty must be the owner of the properties, mines or wells. Moreover, the royalty varies in amount according to the production.
>
> In the present case, the appellant's rights in the fund created by Merland pursuant to the agreement does not give the appellant a right in the oil and gas wells. . . .
>
> The fact that the net profit of oil and gas wells production is used as a yardstick in the accumulation of the fund is not sufficient to meet the wording of subparagraph 66(15)(c)(iv) of the Act and make the payment a royalty.

The Court found that the word "interest" in subparagraph 66(15)(c)(vii) means "financial interest" coming from the ownership of property described in any of subparagraphs (i) to (vi). Markin did not have an ownership interest in any such property.

The Court's finding that the net profits interest is not a Canadian resource property is acknowledged by the trial judge to be *obiter dicta*. In any event, it is submitted that the Court's analysis is incorrect. In the writer's experience, a royalty owner never has an interest in the wells to which the royalty pertains. It may be that the Court meant that for an interest to be a royalty, it must have been reserved out of an interest in the mines and minerals. In that case, lessor royalties and gross overriding royalties reserved upon the grant, sale or farmout of an interest in mines and minerals may fit within the definition of Canadian resource property but other gross overriding royalties, such as those granted to a geologist, may not. It remains to be seen if a net profits interest reserved on a sale of an interest of mineral rights would be a Canadian resource property.

It is understood that the decision has been appealed.

VII. SURFACE RIGHTS

A. HUSKY OIL OPERATIONS LTD. v. SHELF HOLDINGS LTD.[114]

The issue in this case was whether a pipeline right of way constituted an easement. Under s. 65(1)(g) of the Alberta Land Titles Act,[115] a "right of way or other easement granted or acquired under any Act or law in force in Alberta" is

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112. *Ibid.*

113. *Supra*, note 110 at 1319.

114. (1989), 94 A.R. 241 (C.A.).

115. *Supra*, note 18.

an exception to the indefeasibility of a certificate of title so that any such right-of-way or other easement which is not registered against the title will nevertheless have priority over registered interests.

The Crown in right of Alberta agreed to sell certain unpatented lands (i.e. lands for which no certificate of title had been issued). The purchaser gave Husky a right of way for the construction of a pipeline across the lands. The right of way was registered in the day book at the Land Titles Office. Subsequently, a certificate of title to the lands was issued to the Crown. The lands were then transferred to the purchaser. The lands were subsequently sold and became registered in the name of Shelf. At no time was Husky's right of way noted on any of the certificates of title to the lands.

It was acknowledged that the pipeline right of way was granted or acquired under an Act or law in force in Alberta. The only question in the case was whether or not it was a "right of way or other easement" for the purposes of s. 65(1)(g) of the Land Titles Act.[116]

The habendum clause in the right of way granted the following interest:

> The right, licence, liberty, privilege and easement to use so much of the said lands as may be necessary for a right of way for the laying down, construction, operation, maintenance, inspection, removal, replacement, reconstruction and repair of a pipeline, together with all such stations . . . and other equipment . . . as may be necessary or convenient in connection therewith . . . and the right of ingress and egress for all purposes incidental to this grant . . . for so long hereafter as the Grantee may desire to exercise the rights and privileges hereby given. . . .

The grantor was prohibited from excavating and similar acts along the right of way but otherwise retained full use of the right of way. The grantee was required to compensate the grantor for damage to the lands, including crop damage. On abandonment of the right of way, the grantee was required to restore the lands to their original condition. The right of way contained a covenant by the grantor of quiet enjoyment, subject to the grantee observing the terms and conditions of the right of way agreement.

The Court of Appeal carefully reviewed the law relating to the nature of easements. It concluded that the instrument was either an easement or a conveyance of exclusive ownership and possession of land. The mere fact that the grant interfered with or impaired the use of the right of way lands by the owner does not mean that the grant is an outright conveyance of ownership. An easement must give the grantee some rights in respect of the land and therefore must detract from the owner's rights in respect of the land. In the present grant, the owner's rights to use the lands were impaired only to the extent of the grantee's limited rights to use the lands. The requirements that the grantee compensate the grantor for damages to the lands, return the lands to the grantor in their original state when the grantee abandoned its rights and would have quiet possession only if it observed the terms of the agreement are inconsistent with a conveyance of exclusive ownership and possession. The grant was construed to be an easement.

116. *Ibid.*

B. CABRE EXPLOR. LTD. v. ARNDT[117]

Section 26(9) of the Alberta Surface Rights Act[118] provides that costs of appeals of decisions of the Surface Rights Board shall be paid by the operator (i.e. the oil company) unless there are special circumstances or the appeal is brought by the surface owner and is unsuccessful, in which case costs are in the discretion of the Court. In this case, it was held by the Alberta Court of Appeal that s. 26(9) does not violate s. 15 of the Canadian Charter of Rights and Freedoms.

C. SANDBOE v. COSEKA RESOURCES LTD.[119]

A decision of the Alberta Court of Queen's Bench on an appeal under the Surface Rights Act[120] was returned to the Court of Queen's Bench for a new trial because of a reasonable apprehension of bias on the part of the trial judge. The apprehension of bias resulted from remarks made in a pre-trial conference. The issue of bias had been raised at the outset of the trial and had been rejected by the trial judge. The Court of Appeal held that the appellants did not lose the right to appeal by waiting until the conclusion of the case rather than refusing to participate in the trial because of the alleged bias.

D. PEACOCK v. SURFACE RIGHTS BOARD (ALTA.)[121]

Two right-of-entry orders had been granted by the Alberta Surface Rights Board to TransAlta Utilities Corporation for the erection of power transmission towers and lines on Peacock's lands in 1978. In 1985, Peacock and TransAlta signed a settlement agreement providing for compensation to be paid to Peacock for TransAlta's use of his lands. The acknowledgement agreement expressly reserved all rights under the Surface Rights Act,[122] including rights to a rehearing under s. 32. Peacock subsequently sought additional compensation on account of damages resulting from the effect of the power lines on the installation and operation of irrigation equipment. The irrigation equipment had not been installed at the date of the right-of-entry orders. At the hearing before the Surface Rights Board, TransAlta contested the Board's jurisdiction to award damages on account of facts occurring after the right-of-entry orders were issued. The Board adjourned the hearing without receiving evidence from Peacock and thereafter dismissed Peacock's application. Peacock appealed.

The Court held that under the Administrative Procedures Act,[123] and at common law, the Surface Rights Board has a duty to act in accordance with the principles of natural justice and to accord each applicant the opportunity to present its case. The Board failed to do that in this case and therefore its ruling was quashed and the matter referred back to the Board for determination.

117. [1988] 5 W.W.R. 289, 60 Alta. L.R. (2d) 172, 87 A.R. 149 (C.A.).
118. S.A. 1983 (1st session), c. S-27.1, as am.
119. (1989), 64 Alta. L.R. (2d) 172 (C.A.).
120. *Supra*, note 118.
121. (1989), 94 A.R. 25 (Q.B.), 41 L.C.R. 11.
122. *Supra*, note 118.
123. R.S.A. 1980, c. A-2.

E. ZAJES v. PANCANADIAN PETROLEUM LIMITED[124]

An appeal of a decision of the Alberta Surface Rights Board under the Surface Rights Act[125] was dismissed because there was no cogent reason for disturbing the decision. In particular, the Court of Queen's Bench noted that the compensation provided for under the Act does not extend to damages resulting from the conduct of the operator, even if that conduct has been objectionable.

F. INTENSITY RESOURCES LTD. v. DOBISH[126]

This decision exhaustively reviews the case law pertaining to appeals of decisions of the Surface Rights Board under the Alberta Surface Rights Act.[127] In particular, it considers when the Board should award damages for the taking of land under a right of entry order on the basis of an agreement between a group of landowners and an operator or a pattern of voluntary settlements between surface owners and operators rather than on the basis of the specific heads of damages enumerated in s. 25(1) of the Surface Rights Act.[128] It states that an agreement or pattern of dealing should only be relied upon if it is similar to the fact situation under consideration by the Board. It lists the following factors where similarities should exist:

1. The region.
2. The location of the site being taken (i.e. corner, border or centre of the owner's lands).
3. The size of the site being taken.
4. The configuration of the site.
5. The presence or absence of access roads.
6. The nature of the land and its use.
7. The type of crops grown, the rotation and the expected return.
8. The type of well-site, gas or oil.
9. The presence or absence of inconvenience such as noise, odour, weeds and frequency of servicing.

The trial judge stated that this list is not exhaustive.

In this case, only one agreement between an operator and a group of landowners had been in evidence before the Board. Nevertheless, it appeared that the Board relied upon other agreements of which it had knowledge as a result of other applications which it had considered. The Court found that the Board erred in relying on the other agreements since the parties were not given the opportunity to comment on the other agreements.

Nevertheless, based upon the information before it and after an exhaustive review of each of the heads listed in s. 25(1) of the Act, evidence of voluntary settlements in similar situations and of the agreement between an operator and a group of surface owners, the Court found that there was no cogent reason for disturbing the decision of the Board and dismissed the appeal.

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124. (1989), 96 A.R. 39 (Q.B.).
125. *Supra*, note 118.
126. (1989), 66 Alta. L.R. 43 (Alta. Q.B.).
127. *Supra*, note 118.
128. *Ibid.*

G. HUSKY OIL OPERATIONS LTD. v. NELSON[129]

Nelson had granted a surface lease to Husky for use as a well-site, a pipeline right of way and a roadway. Husky subsequently obtained a right-of-entry order over the land for a flowline. In fact, Husky laid a service line rather than a flowline. The surface owner sought additional compensation arising from the change in use. The Saskatchewan Surface Rights Acquisition and Compensation Act[130] defines a "flowline" as a pipeline used to transport production to a separator, treater or similar facility, and a "service line" as a pipeline which is not a flowline. However, the method of computing compensation is the same for a flowline or a service line. In any event, the Court of Appeal found that either use was covered by the surface lease and that to award additional damages would be unfair since Nelson had already accepted the payments under the surface lease as full compensation.

H. KRUCZKO v. NORTH CANADIAN OILS[131]

In April, 1988, North Canadian sought a right-of-entry order for a well-site on Kruczko's lands. The application was dismissed by a Board of Arbitration appointed pursuant to the Saskatchewan Surface Rights Acquisition and Compensation Act[132] on the basis that North Canadian had not made sufficient attempts to negotiate a surface lease and there was no urgency when the application was made. In July, 1988, North Canadian brought another application for a right-of-entry order, which was granted. Kruczko appealed the latter decision on the basis that it constituted a rehearing or appeal of the earlier decision. The Saskatchewan Court of Queen's Bench dismissed Kruczko's appeal and upheld the Board's ruling. The Court also dismissed Kruczko's appeal with respect to costs awarded by the Board, ruling that the Board has discretionary powers on the awarding of costs.

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129. (1987), 59 Sask. R. 47, 38 L.C.R. 136 (Sask. C.A.).

130. R.S.S. 1978 c. S-65, as am.

131. (1988), 40 L.C.R. 1 (Sask. Q.B.).

132. *Supra*, note 130.