

THE NEGOTIATOR

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But You Didn't Ask Me to Pay!

Triggering Offset Well Payments under the 1991 CAPL Lease

EVERY YEAR I TEACH THE CAPL FREEHOLD MINERAL LEASE COURSE and spend about an hour discussing offset wells under clause 8 of the 1991 CAPL Alberta form of PNG Lease. It never ceases to amaze me how many issues and strongly held opinions arise in relation to a clause that seems very simple. The problem I face

as an instructor is that all I can really share are my opinions on how to interpret the offset clause. There is unfortunately very little Canadian judicial authority that clarifies the many issues that arise in interpreting the text.

When I was younger and better looking, I imagined I had some special inside knowledge into

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interpreting the CAPL lease. Information I could only share with my clients. However, after having viewed the 10 minute slide show presentation on the Freehold Owners Association website entitled "Understanding Your Lease – The Offset Well Clause", I came to realize there are no secrets. The slideshow and a lot more useful lease information are located on the Freehold's website at www.fhoa.ca. I highly recommend that any landman working freehold lands spend a couple of hours on the site.

So being freed from my concern for giving out secrets, I have decided to discuss one offset issue a month in *The Negotiator*. My thoughts only, for what it's worth.

This month we will consider the issue of *when* the requirement to pay offset compensation under clause 8(d) is triggered. I thought this issue was extremely straight forward and simple, however when I provided my interpretation (as set out below) I thought a couple of landmen in class were going to start a fist fight.

Clause 8 and the offset well definition in clause 1(f) contain numerous conditions and provisos that we will not discuss. For now, just remember that not every well is an offset well and the facts with respect to your lands and the offset well must be carefully considered prior to responding to potential offset wells.

Let's assume you have a straight forward offset well. What happens after six months of commercial offset production? Under clause 8, the lessee has four options:

- (a) drill;
- (b) pool or unitize the offset well with the said lands;
- (c) surrender the offset zone; or
- (d) pay the compensatory royalty.

In my view, until one of (a), (b) or (c) has occurred, the obligation to pay the compensatory royalty is the default election of the lessee. That is to say the obligation to pay is triggered immediately upon the expiry of the six month period without any further notice or action by the lessor.

The kicker is that the lessee or landman usually finds out about this obligation to pay by way of a nice letter from the lessor (or usually a middleman broker) which notes the offset well and request back payment of about two years of compensatory royalty payments. This is where the fireworks usually start. The lessee or landman often responds that since the lessor did not ask them to pay compensatory royalties it is unfair that an obligation to pay was automatically triggered at some date in the past.

Another way of putting this argument is to say that the failure to pay compensatory royalties is an event of default under the lease and that the lessor can only enforce such a breach by issuing a default notice under clause 15. Only after the default notice has been issued must the lessee make an election under clause 8, which might include an election to pay compensatory royalties. A smart landman usually comes to the conclusion that had he been provided notice of the offset a couple of years back he would have surrendered the lease. Hence his response to the default notice today is to surrender the offset zone and refuse to pay past compensatory royalties.

Right. Sounds good. I don't buy it for a minute. Clause 8 states that the lessee shall do (a), (b), (c):

or ... (d) pay to the Lessor at such times as royalty would be payable pursuant to the provisions of this Lease, until the provisions of paragraphs (a), (b) or (c) of this clause are met, a royalty which shall be proportionally equivalent...



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By not doing (a), (b) or (c) the lessee is deemed to have elected (d) until the provisions of paragraphs (a), (b) or (c) are met. Sounds like an automatic trigger after six months of production to me. There is no requirement in clause 8 for the lessor to provide notice to the lessee to trigger the obligation to pay. A default notice may eventually be issued demanding payment for unpaid compensatory royalties, however I do not support an interpretation of clause 8 which would require such notice prior to the payment obligation being triggered. In fact, if you refuse to pay in response to a default notice, I think you risk having your lease terminate under clause 15 and still have the obligation to pay for past compensatory royalties.

Sounds like tough love, but apart from the wording being pretty unambiguous, this interpretation is, I believe, supported by:

- the legal drafting principle of contra preferentem, which means that any ambiguity in a standard form document is interpreted against the party that drafted it. CAPL drafted the document and should have been more clear if they didn't want an automatic compensatory royalty;
- the common law duty of a lessee to protect a lessor from drainage. I do not believe that this duty can be implied into the lease, however I expect a court would look to this duty to prevent drainage in interpreting the offset clause. If you have

the exclusive right to win, take and remove leased substances, you probably have an active duty to prevent drainage; and

- the truly brutal track record of lessees in legal decisions regarding freehold leases. Do you honestly think a judge will say to some little old lady from Milo that she is not entitled to compensatory royalties under her lease, unless and until, she provides a notice of default to an oil company that is in the business of drilling wells and keeping track of activity in the area? Maybe, but I think not.

One bit of consolation may be limitations under the Limitations Act. It is possible that the lessee is limited to a two year look back in Alberta with respect to unpaid compensatory royalties. You will find that lessors will settle for two years of back payments without too much fuss.

Feel free to sign up for the CAPL Freehold Mineral Lease course on February 28, 2008 if you wish to yell at me about my crazy views. Next month I hope to discuss the issue of whether the payment of the compensatory royalty will continue a CAPL lease beyond its primary term. ☐

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