the negotiator

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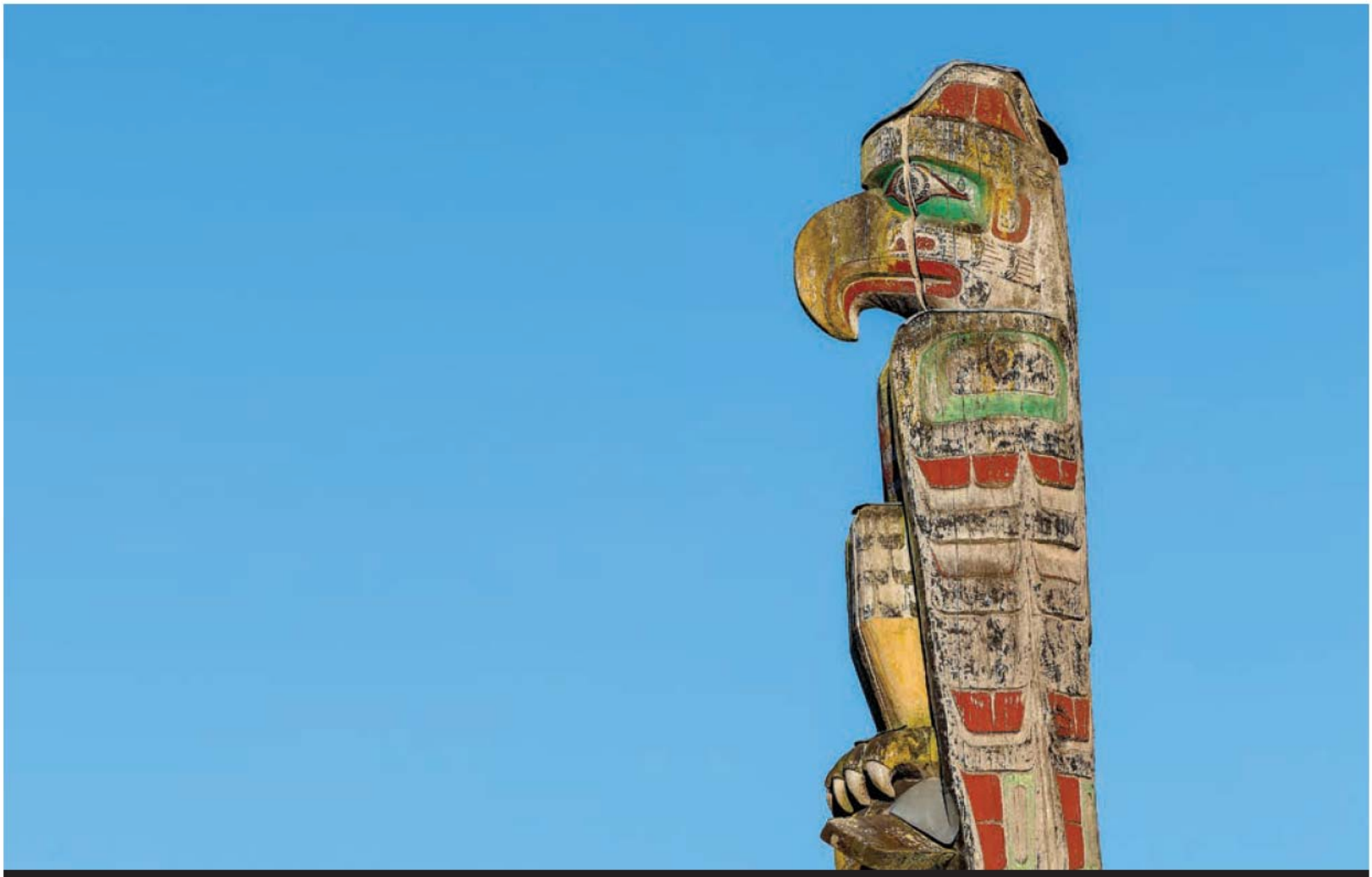

NOVEMBER BREAKFAST – **TRANSMOUNTAIN** COUNCIL LARS OLTHAFER

Why Can't We Be Friends? Consent Not To Be Unreasonably Withheld Provisions

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Negotiators Beware Anything Can and May Be Used Against You in a Court of Law

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Why Can't We Be Friends?

(Consent Not To Be Unreasonably Withheld Provisions in WCSB A&D Transactions)

written by
PAUL NEGENMAN
Lawson Lundell

AUTHOR'S NOTE

The following is the text of my presentation at the 2018 CAPL Conference in Regina, Saskatchewan. Fantastic Conference. Great to be in a place where oil and gas development is recognized as a fundamental part of human flourishing and prosperity.

I must also confess that I first wrote this article for a legal publication a few months earlier and simply cut and pasted the text onto the PowerPoint for the Conference. Hey, you get what you pay for. Ergo, the tone is unbearably calm, reasonable and serious. I believe I managed to add a bit more humor when I presented at the Conference. Your loss.

INTRODUCTION

The western Canadian sedimentary basin (WCSB) has a large and active acquisition and divestiture (A&D) component. Companies regularly buy and sell Crown and freehold mineral leases together with associated tangibles such as wells, facilities and pipelines (Assets). The liquidity and ease of Asset dispositions in the WCSB has been a source of pride for our industry for many years.

The recent trend of third parties (TPs) refusing to consent to the sale of Assets and the resultant confusion and uncertainty caused by such actions is the subject of this article.

NOVATION

Where Assets are held jointly with TPs, one element of closing an A&D transaction is the assignment of the underlying land and joint venture contracts from vendor/assignor to purchaser/assignee (Underlying Contracts). While the sale agreement and closing are sufficient to convey the Assets from vendor to purchaser (Disposition), under common law, Disposition alone is insufficient to assign the rights and obligations in the Underlying Contracts as between the assignee and TPs. Rather, the transfer of rights and obligations requires that the existing TPs agree in writing to the substitution of the assignor with the assignee as a party to each Underlying Contract (Novation). Novation is typically evidenced by way of a standard form assignment and novation agreement (A&N) or by the industry-adopted form of notice of assignment (NOA).

PRIOR CONSENT

Novation is contractually codified under the Canadian Association of Petroleum Landman (CAPL) and Petroleum Joint Venture Association (PJVA) standard form documents, which commonly form part of the terms and conditions of Underlying Contracts. The CAPL and PJVA documents typically contain a covenant that TPs prior consent to a Disposition be obtained for Novation to occur, with consent not to be unreasonably withheld (Prior Consent).

INDUSTRY PRACTISE

For many, many years, industry practise has been to ignore the Prior Consent requirement on Dispositions. Rather, a vendor will typically issue a consent cover letter, together with the underlying A&N or NOA after the Disposition has occurred, requesting the TPs to consent to the Disposition (Consent Request). As an industry, we simply choose to ignore the strict application of the Prior Consent obligation to increase A&D transaction efficiency and to reduce general and administrative expenses. Until very recently, this was not a problem as industry practise was for TPs to almost universally consent to Dispositions.

REFUSAL TO NOVATE: LACK OF FINANCIAL CAPACITY

However, the 2014 collapse of oil prices, combined with the earlier and more sustained destruction of natural gas prices in the WCSB, resulted in the financial crippling and/or insolvency of many oil and gas companies. For TPs, this in turn lead to increased concern about the financial capacity of joint venture partners ability to fund and pay their share of:

- asset retirement obligations (ARO);
- joint interest billings (JIBs);
- future capital costs; and
- royalties and other encumbrances.

The problem for TPs is that the financial troubles or insolvency of joint venture partners increases your risk and exposure to all of the above costs and expenses. This can occur directly, where an operator of an Asset is not reimbursed for JIBs borne for the joint account; or indirectly, where joint venture partners ultimately bear the share of the unpaid costs and expenses of an insolvent partner.

The ARO problem was exacerbated by the aggregation of low value, high ARO Assets by newco companies who acquired such Assets with the goal of lowering costs and waiting for the price cycle to turn. Sadly, some of these newco aggregators are among the insolvencies in the WCSB. Upon insolvency, the applicable provincial regulator of the well, facility and pipeline licenses will call upon the remaining joint venture partners to bear the cost and expense of immediately abandoning and reclaiming the licensed Assets, with minimal real recourse to recouping the share of costs payable by the insolvent joint venture partner.

Further, the right of provincial oil and gas regulators to charge all of the Assets of an insolvent licensee to pay for outstanding ARO is being challenged in the context of federal bankruptcy and insolvency laws. The matter is currently before the Supreme Court of Canada (SCC file 37627) and a decision is expected shortly. See *Orphan Well Association v Grant Thornton Limited*, 2017 ABCA 124 (the "Redwater Decision"). If upheld, the Redwater Decision will result in significantly greater ARO risk to TPs of insolvent joint venture partners.

As a result, a small, but growing list of TPs are refusing to accept Novation of purchaser/assignee into Underlying Contracts by refusing to provide Prior Consent to the Disposition on the basis of the reasonable belief that the proposed assignee does not have the financial capacity to meet the obligations under the Underlying Contract (Refusal to Novate). This practise is causing havoc in A&D transactions and the go forward relationship of joint venture partners in Underling Agreements.

SPLIT IN BENEFICIAL OWNERSHIP AND CONTRACTUAL PRIVITY

The crux of the problem is that until Novation occurs, the vendor/assignor remains in contractual privity with the TPs to the Underlying Contract. This fact, together with the industry practise of issuing Consent Requests after the Disposition of the Assets, results in:

- The underlying beneficial interest in the Assets being conveyed to the purchaser/assignee (often including physical operations and regulatory licenses).
- The legal rights and obligations of the Underlying Contract remaining between the vendor/assignor and the TPs.

This awkward split makes the go forward operation of Underlying Contracts extremely difficult to properly administer and maintain. Almost all accounting, environmental, field operations, mineral land, joint venture, marketing and surface land activities will be affected. In each case, the affected vendor and purchaser must make a decision as to how to respond to a Refusal to Novate. Do you:

- ignore the Refusal to Novate on the basis that the withholding of consent was unreasonable and assume that the purchase/assignee is properly Novated into the Underlying Contracts; or
- accept the Refusal to Novate and have the vendor/assignor continue to act in its capacity as a party to the Underlying Contract unless and until the Refusal to Novate is rescinded.

In practise, neither approach is satisfactory and industry is currently grappling with what to do next.

THE LEGAL TEST FOR REFUSAL TO CONSENT TO AN A&D DISPOSITION

The Alberta Court of Queen's Bench decision in *IFP Technologies (Canada) Inc. v EnCana Midstream and Marketing*, 2014

ABQB 470, together with the Alberta Court of Appeal decision in *IFP (supra)*, 2017 ABCA 157 (leave to appeal to the Supreme Court of Canada denied) provide an excellent summary of the current law on Refusal to Novate applied to a WCSB Disposition.

The trial decision provides a summary of the general legal framework for considering a Refusal to Novate at paragraphs 155 to 158. The framework can be paraphrased as follows: (a) The burden of proof is on the TPs asserting Refusal to Novate; (b) A TP is entitled to base its decision on its interests alone; (c) The factual circumstances matter; (d) "The question is not whether a reasonable person might have given consent, but whether a reasonable person could have withheld consent in the circumstances" [paragraph 155]; (e) A collateral purpose for a Refusal to Consent, not contemplated by the Underlying Contract, is not permissible; (f) "Proceeding with an assignment in the face of a reasonable refusal to consent is a clear breach of a negative covenant" [paragraph 157]; and (g) The reasonable person test, within the specific factual circumstances, will apply.

Although the specific decision on Refusal to Consent was reversed on appeal, the general legal framework above was not overturned. In addition, the Court of Appeal adds the following considerations to the general legal framework: (a) The general organizing principle of the duty of good faith, as expressed through the appropriate regard to the legitimate contractual interests of the contracting partner, will apply to the Courts consideration of a Refusal to Novate, following *Mesa Operating Limited Partnership v Amoco Canada Resources Ltd.* (1994), 149 AR 187 (CA) and *Bhasin v Hrynew*, 2014 SCC 71, [2014] 3 SCR 494; (b) When exercising a discretionary power such as a Disposition of Assets, the vendor/assignor must exercise the discretion in a manner that gives effect to the reasonable expectation of the parties; (c) The reasonable expectations of the parties can be informed by the commercial context of the Underlying Contract.

WHAT HAPPENS NEXT?

Industry is at a tipping point. Either Refusal to Novate will spread to most industry participants; or the practise will wither away and we will return to the prior status quo.

If the status quo returns, this "trend" will be much to do about nothing. However, if Refusal to Novate spreads, we could see a plethora of legal actions being brought by vendor/purchaser parties as against TPs who have applied Refusal to Novate. In each case, the Court will be tasked with determining if the Refusal to Novate meets the legal test above. In my view, the outcome of such cases will be highly fact specific and could lead to a chill on A&D deal flow in the WCSB.

In the interim, lawyers in A&D transactions must advise clients of this potential risk and must consider if it is time to end our industry practise of ignoring Prior Consent and instead make Dispositions subject to the condition precedent that Prior Consent has been obtained from all TPs. Such a change is not without its own problems and issues. However, if a specific A&D transaction includes a large number of TPs who are likely to apply Refusal to Novate, a prudent vendor and purchaser must consider the risk and proper approach to closing the transaction. ♦

CAPL Guest Speaker

LARS OLTHAFER

Lars advises and represents upstream oil and gas producers, pipeline companies, and electrical generation and transmission companies on regulatory and environmental compliance and approval processes, public and aboriginal consultation, and land rights acquisition and compensation, in the context of both provincially and federally regulated projects, including northern and offshore developments.

Lars regularly appears before energy boards and other regulating bodies in Alberta and B.C., as well as the National Energy Board and the National Energy Board Act Pipeline Arbitration Committee. He has also appeared before the Alberta Court of Queen's Bench, the Alberta Court of Appeal, and the Federal Court of Canada.

Lars has worked as an engineer with a major Canadian pipeline company and has completed terms with the Canada Oil and Gas Lands Administration and with a major oil and gas company in relation to frontier exploration, reservoir exploitation, oil sands development, research and development, and natural gas new ventures. ♦