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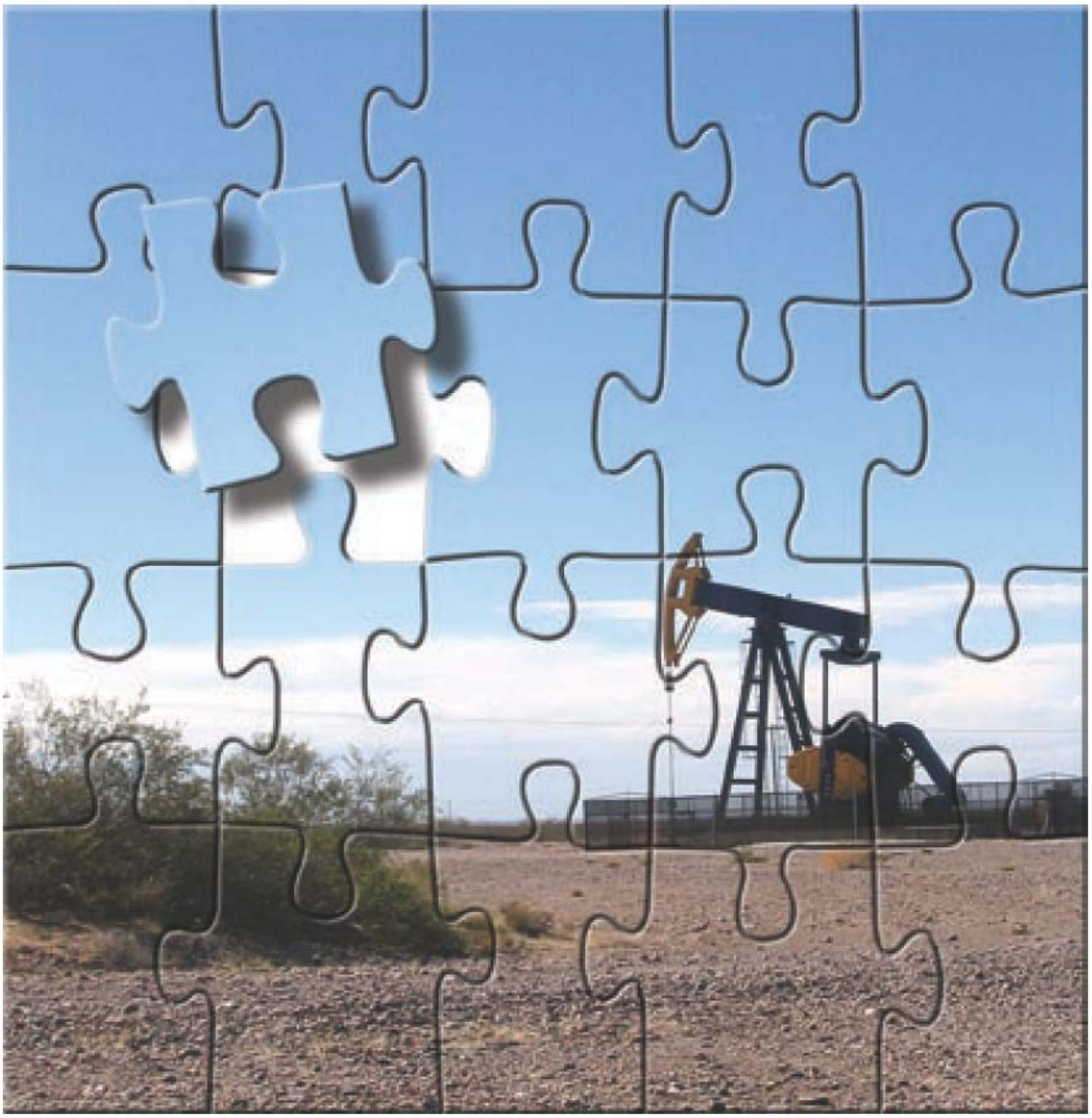

From a Well on the Lands at the End of the Primary Term

A Unique Court Interpretation of a Freehold Lease Habendum Clause

BE CAREFUL WHAT YOU WISH FOR. This was the first thought that popped into my head after reading the Alberta Court of Queen's Bench, Master's decision in *Desoto Resources Ltd. v. EnCana Corp.* (2009 CarswellAlta 818).

The case deals with EnCana's lapse proceeding against caveats filed by Desoto on EnCana's fee simple mineral title. Very common and straight forward process. EnCana sends a Notice to Take Proceeding on Caveat to Desoto. Desoto then filed a statement of claim to defend its caveat (and therefore the underlying lease).

The kicker comes from how the court interpreted the text of the habendum clause in the lease. The clause reads as follows:

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The obvious problem for industry with this interpretation of the lease is that is does not allow for lease continuation by wells drilled after the primary term. This is a deal stopper if you are considering drilling new wells on this form of lease and then abandoning the old wells. Think infill drilling. Think new fangled horizontal wells on old leases.

> The Lessor, for the initial consideration paid by to the Lessor by the Lessee ... DOES HEREBY GRANT AND LEASE ... the leased substances ... for the primary term *and so long thereafter as any of the leased substances is being produced or is capable of production in paying quantities* **from a well or wells on the said lands at the end of the primary term**, but subject to sooner termination as provided in this lease; provided that if at the expiration of the primary term each well drilled on the said lands by the Lessee is abandoned and the Lessee is then drilling a further well on the said lands for the leased substances, this Lease shall remain in force so long as such drilling is diligently and continuously prosecuted and so long thereafter as any of the leased substances is being produced or is capable of production in paying quantities from the said lands from the well so drilled (paragraph 23. Emphasis mine)

This is not uncommon wording. Most of my time, and most prior court decisions, deal with determining if wells on the lands are "capable of production in paying quantities". I must admit I had not put very much thought into the bolded text that follows. That bolded text qualifies the prior italicized wording and requires that only production *"from a well or wells on the said lands at the end of the primary term"* will continue the lease.

Think about those words again for a minute. I mean, really, really think about them. This wording literally means that the *only* wells that can continue the lease are those wells drilled during the primary term. The only wiggle room comes from the proviso at the end of the clause that allows for certain wells drilled over the primary term to be included as continuation wells.

The court very succinctly summarizes this view by stating:

> 27 Whether or not the Lands are capable of production in paying quantities, the plain terms of the Leases require that the production be from *a well or wells drilled during the primary term*. A well drilled in 2007 cannot operate to satisfy this requirement.

The New Well Problem

The obvious problem for industry with this interpretation of the lease is that is does not allow for lease continuation by wells drilled after the primary term. This is a deal stopper if you are considering drilling new wells on this form of lease and then abandoning the old wells. Think infill drilling. Think new fangled horizontal wells on old leases.

Under a traditional "capable of production in paying quantities" test, you are ok so long as you continue to produce the old well until the new well is on production. Simple strategy. Simple risk management process.

However, under this new interpretation, your new well will never be able to continue the lease. You lease simply cannot be continued by production from wells drilled after the primary term. Never ever.

Holy crap. This is what I mean by being careful what you wish for. I never really thought a court would interpret this text literally. I am constantly blathering on about how important it is for courts to stop trying to interpret the intention of the parties to leases and to avoid results based reasoning. Just read the darn words I bellow. We will all be much better off it we just read the words and leave it at that. Certainty is the holy grail of lease interpretation. Fairness just screws everything up.

Well don't I look foolish. I can't argue with the court's strict interpretation of the words in the lease. Once you really read the words, it is what they say. The only way to challenge this interpretation is to start yelping about how this could not possibly be what the parties intended, or that the result is to harsh or unjust. This is hippy socialist speak that I cannot bring myself to utter.

Summary Judgment

Just a note that this case was an application by EnCana for summary judgment against Desoto. Summary judgment is a somewhat unusual remedy that allows the court to make a final decision in a matter without having a full trial. Summary judgment will only be granted where the court decides that "... there is no genuine issue of material fact requiring trial." (paragraph 20).

The court totally starts over and comes to a completely different rational as to why lease is dead. Totally different. Totally. The ERCB goes on and on about what it really means for a well to be capable of production. Never looks at the when the well was drilled. The current court decision deals strictly with when the well was drilled and does not even consider the capable of production issues.

For our purposes, a summary judgment application is material in that the decision is made by a "Master", which is a special class of judge that is just below a Queen's Bench justice. The decision therefore may have slightly less precedent value than a decision by a full Court of Queen's Bench Justice.

Caution Appeal by Trial De Novo

Also important is that this decision is currently under appeal. The latest ruling I could locate was a September 9, 2009 preliminary ruling on some procedural matters (see *Desoto Resources Ltd. v. EnCana Corp.*, 2009 CarswellAlta 1376). This ruling is interesting in that it confirms that the appeal to a Justice of the Court of Queen's Bench will be a *de novo* hearing. This is just fancy Latin meaning lets start all over again. For us this means that the next court may not agree with the Master's decision above and is not really bound by the Master's reasoning.

Continuing The Desoto ERCB Saga

Oh yeah, you may remember *Desoto* from my May 2009 article "Is the Board Bored?" which dealt with the ERCB decision regarding the validity of this exact same cursed freehold lease in the context of the ERCB's jurisdiction to grant and revoke well licences in Alberta. How can this be you say? The ERCB already found that the lease was dead and terminated the well licence, what more could a court decide?

Well, as I ranted on ad nauseam in my prior article, an ERCB decision on the well licence issue cannot bind a court when it deals with a separate action dealing with the lease. The court in the current case makes note of the ERCB decision, but then starts over again, as it should. Nuff said. No use beating a dead horse.

Ok, maybe just a few whacks. The court totally starts over and comes to a completely different rational as to why lease is dead. Totally different. Totally. The ERCB goes on and on about what it really means for a well to be capable of production. Never looks at when the well was drilled. The current court decision deals strictly with when the well was drilled and does not even consider the capable of production issues. Arrrgghh.

As a poor oil and gas solicitor I am now left with two sets of reasoning on the same lease wording depending in which forum the lease is challenged in. One set of reasoning applies to the ERCB. A different set to the courts. Plus the court decision is currently under appeal by a *trial de novo*. I am not complaining (much), but this makes my job quite difficult. All I ask is that my clients try to remember just how screwed up this single clause in one form of lease has gotten the next time you call with a "real simple lease question". I should have been an engineer.