Freehold Lease Termination and Damages: The Post Stewart Estate World

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BUSINESS LAW

Welcome

Today we are going to talk about **“Disgorgement”**.

THE POST STEWART ESTATE WORLD - DISGORGEMENT

Disgorgement is a funny sounding word, isn't it?

Disgorgement is generally **unpleasant** for the party who must disgorge (the *"disgorger"*).

THE POST STEWART ESTATE WORLD - DISGORGEMENT

Spoiler Alert:

In *Stewart Estate*, the "disgorger" was the oil company (lessee).

THE POST STEWART ESTATE WORLD - DISGORGEMENT

At law, disgorgement can be *"Mild"*

THE POST STEWART ESTATE WORLD - DISGORGEMENT

Or, Disgorgement can be *"Harsh"*

LET'S BACK UP A BIT

But wait, we are getting a bit ahead of ourselves.

Before we can speak about disgorgement damages for trespass and conversion under a "dead" freehold lease, we must first spend a bit of time thinking about:

- What is a freehold mineral lease?
- How does it die?

WHAT IS A FREEHOLD PNG LEASE?

The Courts have gone to great pains to legally categorize the freehold oil and gas lease.

Basically, they have said that a freehold lease is a ***profit à prendre***

(a.k.a. the right to win, take and remove petroleum substances from the land of another person).

WHAT IS A FREEHOLD PNG LEASE?

A freehold lease is not like a typical office space lease with exclusive possession of a physical space for a fixed period of time.

It is also not a "sale" as there is a returning of the lands to the freehold owner at the end of the term of the lease.

As a freehold lessee, you acquire only the contractual right to sever (produce) leased substances from the lands.

WHAT IS A FREEHOLD PNG LEASE?

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

AUTOMATICALLY TERMINATES

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

PRIMARY TERM OF A FREEHOLD LEASE

Primary term. Fixed term. Golden.

Grant to lessee of exclusive possession and the right to win, take and remove for a term of years.

POST PRIMARY TERM LEASE CONTINUATION (CAPL LEASES)

After the expiry of the primary term of a CAPL lease, **you can continue the lease in only two ways**:

- by "***Operations***" under the Habendum clause (with no cessation of Operations for more than 90 consecutive days); or
- by virtue of a ***shut-in well*** "capable of producing the leased substances or any of them" (clause 3).

POST PRIMARY TERM LEASE CONTINUATION (CAPL LEASES)

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

It is irrelevant if you:

- restart production later; or
- make payments during the shut-in period.

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

POST PRIMARY TERM LEASE CONTINUATION (CAPL LEASES)

Therefore, anytime you have a lack of Operations for more than 90 consecutive days:

- your lease will automatically terminate;
- unless you have a well "capable of producing the leased substances or any of them" (clause 3) situate on the lands, pooled lands or unitized lands.

HABENDUM (CAPL)

Extension of the primary term, i.e. the "thereafter" clause, 91 CAPL lease states:

> "...**so long thereafter as *Operations* are conducted** upon the said Lands, the Pooled Lands or the Unitized Lands, **with *no cessation*, in the case of each cessation of Operations, *of more than 90 consecutive days***"

The legal onus is on the lessor to establish, on a balance of probabilities, that Operations have occurred at all times after the expiry of the primary term.

HABENDUM (CAPL)

Preparatory actions to drilling can sometimes be sufficient to constitute drilling or working operations under the Habendum. This is often described as the drilling over issue.

The leading Canadian case on preparatory actions is *Canadian Superior v Crozet*, Alta QB, 1982.

The Court sets out a three part test as to whether ***preparatory actions*** could constitute a "drilling operation" in a non-CAPL lease.

HABENDUM (CAPL)

The test is as follows:

- the preparatory steps or actions must be taken in good faith with the intention of completing the drilling.
- the preparatory steps or actions must be taken with reasonable diligence and dispatch tested by the principles of good oilfield practice.
- the preparatory steps or actions must not be minimal (i.e. a geological survey would not be sufficient).

HABENDUM (CAPL)

Aside - Just Produce Baby

Production is always part of Operations. No requirement for production to be in paying quantities or for a royalty to be paid.

Old school solution is to simply ensure some production is recorded in every third production month. No need to go to shut-in clause. Useful method to reduce risk of termination during low price environment.

However, post *OMERs*, we may need to actually pay the lessor something for this to work. Good luck talking the accountants into this approach. G&A is King.

SHUT-IN WELLS (CLAUSE 3) (CAPL)

If you have a well "**capable of producing the leased substances, or any of them**“, you can continue the lease even where you do not have Operations under the Habendum.

"Capable of production" is the million dollar question. If a well is factually not capable of production, your lease will **automatically** come to an end as you no longer meet the terms of the grant of the *profit à prendre*.

OMERS ENERGY INC. v ALBERTA (ERCB), 2011 ABCA 251

The 2011 decision of the Alberta Court of Appeal in *Omers Energy Inc. v Alberta (Energy Resources Conservation Board),* 2011 ABCA 251 finally provides an interpretation of the CAPL shut-in clause wording "capable of production" discussed above.

Nice to finally have a decision on the CAPL shut-in clause, but a very bad decision in relation to industry shut-in programs due to low gas or low oil prices.

OMERS ENERGY INC. v ALBERTA (ERCB)

[3] The appeal is dismissed. **The Board** did not err in finding that the phrase "capable of producing the leased substances" means the "**demonstrated, present ability of a well** on the lands to produce the leased substances in a ***meaningful quantity*** within the time frames contemplated in the lease." (Board Decision 2009-037 at 9, hereafter Board Decision) **The lease is a contract through which the lessor and lessee agreed to develop the leased substances for mutual benefit**. This purpose would be defeated if the lease were interpreted in a manner that allowed it to continue almost indefinitely at a time when a drilled well is incapable of producing a meaningful quantity of oil or gas in its present state and operations are not being conducted to make it produce. Requiring a "meaningful" volumetric quantity was sufficient to determine this case. Considering each lease and its surrounding circumstances will allow this test to develop in a contextual setting. (emphasis mine)

OMERS ENERGY INC. v ALBERTA (ERCB)

But we are not here to talk about *Omers*.

Omers' makes me sad and mad, but it is the law.

STEWART ESTATE v TAQA NORTH LTD., 2015 ABCA 357

We are here to speak about ***Stewart Estate v TAQA North Ltd., 2015 ABCA 357***.

This may be the most important freehold lease case in the last 20 years.

Think back to “disgorgement”.

STEWART ESTATE v TAQA NORTH LTD.

This case deals with the **measure of damages** under a terminated freehold lease. This will apply anywhere in the WSB.

This case is a big deal due to the **astronomical increase in damages** payable by lessees who produce under dead leases.

Further, the risk of terminated leases is also on the increase due to wide scale industry practice of shutting-in production of freehold lands during periods of low prices.

STEWART ESTATE v TAQA NORTH LTD.

First, a quick summary of the facts:

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

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

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

STEWART ESTATE v TAQA NORTH LTD.

Shockingly, the Court found the leases were dead.

Of course, I jest.

The leases are always dead.

It’s kinda funny to hear the Court speak to this issues, yet again:

STEWART ESTATE v TAQA NORTH LTD.

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

STEWART ESTATE v TAQA NORTH LTD.

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

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

SPECULATION IS EVIL

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

MEASURE OF DAMAGES

Once the lease is dead, the issue is how much does it cost the oil and gas company

i.e. what are the damages payable by the lessee to the lessor for producing under a dead lease.

Damages are based upon two causes of action, trespass and conversion.

COMPENSATORY DAMAGES

Most shocking to me was that the Court rejected the traditionally applied "*compensatory*" measure of damages.

Compensatory damages seem very Canadian. Damages should put the injured party back to the same place as if the damage never occurred.

This is in contrast to the big mean American standard of **punitive damages**. Being that damages are harsh enough that the wrongdoer will think twice next time.

ROYALTY METHOD REJECTED

Until *Stewart Estate*, the "traditional" Canadian measure of damages for producing under a dead freehold lease was the:

Best royalty plus fresh bonus approach

This approach fully embraces the concept of compensatory damages by understanding that the lessor is almost certainly not in a position to drill its own well on the lands.

Accordingly, measure of damages should reflect that fact.

ROYALTY METHOD REJECTED

The best royalty plus bonus was described by the Court as follows:

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

ROYALTY METHOD REJECTED

This is sometimes also described as being a “good faith” trespasser.

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

ROYALTY METHOD REJECTED

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

ROYALTY METHOD REJECTED

[209] First, and foremost, the royalty approach ignores the ownership of the gas after the termination of the lease. **It is the lessor and not the lessee who owns the gas**. Once a lease has terminated, "it is the lessor, not the lessee who owns the minerals. In the absence of bad faith on the part of the lessee, and following the [Sohio] approach, it would seem equitable to apply a form of restitution": Ballem at 388. **Moreover, the royalty approach used by the trial judge "could encourage the lessee to continue producing the well after the lease has been challenged, knowing that the financial consequences will not be severe**. Indeed, it would be very much to the lessee's advantage to do so, as the result could end up being almost the same as if the lease continued to be valid. ...This, despite the fact that the lessee had enjoyed revenue from the production of minerals to which it had no legal title": Ballem at 389. (emphasis mine)

DISGORGEMENT DAMAGES

Now we get to the crux of the matter.

- Speculation is evil
- Best royalty plus bonus is unfair

So what is the proper measure of damages?

The answer is **disgorgement**.

DISGORGEMENT DAMAGES

[213] … but when circumstances call for a different measure, disgorgement of defendant's benefit is a potential remedy…

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

DISGORGEMENT DAMAGES – THE MILD RULE

At law, disgorgement can be applied harshly or mildly.

Two of the three judges chose the "*mild rule*" to calculate damages in this case:

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

Ouch. The cost for producing a dead lease is now your **total net revenue**.

DISGORGEMENT DAMAGES – THE HARSH RULE

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

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

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

DISGORGEMENT DAMAGES – THE HARSH RULE

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

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

LIMITATIONS

Now for some good news.

At least until lessors, or top lessee's like Freehold Solutions, get smart and start suing faster and more often.

Two of the three judges found that the **two-year limitation** in the *Limitations Act* applied to the lessors.

The Court found that the lessors knew or ought to have known that the leases might have terminated once they stopped receiving royalties.

LIMITATIONS

Once that trigger starts, they need to sue or lose the right to sue for damages:

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

LIMITATIONS

Note: Limitations does not mean no damages are payable, i.e. that the claim is not statute barred.

Due to the breach (trespass and conversion) being continuous, **a new cause of action accrues monthly**.

So the leases are dead in either 1995 (two judges) or 2000 (one judge), and the lessor limitation starts from when the cheques stopped rolling in.

However, the limitation period is a two-year **look back** from the statement of claim date due to the continuous breach.

LIMITATIONS

Further, damages are ALSO payable for the entire period AFTER the date the Statement of Claim was issued.

The measure of those go forward damages will be either:

- Mild disgorgement; or
- “Mere” compensatory (Royalty Method)

depending on the actions of the parties.

LEAVE AND LICENSE

There is also the possibility of lower damages during the period after lease termination and before the statement of claim is issued.

This is due to the possible leave and license “granted” to the lessee by the lessor’s conduct.

STEWART ESTATE v TAQA NORTH LTD.

Final Thoughts:

The Court of Appeal decision was split among the three judges that heard the case. Even so, leave to appeal was denied by the SCC.

This has led many commentators to infer that the measure of damages portion of the decision is unclear or muddled.

STEWART ESTATE v TAQA NORTH LTD.

There may be some uncertainty in the decision, however, what is certain is that:

- the *"royalty plus best bonus"* approach is gonzo; and
- damages for trespass and wrongful conversion under dead freehold leases is now, at least, **disgorgement of net revenue.**
- subject only to:
  - limitations; and
  - leave and license,

  defences.

Thanks for Listening

Presented by

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