In the Court of Appeal of Alberta

Citation: Stewart Estate v TAQA North Ltd, 2015 ABCA 357

Date: 20151119
Docket: 1301-0360-AC
Registry: Calgary

Between:

Lynda Calder in her capacity as Executrix of the Estate of Merville V. Stewart (Deceased), Lynda Calder, Morgan Stewart, Cody Stewart, Cody Stewart in her capacity as Administrator or Litigation Representative for the Estate of James D. Stewart (Deceased), and as Litigation Representative for Morgan Stewart, Jerome Development Limited, Bowen Family Properties Ltd, Ronald B. Pole, Kevin R. Pole, Danny G. Oneil in his capacity as Executor of the Estate of Mabel B. Oneil (Deceased), Robert Copley, Karen Nell Copley, Margaret Alice Demers, Mary Jean Biggar, Goldie Alberta Danielsen, Edna Keam, Wilma Marshall, Laurel Lee McLaren

Appellants
Not Parties to the Cross-Appeal of Coastal Resources Ltd
Not Parties to the Cross-Appeal of Nexen Inc and ExxonMobil Canada Ltd
(Plaintiffs)

– and –

1088294 Alberta Ltd

Appellant
Cross-Respondent to the Cross-Appeal of Coastal Resources Ltd
Cross-Respondent to the Cross-Appeal of Nexen Inc and ExxonMobil Canada Ltd
(Plaintiff/ Defendant by Counterclaim)

– and –

J. Timothy Bowes

Appellant
Not a Party to the Cross-Appeal of Coastal Resources Ltd
Cross-Respondent to the Cross-Appeal of Nexen Inc and ExxonMobil Canada Ltd
(Defendant by Counterclaim)

– and –

TAQA North Ltd, Esprit Exploration Ltd, Bonavista Energy Corporation, and Triquest Energy Corp

Respondents
Not Parties to the Cross-Appeal of Coastal Resources Ltd
Not Parties to the Cross-Appeal of Nexen Inc and ExxonMobil Canada Ltd
(Defendants)

– and –

Coastal Resources Limited

Respondent/ Cross-Appellant
Not a Party to the Cross-Appeal of Nexen Inc and ExxonMobil Canada Ltd
(Defendant/Plaintiff by Counterclaim)

– and –

Nexen Inc and ExxonMobil Canada Ltd

Respondents/ Cross-Appellants
Not a Party to the Cross-Appeal of Coastal Resources Ltd
(Defendants/Plaintiffs by Counterclaim)

Corrected judgment: A corrigendum was issued on March 18, 2016; the corrections have been made to the text and the corrigendum is appended to this judgment.

The Court:

The Honourable Madam Justice Patricia Rowbotham
The Honourable Mr. Justice J.D. Bruce McDonald
The Honourable Mr. Justice Brian O'Ferrall

Reasons for Judgment Reserved of The Honourable Madam Justice Rowbotham

Reasons for Judgment Reserved of The Honourable Mr. Justice McDonald
Concurring in the Result

Reasons for Judgment Reserved of The Honourable Mr. Justice O'Ferrall

Appeal from the Judgment by
The Honourable Madam Justice B. E. C. Romaine
Dated the 22nd day of November, 2013
Filed on the 25th day of November, 2013
(2013 ABQB 691, Docket: 0501 11695)

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Reasons for Judgment Reserved of
the Honourable Madam Justice Rowbotham

Executive Summary

[1] There are three judgments in this appeal and we summarize our conclusions as follows:

a. The appeal is allowed on the core issue of whether the oil and gas leases terminated.

   i. O'Ferrall JA (McDonald JA concurring) finds that the leases terminated in 1995 and concludes that there is a sufficient basis for finding that all five leases terminated.

   ii. Rowbotham JA concludes that the leases terminated in January 2000, and would uphold the trial judge's provisional conclusion that no declaration of lease validity can be made on two of the five leases in the absence of all the parties vying for the fee simple title to those quarter sections (the Snell/Wheatland issue).

b. The judgments differ on the standard of appellate review of the interpretation of the leases:

   i. McDonald JA (O'Ferrall JA concurring) would review for correctness.

   ii. Rowbotham JA finds the standard to be reasonableness.

c. As to the date from which the appellants are entitled to a remedy:

   i. Rowbotham JA (McDonald JA concurring) finds it is August 9, 2003, two years prior to the issuance of the statement of claim.

   ii. O'Ferrall JA concludes that the appellants are entitled to a remedy from the date it was made clear to the respondents that the appellants no longer consented to continued production in accordance with *Sohio Petroleum Co. et al v Weyburn Security Co Ltd*, [1971] SCR 81, 13 DLR (3d) 340, aff'g (1969), 7 DLR (3d) 277 (SKCA). He finds that date to be October 1, 2005.

d. As to remedy, we all agree that the so-called 'royalty and bonus' remedy provisionally applied by the trial judge is inappropriate.

i. Rowbotham JA and O'Ferrall JA direct the respondents to disgorge revenues less production, gathering and processing, i.e., on a net basis in accordance with the January 6, 2012 "Agreed Statement of Facts Pertaining to Revenues, Expenses and Royalties" (the so-called "mild rule").
ii. McDonald JA would impose disgorgement of the respondent's gross revenues (the so-called-harsh rule).

e. Justice Rowbotham and Justice McDonald agree that the Irwin Group did not give leave and licence from December 5, 2005 to January 12, 2007.

f. We dismiss the appeal from the decision regarding 108's independent claim for damages.

g. As regards the liability of Esprit to disgorge the royalties it earned and that Esprit must account for the royalties it actually received:

i. O'Ferrall JA would allow the appeal (McDonald JA concurring)

ii. Rowbotham JA would dismiss the appeal.

h. The cross appeal (champerty and maintenance) is dismissed for the reasons of O'Ferrall JA, Rowbotham JA and McDonald JA concurring.

[2] Accordingly, the appeal is allowed on the main issue, the termination of the leases. If the parties are unable to agree on costs, they may make written submissions of a maximum of ten pages. The appellants should do so within 60 days of the date of this judgment and the respondents within 15 days after the appellants' submissions.

I. Introduction

[3] This appeal is about the interpretation of five freehold petroleum and natural gas leases entered into in the 1960s. At its heart is the interpretation of the *habendum* clause which, together with its provisos, establishes the conditions under which a lease continues in force after its primary term once production has been suspended.

[4] The appellants submit that the leases terminated sometime between 1995 and 2001. The respondents' position is that the third proviso to the *habendum* clause operates to continue the leases. Central to the issue of the leases' validity is the 7-25 Well. It was shut in from 1995 until early 2001 when production resumed. If production ceased during the shut-in period because of a "lack of or intermittent market" or "any cause whatsoever beyond the lessee's reasonable control", the leases continue. If not, the leases terminated according to their terms and the respondents have been trespassing on the lessors' reversionary property rights since then. The nature and measure of the remedy, and which of the appellants are entitled to a remedy, is also at issue.

[5] The appellants argued at trial that the 7-25 Well was shut in because the operator's internal profitability goals were not met, the respondents held the leases for purely speculative purposes and the leases cannot be read to justify their continuation on this basis. The respondents submitted that the 7-25 Well was shut in because production was uneconomical and therefore in accordance with recent jurisprudence interpreting the phrase "lack of or an intermittent market".

[6] The appeal also engages issues of limitations; the effects of alleged assignments of two of the leases and the impact this has on the standing of those lessor appellants; the liability of a party which is no longer a lessee but has a caveat for a gross overriding royalty interest; whether one lessee was given leave and licence by certain lessors to continue to produce; and (in cross-appeal) whether the action of two of the appellants is champertous or an interference with contractual relations.

[7] I would allow the appeal in part. I conclude that production became objectively economical by January 1, 2000 when the industry's hurdle rates were met, after which the lessees had 90 days to resume production. Their failure to do so terminated the leases. 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.

[8] I agree with the trial judge that the lessors of the two Scurry leases are not entitled to a declaration that those leases terminated because interests in those properties had arguably been assigned to other parties (Snell Farms Ltd and Wheatland Farming Company Ltd). Neither was a party at trial and neither was granted status on appeal. Consequently, the Scurry lessors are not entitled to a remedy in these proceedings.

[9] I have concluded that the appropriate remedy for all but the Scurry lessors is disgorgement of the lessees' net profits from production, with some qualifications. In general terms, the formula for calculating the remedy is revenue *less* royalties *less* reasonable expenses.

[10] For the reasons expressed by Justice O'Ferrall, I would dismiss the cross-appeal.

II. Facts

[11] Most of the appellants are families or family holding companies that are the current registered freehold owners of the lands in Section 25, Township 27, Range 1 West of the 5th Meridian (Section 25). In the 1960s the appellants' parents or grandparents entered into leases with the predecessors of the respondent companies.

A. The Leases

[12] There are five leases in issue: the Imperial NW1/4 lease, the Jefferson SW1/4 lease, the Union NE1/4 lease, the Scurry NE1/4 lease and the Scurry SE1/4 lease. There is a pooling agreement (see below). The 7-25 Well is on the Scurry SE1/4 lands. Appendix 1 includes a summary (as of December 2011) of the registered owners of the mines and minerals, the lessees and the caveats registered as regards to the original leases.

[13] The wording of the five leases differs somewhat but all have a 10-year primary term and *habendum* clauses which continue the lease so long as there is production. After the primary term, if production ceases and the lessee recommences working operations within 90 days the lease remains in force as long as operations continue or production results. The *habendum* clauses contain a "third proviso" providing that if a well is not producing because of the "lack of or an intermittent market" or a cause "beyond the lessee's reasonable control", the period of such non-production shall not be counted against the lessee. There are three variations of the third proviso.

Imperial NW1/4 Lease

[14] On December 13, 1961 William Murdoch Copley entered into a lease with Imperial Oil Limited. This is the **Imperial NW1/4** lease. The successors of Mr. Copley's interest are Robert Copley, Karen Nell Copley, Margaret Alice Demers, Mary Jean Biggar and Goldie Alberta Danielsen, collectively the **Copley Group**.

[15] Imperial's interest in this lease was assigned to Canadian 88, which subsequently became Esprit Exploration Ltd. and ultimately Pengrowth Energy Corporation. When Esprit disposed of its interest to Triquest Energy Corp (now Bonavista Energy Corporation) it reserved to itself a gross overriding royalty interest and registered a caveat against this title, the significance of which is discussed in Part G of my analysis.

Jefferson SW1/4 Lease

[16] On January 8, 1968 Nellie B. Pole, as lessor, and Jefferson Lake Petrochemicals of Canada Ltd, as lessee, executed the **Jefferson SW1/4** lease. The current registered owners of Ms. Pole's interest are the appellants Danny G. Oneil (as executor of the estate of his mother Mabel B. Oneil), the Bowen Family Properties Ltd and Ronald B. Pole, collectively the **Oneil Group**. Nexen Inc is

the ultimate successor to Jefferson Lake. Nexen and ExxonMobil Canada Ltd are 50 percent working interest owners under the Jefferson SW1/4 lease. ExxonMobil is the successor to Mobil Oil Canada Ltd, a party to the 1968 pooling agreement.

Union NE1/4 Lease

[17] There are two leases on the NE1/4, one covering the north 716 feet (43.39 acres) and the other, the balance. The first, the **Union NE1/4** lease, was executed on May 9, 1961, between Jean Ella Irwin and the Union Oil Company of California. Ms. Irwin's successors are Edna Keam, Wilma Marshall and Laurel Lee McLaren, as executrix for Betty Blanche Carter, collectively the **Irwin Group**. Coastal Resources Limited is the successor to Union under the lease and is a party to the pooling agreement.

Scurry NE1/4 and SE1/4 Leases

[18] The second lease on the NE1/4, **the Scurry NE1/4**, covers the balance of the NE1/4. It was executed on November 30, 1967, between Merville Stewart, as lessor, and Scurry Rainbow Oil Limited, as lessee. Before trial, Mr. Stewart's interests in the mines and minerals, other than coal, were held one-half by Jerome Development Limited, a family holding company, and the other half by Lynda Calder, James Stewart, Cody Stewart and Morgan Stewart, the latter individuals collectively referred to as the **Jerome Group**. The registered owner of the mines and minerals at the time of trial was Jerome Development Limited. The successor to Scurry Rainbow's interest is Bonavista. Coastal is successor to a named party in the pooling agreement. At one time Triquest Energy Corp had an interest, see generally paras 34-35 of *Stewart Estate v TAQA North Ltd*, 2013 ABQB 691 ("reasons").

[19] Complications arising from the interests held by the Jerome Group and Jerome Development Limited are discussed in Section V, Part B of my analysis.

[20] On January 7, 1964, Merville Stewart entered into a lease of the petroleum and natural gas on the SE1/4. The lessee is also Scurry Rainbow. The 7-25 Well was drilled on the **Scurry SE1/4** lease. By a series of transactions, Bonavista succeeded Scurry Rainbow's interest in the lease and became the working interest owner in the natural gas in specified formations. TAQA became the working interest owner of the natural gas in formations other than those specified as Bonavista's.

[21] The same complications adverted to in the preceding paragraphs apply to this lease.

B. The 7-25 Well and the Pooling Agreement

[22] A pooling agreement combined the respondent lessees' (or their predecessors') interests in the production of leased substances from Section 25.

[23] At the time of the litigation, under the pooling agreement, the respondents Nexen Inc, ExxonMobil, Coastal and Bonavista held the working interests in Section 25. The respondent, TAQA North Ltd, is successor to minerals in certain zones. From 1968 to 2004, Nexen or a

predecessor was the operator of the pooled interest in Section 25. Since 2004, Bonavista has been the operator.

[24] The history and production from the 7-25 Well is central to the issue of the leases' validity. The trial judgment extensively discusses its history. Therefore only the most essential facts are summarized for the purposes of the appeal.

[25] On September 17, 1968, the 7-25 Well was drilled into the Basal Quartz (BQ) formation from which it produced sweet gas. In 1980 that part of the well was shut in. In 1978 the well was drilled into the Wabamun (sometimes called Crossfield) formation and began producing sour gas from 1981.

[26] In 1995, the 7-25 Well was shut in and production was suspended until 2001. During that time shut in payments, also called annual rentals or delay rentals (collectively, "rentals") were paid.

[27] In 2001, production of natural gas from the BQ formation recommenced, and the appellant lessors again received royalties. The 7-25 Well was shut in by order of the Court of Queen's Bench in January 2011.

C. 1088924 Alberta Ltd, Freehold Solutions and J. Timothy Bowes

[28] The involvement of the appellants and cross-respondents J. Timothy Bowes, Freehold Solutions Inc and 1088294 Alberta Ltd (108) is also an issue. The business of Freehold Solutions includes acting on behalf of lessors with limited experience in oil and gas disputes with corporate lessees. Mr. Bowes is president of 108 and Freehold Solutions.

[29] 108 was added as a party in 2009. It was formed by Freehold Solutions after Freehold Solutions entered into top lease agreements with the other appellants in 2004 and 2005. Freehold assigned the top leases to 108, and 108 executed trust declarations acknowledging that it held those interests in trust for Freehold Solutions.

[30] The litigation originated when Danny Oneil (son of one of the registered interest holders under the Jefferson SW1/4 lease) raised concerns about royalty payments. In August 2003, Mr. Oneil contacted others with leasehold interests. He sought legal advice and in late 2003, the issue of the validity of the leases was raised with ExxonMobil and Nexen, which claimed the leases were valid.

[31] In July 2004, some of the other appellants met with Mr. Bowes. Mr. Bowes said his company would take a top lease if the existing leases were invalid but he would not provide a title opinion unless the remaining parties with interests in the lands agreed to join in litigation against the lessees. In addition to paying royalties, the top lessee would pay legal costs and split any damages recovered.

[32] In November 2004, some of the appellants signed an agreement with Freehold Solutions that, among other terms, attached a top lease effective automatically if the existing lease terminated. Other appellants signed similar agreements in 2005.

[33] In August 2005, the appellants commenced this action seeking a declaration that the leases terminated in 1995 when the 7-25 Well was shut in. They claimed an accounting of profits, restitution, other compensation and damages.

[34] Coastal counterclaimed against 108 alleging that its actions were champertous. Nexen and ExxonMobil commenced similar counterclaims against 108 and Bowes.

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[35] The trial judge found that the third proviso in the leases applied and therefore the leases did not terminate as a result of lack of production. She dismissed the claims and counterclaims. She gave lengthy reasons which will be discussed later under the specific grounds of appeal.

[36] There were a number of collateral issues, some of which form grounds of appeal.

[37] The trial judge found that the Jerome Group appellants were not proper parties to seek a declaration that the Scurry leases had terminated. She found that their interest had arguably been assigned to Wheatland and Snell. The trial judge was not prepared to make a declaration about the validity of the Scurry leases in the absence of Wheatland and Snell because they were not parties to the litigation but could be affected by such a declaration.

[38] The trial judge also held that 108 was not entitled to claim damages independently of the appellant lessors, as the top leases would not become effective until there had been a determination that the original leases terminated. However, she found that 108 had standing to make representations on the issue of the leases’ validity.

[39] As regards the appellants’ claims for unjust enrichment, trespass and conversion, the trial judge found they were barred by the *Limitations Act* as the appellants knew or ought to have known that production had ceased shortly after July 1995.

[40] The trial judge was not prepared to find that estoppel, laches or acquiescence barred the lessors’ claims. On the issue of leave and license she provisionally concluded that the Irwin Group had given leave and license after they entered into the top leases because they continued to accept royalties.

[41] The trial judge noted difficulties with the various causes of action raised by the pleadings. Had she found the leases had terminated, “an energy company that extracts resources from land owned by another without a valid lease violates a property right of that person, and a remedy must be found”: para 586. Nevertheless, she applied remedial principles associated only with trespass in her provisional damages assessment.

[42] She provisionally assessed damages on a royalty plus a bonus for lease renewal; the same basis as *Montreal Trust Co v Williston Wildcatters Co*, 2001 SKQB 360, aff'd 2002 SKCA 91, 223 SaskR 276 and *Freyberg v Fletcher Challenge Oil & Gas Inc*, 2007 ABQB 353, 428 AR 102. She declined to adopt the appellants' approach that the proper remedy was disgorgement of the lessees' revenues.

[43] The trial judge dismissed the counterclaims. She reasoned that although 108 and Mr. Bowes promoted, directed and managed the litigation, as well as funded it in return for 50 percent of any damages awarded, their actions were not champertous as they had a sufficient commercial interest in the action itself. She also rejected the respondents' claim for interference with contractual relations.

IV. Grounds of Appeal

[44] The appellants raise 16 grounds of appeal. Those grounds, the applicable standards of review and my analysis, are considered in Section V as follows:

- Part A concerns the validity of the leases, including their interpretation and whether the respondents discharged their burden of proving that the ameliorating provisos meant the 7-25 Well was properly shut in until production resumed in 2001.
- Part B discusses the trial judge's conclusion that she could not make a declaration about the validity of the Scurry leases because parties whose rights might be affected by the declarations (Snell and Wheatland) were not parties to the litigation.
- Part C discusses the *Limitations Act* arguments.
- Part D concerns the respondents' argument that by accepting royalty payments, the Irwin Group gave leave and licence.
- Part E discusses the appropriate remedy.
- Part F assesses 108's independent claim for damages.
- Part G addresses the joint and several liability of Esprit arising from its 10% gross overriding royalty interest.

V. Analysis of the Appeal

A. Validity of the Leases

[45] The appellants raise several grounds of appeal with respect to the leases' continuing validity. Some relate to the trial judge's interpretation of the leases and others to her fact findings about whether the respondents were entitled to rely upon the third proviso during the period of

non-production. The appellants also contend that the trial judge erred in admitting expert evidence or, in the alternative, finding it met the respondents' burden. Finally, they submit that the trial judge failed to consider and find that the respondents had self-frustrated the leases.

1. Interpretation of the Leases

[46] Each *habendum* clause provides that the lease continues after the primary period, "so long thereafter as the leased substances or any of them are produced" or any cessation in production is no longer than 90 consecutive days. There are three versions of the third proviso in the leases' *habendum* clause.

[47] The first version is found in the Imperial NW1/4 lease, the Jefferson SW1/4 lease and the Scurry NE1/4 lease. The relevant part of third proviso of the *habendum* clause (with emphasis added) reads:

> ... if any well on the said lands or the pooled lands ... is shut in ... or otherwise not produced <u>as the result of a lack of or an intermittent market, **or** any cause whatsoever beyond the Lessee's reasonable control</u>, the time of such interruption or suspension or non-production shall not be counted against the Lessee, anything hereinbefore contained or implied to the contrary notwithstanding.

[48] A slightly different version of the third proviso is in the Scurry SE1/4 Lease, with emphasis on the variation:

> ... if any well on the said lands or the pooled lands ... is shut in ... or otherwise not produced as the result of a lack of or an intermittent market, or any cause whatsoever beyond the Lessee's reasonable control, the time of such interruption or suspension or non-production shall not be counted against the Lessee, <u>and shall be added to the said ten (10) year term</u>, anything hereinbefore contained or implied to the contrary notwithstanding.

The underlined variation is not relevant because the 10-year primary term had ended.

[49] The Union NE1/4 lease's third proviso (with emphasis on the variation) is:

> ... if ... production operations are interrupted or suspended <u>as the result of any cause whatsoever beyond the Lessee's reasonable control including, in the case of production operations, lack of or an intermittent market</u>, the time of such interruption or suspension shall not be counted against the Lessee, anything hereinbefore contained or implied to the contrary notwithstanding.

[50] The shut in clauses in the leases are also slightly different but nothing turns on the differences. In effect, when a well is not producing as the result of a lack of or an intermittent market or any cause whatsoever beyond the lessee's reasonable control, rental payments deem the well to be producing.

[51] In summary, because each lease was outside the primary term and production of the 7-25 Well had ceased for more than 90 consecutive days, each lease would have terminated were it not for the third proviso. The lessees had the onus of proving that the third proviso prevented the leases from terminating: *Freyberg v Fletcher Challenge Oil & Gas Inc*, 2005 ABCA 46 at para 82, 363 AR 35. I refer to this case as *Freyberg* and alert the reader that there is a subsequent decision in the Freyberg litigation as the case was referred back to the Court of Queen's Bench to determine the remedy: *Freyberg v Fletcher Challenge Oil & Gas Inc*, 2007 ABQB 353, 428 AR 102. I refer to it as the *Freyberg* remedies decision.

[52] All five leases are silent on the period within which production must resume when the ameliorating provisions (lack of or intermittent market or causes beyond the lessee's reasonable control) are no longer satisfied. I will return to this point in subsection (d), "Time Period to Resume Production".

[53] An oil and gas lease is a contract and the principles relevant to its interpretation are summarized in *Omers Energy Inc v Alberta (Energy Resources Conservation Board),* 2011 ABCA 251 at para 33, 513 AR 292 with citations omitted:

> A tribunal, interpreting such a contract, must search for the intention of the parties by examining the specific words used with regard to the whole contract and the demonstrated intention of the parties .... Individual words or phrases may achieve a clear meaning when the entire document is read .... Where the words of the contract are unambiguous, the court should not deviate from its clear terms unless the contract is absurd, or has an effect clearly contrary to the intention of the parties .... Where the words of the contract are ambiguous, extrinsic evidence can be relied upon as an interpretive aid. It is from the whole of the document coupled with the surrounding circumstances that the general intention of the party or parties is to be ascertained ....

(a) Standard of Review

[54] The proper standard of appellate review of the interpretation of oil and natural gas contract arises given the recent decision *Creston Moly Corp v Sattva Capital Corp,* 2014 SCC 53, [2014] 2 SCR 633. The respondents urge review of the trial judge's interpretation of the leases for palpable and overriding error. They say that she made no such errors and her decision is entitled to deference. The appellants contend that we should review for correctness.

[55] *Sattva* rejected the correctness approach historically used to review a trial judge's interpretation of a contract. Rothstein J observed that contractual interpretation involves issues of

mixed fact and law; that is, the principles of contractual interpretation are applied to the words of the contract, considered in light of the factual matrix: para 50. He held at para 47 that courts:

> must read the contract as a whole, giving the words used their ordinary and grammatical meaning, consistent with the surrounding circumstances known to the parties at the time of formation of the contract. Consideration of the surrounding circumstances recognizes that ascertaining contractual intention can be difficult when looking at words on their own... the commercial purpose of the contract which presupposes knowledge of the genesis of the transaction, the background, the context and the market in which the parties are operating are relevant.

[56] When there is an extricable error of law, review for palpable and overriding error may not be appropriate. Extricable legal errors might include the application of an incorrect principle, the failure to consider a required element of a legal test, or the failure to consider a relevant factor: para 53. However, Rothstein J urged caution in identifying extricable questions of law in disputes over contractual interpretation: para 54.

[57] In the context of these five leases, the *Sattva* approach to appellate review raises interesting questions. Lease language was relatively standard in freehold oil and gas leases executed in the 1960s and 1970s, although the language is not identical. Even in a province where most of the mines and minerals are held by the Crown, there are still a significant number of freehold leases. Should these leases be reviewed for correctness so that there is consistency in the interpretation of that particular lease? When variations exist in lease language, is it still a 'standard' form lease? When a lease was executed fifty years ago, what background, context and market conditions should a court consider when interpreting the lease?

[58] The standard of review of standard form contract interpretation was discussed in *Vallieres v Vozniak*, 2014 ABCA 290, 5 Alta LR (6th) 28, leave to appeal to SCC abandoned. The court concluded that *Sattva* must be read in its context and some of the restrictive language about standard of review did "not apply to ordinary appeals in Alberta": para 12. And, because the dispute in *Vallieres* was about a standard form real estate contract, its "interpretation is of general importance beyond this dispute, any decision on its proper interpretation has great precedential value, and the primary objective should be certainty": para 13. This conclusion was based on *Sattva*'s statement that appeal courts should be slow to intervene unless the "results can be expected to have an impact beyond the parties to the particular dispute" and an appellate court's role is "ensuring the consistency of the law, rather than in providing a new forum for parties to continue their private litigation": *Sattva* at para 51.

[59] This led the *Vallieres* court to conclude that "attempting to inject the circumstances surrounding the formation of the contract into the analysis, or any attempt to identify the intention of the parties, is nothing but a legal fiction": para 13. The trial judge's contractual interpretation was therefore reviewed on the correctness standard.

[60] Other appellate decisions post-*Sattva*, including some interpreting arguably standard form contracts, have not distinguished the standard of review on that basis, see e.g.: *Bell Mobility Inc v Anderson*, 2015 NWTCA 3, 593 AR 79; *Kassburg v Sun Life Assurance Co of Canada*, 2014 ONCA 922, 379 DLR (4th) 665; and *De Beers Canada Inc v Ootahpan Co*, 2014 ONCA 723, 246 ACWS (3d) 448. *Sattva* itself relied on cases that interpreted what were likely standard form contracts: para 47. The court relied upon those cases for the proposition that contractual interpretation has "evolved towards a practical, common sense approach not dominated by technical rules of construction" but rather to "determine 'the intent of the parties and the scope of their understanding'": *ibid*.

[61] In *Freyberg*, this court reviewed the trial judge's interpretation of an oil and gas lease on a standard of correctness. It determined that the trial judge erred in her interpretation when she implied a term which resulted in extending the lease. In reviewing the trial decision, this court's approach was consistent with a considerable body of jurisprudence interpreting oil and gas leases. Historically, these leases were strictly construed. If the lessee failed to meet a deadline with respect to drilling, production or payment of rentals, the lease terminated whether it was in its primary or subsequent term: *Weyburn Security Co v Sohio Petroleum Co*, [1971] SCR 81, 13 DLR (3d) 340 [*Sohio*]; *Canada-Cities Service Petroleum Corp v Kininmonth* (1963), 42 DLR (2d) 56 (Alta SC(AD)); aff'd [1964] SCR 439, 45 DLR (2d) 36 [*Kininmonth*]; *Canadian Superior Oil of California Ltd v Kanstrup*, [1965] SCR 92, 47 DLR (2d) 1*; Durish v White Resource Management Ltd* (1985), 55 Alta LR (2d) 47 (QB), aff'd (1988), 63 Alta LR (2d) 265 (CA); *East Crest Oil Co Ltd v Strohschein and Strohschein*, [1952] 2 DLR 432, [1952] AJ No 47 (Alta SC(AD)).

[62] But even in the context of a review for correctness, Ritter JA, writing for the majority in *Freyberg*, discussed contextual factors. These included the lessor's desire for production during the lessor's lifetime, the fact that earlier production would have resulted in earlier profits for both parties, and the practical observation that during non-production, the gas from an "inactive" well might be captured by other wells. It seems that even when applying the correctness standard, courts have looked at the surrounding circumstances, including the economic consequences of interpreting the contract in a certain manner.

[63] Given the cases cited above and *Sattva*'s reliance on cases that appear to have interpreted standard form contracts to reach the conclusion that the correctness approach to appellate review of trial decisions is no longer appropriate except in the most exceptional cases, I am persuaded that the trial judge's interpretation of these leases is reviewable on the palpable and overriding error standard unless the decision reveals an extricable error of law or principle.

(b) "Lack of or Intermittent Market"

[64] The trial judge found that the phrase "lack of or intermittent market", read in context and with a view to the reasonable intention of the parties to a lease to profit from the extraction of the leased substances, should be read to mean lack of an <u>economical or profitable</u> market: para 542 (with emphasis).

[65] The appellants submit that adding the qualification "economical and profitable" is an error because the words "lack of or intermittent market" are not ambiguous. They urge a literal interpretation of the word "market" and rely on *Blair Estate Ltd v Altana Exploration Co*, 1987 ABCA 123, 53 Alta LR (2d) 419 (note), which considered a lease containing the identical phrase.

[66] In *Blair* the court did not consider whether the phrase was ambiguous, as the focus was on whether the conditions of the clause had been met. The court found that although there was evidence of the respondent's ability to market gas to its major customer that was only intermittent, it failed to prove that it could not market elsewhere. The appellants also point to the offset well clause in the leases which provides that offset well obligations can be postponed pending the establishment of "an adequate and commercial profitable market for the natural gas." They argue that had the parties intended to modify the words "lack of or intermittent market" in the third proviso, they could and would have done so.

[67] Some preliminary comments about the leading Alberta cases, *Freyberg* and *Omers*, are essential to clarify what those cases decided as it pertains to this appeal.

[68] The *Freyberg* lease was similar to those in this appeal. However, relative to the issue before us, the wording of the relevant proviso and shut in rental clause were very different. The proviso in *Freyberg* stated that if a well is shut in or suspended as a result of an "uneconomical or unprofitable market", such suspension shall not be deemed to be a discontinuance of production. The "Shut-in Gas Well" clause in *Freyberg* likewise stated that a well shut in as a result of the lack of an "economical or profitable" market is deemed to be producing. The leases in this appeal have no such qualifying language. The significance of this difference in wording is that the issue in *Freyberg* turned on whether or not an economic or profitable market in fact existed, not whether the absence of an economic or profitable market permitted the shutting in of a well capable of production.

[69] *Omers* was about determining whether a well is capable of production. It was not a case involving a deliberate suspension of production from a well which the operator considered capable of production, but not economic or profitable. The lease in *Omers* provided that if a well is capable of production at the end of the primary term and the well is shut in for whatever reason, the lease continued so long as "suspended well payments" were paid. The leases in this appeal are not as generous to the operator. Also, the issue of the lessee's entitlement to shut in the well was expressly not engaged in *Omers*. That, of course, is part of the backdrop to this appeal. Unlike the leases in this appeal, the lease in *Omers* did not prescribe when or under what circumstances a well could be shut in. The terms of this appeal's leases say that a well can only be shut in if there is no market or only an intermittent market. In *Omers*, the court said, "[a]s the issue of entitlement to shut-in is not directly engaged in this appeal, I leave to another day the question of whether the language of this lease, viewed objectively, demonstrates a common intention that a well, even one 'capable of producing' can only be shut in for prudent reasons." That "other day" has arrived; but I am cognizant that the issue we are being asked to decide did not arise in *Omers*.

[70] Relevant in *Omers* from the perspective of the decision required in this appeal, is that the court indicated in *obiter* that it might find a well to be capable of production so long as production revenues exceeded production expenses The court upheld a ruling by the regulator that a well capable of producing in "meaningful", but not "paying" quantities would have kept that particular lease alive. That is one interpretation of profitability. Another is profitability in the sense that lessees look at investments, i.e., 2 or 3-year payouts and hurdle rates which reflect the many risks the oil business faces. A different issue was admittedly being decided in *Omers*, but the case provides an example of a situation where both the regulator and the court did not merely rely upon the lessee's economics to determine capability (or profitability).

[71] The leases in this appeal are now examined in the context of the broader legal principles articulated in *Freyberg* and *Omers*.

[72] What did the parties intend in the 1960s when they entered into these leases? Something of intention can be learned from *Freyberg* and *Omers*. The search for the parties' intention is conducted on an objective basis; what would a reasonable person infer those intentions to be from the words used?: *Omers* at para 34.

[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.

[74] No one suggested that there was no market or that the market was intermittent: reasons at para 515. However, the literal interpretation advanced by the appellants (i.e., it is unnecessary to modify "market" by adding "economical or profitable") may lead to the result that the lessee would have to produce at a loss if it wished to maintain the lease, a result that is disadvantageous to the lessee and possibly to the lessor as well. The relationship between the owners of the mines and minerals and the lessee of hydrocarbon rights under a petroleum and natural gas lease is unlike that between industry working interest owners under operating agreements, etc., where operators are entitled to recover costs of drilling, etc., before they need to share revenue from the sale of the hydrocarbons produced. Mineral owners lease hydrocarbon rights for a percentage of the production and are therefore largely indifferent to the production costs the lessee incurs.

[75] That said it could not have been the objective intention of the parties to insist that the lessee market the produced substance when it was uneconomical or unprofitable. As the trial judge observed, a contextual reading of the phrase suggests a broader interpretation than the literal and narrow interpretation advanced by the appellants. However, to be clear, this is not an interpretation which suggests that a lessor would agree to tie up its land beyond the primary term for speculative purposes.

[76] In *Freyberg* the court concluded that the test is whether "based on information available at the time, a prudent lessee would have foreseen profitability": para 72. As mentioned earlier, this was in the context of whether there was, in fact, an economic or profitable market in circumstances where the lease expressly permitted a well capable of production to be shut in as a result of an "uneconomical and unprofitable" market. Although it was not a test applied for the purpose of determining whether "economic or profitable" can be inferred in petroleum and natural gas leases which do not contain that wording, the overarching principle remains relevant.

[77] The appellants also argue that the trial judge erred in finding that a drastic downturn in gas prices and accompanying high processing costs were not reasonably foreseeable. They rely on *Kininmonth* which addressed whether a seasonal road ban was beyond the lessee's control. The court found that this was an event that the lessee could have anticipated and for which it could have planned.

[78] The trial judge concluded that the drastic reduction in the price of gas and the accompanying high cost of processing, both caused by external forces, were not as inevitable or foreseeable as seasonal road bans: para 558. Although a different conclusion might also have been available, the trial judge's finding was not unreasonable given the multiplicity of factors necessary to analyze gas markets and production costs.

[79] Accordingly, I discern no palpable and overriding error in the trial judge's interpretation of the third proviso as requiring an <u>economical or profitable</u> market.

(c) "Beyond the Lessee's Reasonable Control"

[80] When read in the context of the entire third proviso the phrase "lack of or intermittent market" may be but one example of a circumstance beyond the lessee's reasonable control. This is certainly so in the Union NE1/4 lease, which suspends time if "production operations are interrupted or suspended as a result of any cause whatsoever <u>beyond the Lessee's reasonable control</u>, including, in the case of production operations, lack of or an intermittent market ..." (emphasis added).

[81] The third proviso in the other leases suspends time "if any well ... is shut in ... as a result of lack of or an intermittent market, **or** any cause whatsoever <u>beyond the Lessee's reasonable control</u>" (emphasis added).

[82] The appellants' submissions on "beyond a lessee's reasonable control" are two-fold. First, they say the lessees self-frustrated the leases decades earlier when they made certain operational decisions. Second, they assert this a true force majeure clause.

Self-Frustration

[83] The appellants' self-frustration submission can be dealt with summarily. They assert that the trial judge erred in failing to consider and find the respondents self-frustrated the leases. They

rely on operational decisions made more than a decade before the 1995 shut in, for example, failing to tie the 7-25 Well into another well and then into the Petrogas Plant, not proceeding with a common carrier or processing application for access and fees at the East Crossfield Plant, etc.

[84] The respondents say that these historical operational decisions are irrelevant to this action for several reasons. I agree. In any event, the 10-year limitations period in the *Limitations Act*, s 3(1)(b) is a complete defence.

"True" Force Majeure Clause

[85] The appellants' argument is that there is no economic aspect to something that is beyond the lessee's reasonable control. The clause should be interpreted as a true force majeure clause so that it does not apply absent an unforeseeable supervening event that interferes with the lessee's ability to produce. The trial judge found that the language of the third proviso was not a true force majeure provision and no absurdity arose by giving it its ordinary meaning: para 553.

[86] The appellants submit that the trial judge's interpretation yields a commercially absurd result and renders the rest of the *habendum* clause meaningless. The clause cannot extend a lease simply because the lessee or the operator would prefer to delay operations until it was more profitable or for other corporate objectives. They rely primarily on *Atlantic Paper Stock v St Anne Nackewic Pulp & Paper Co*, [1976] 1 SCR 580, 56 DLR (3d) 409.

[87] *Atlantic Paper* involved the interpretation of a contract to purchase a specific amount of paper for the manufacture of a corrugating medium. St. Anne wanted to stop purchasing paper because there was no market for the corrugating medium at the time. A clause in the contract said "unless as a result of an act of God, the Queen's or public enemies, war, the authority of the law, labour unrest or strikes, the destruction of or damage to production facilities, or the nonavailability of markets for pulp or corrugating medium."

[88] The Supreme Court found that this was "an act of God or force majeure clause": 583. These clauses generally operate to discharge a party from its obligations when a supervening event beyond the control of either party renders performance impossible. Reading the clause *ejusdem generis*, as the words "nonavailability of markets" appeared in a list of acts of God, war etc., the words were limited to an event over which St. Anne exercised no control. The court found that the lack of market was, in fact, due to St. Anne's lack of an effective marketing plan and hence it could not rely on this clause to discharge itself from its contractual obligations: 584.

[89] The appellants urge us to interpret the third proviso similarly. However, the language is very different. Unlike the clause in *St Anne*, neither version of the third proviso lists events (acts of God, etc.) beyond the control of the parties. Indeed, in the Union NE1/4 lease, the description of causes beyond the lessee's reasonable control <u>includes</u> the lack of or intermittent market, which is an economic factor. That lease also includes a true force majeure clause that includes the "act of God" language similar to that in *Atlantic Paper*.

[90] Reading the leases as a whole and noting the placement of the phrase within the third proviso, I cannot agree that "beyond the lessee's reasonable control" is a true force majeure clause. There must be some meaning to the word "reasonable". It seems to me that in a true force majeure clause, "reasonable" would be unnecessary as the types of events giving rise to a force majeure are beyond the parties' control and usually unforeseeable.

[91] I conclude that the trial judge's interpretation of the phrase "beyond the lessee's reasonable control" was not unreasonable.

(d) Time Period to Resume Production

[92] As noted earlier, none of the leases expressly prescribes the period within which production must resume once the ameliorating provisions cease to have effect. However, each of the five leases' third proviso states (with insignificant minor variations in wording) that if production ceases after expiry of the primary term and the lessee commences further working operations within 90 days after the cessation of production, the lease shall remain in force so long as any such operations are prosecuted with no cessation of more than 90 consecutive days. As noted earlier, the ameliorating provisions and the shut in well clauses provide that non-production shall not be counted against the lessee if rental is paid; in other words, the ameliorating provisions and the shut in clauses maintain the leases.

[93] The phrase "working operations" is not defined in the five leases. What is clear is that the authorities (see generally: *Williston Wildcatters,* 2001 SKQB 360, aff'd 2002 SKCA 91, 223 Sask R 276, and *P Burns Resources Ltd v Locke, Stock & Barrel Co*, 2014 ABCA 40, [2014] AWLD 1034) have said that "working operations" are meaningful activities directed to bringing about production. Further, as stated in John Bishop Ballem, *The Oil and Gas Lease in Canada*, 4th ed (Toronto: University of Toronto Press, 2008) at 169:

> The CAPL lease is very specific on the effect of cessation of production after the expiration of the primary term. The production of any leased substance is included in the definition of "operations" and the habendum provides that the term of the lease shall continue so long thereafter as operations are conducted with no cessation, in the case of each cessation of operations, of more than ninety consecutive days.

[94] In a somewhat different context, Ballem writes that reference to "with no cessation of ninety (90) consecutive days" in the third proviso of conventional leases, makes it "reasonable to suggest that the courts would import that time limitation in those cases where the lease is silent on the point": at 169.

[95] In my view that is also the proper result when the ameliorating provisions no longer maintain the lease. Once profitability becomes foreseeable, production must resume within 90 days or the leases terminate.

2. Did the Respondents Meet Their Burden of Proving the Third Proviso Applied?

(a) Background

[96] Production resumed in early 2001. The respondents had the burden to establish that the third proviso applied during the shut in period.

[97] Well economics must be analysed prospectively. The test is whether, based upon the information available at the time, a prudent lessee would have foreseen profitability. A prudent lessee is defined on an <u>objective standard</u> influenced by the character and nature of the lease and the <u>reasonable expectations of the parties</u>: *Freyberg* at para 72 with emphasis. In determining whether a prudent lessee would have objectively foreseen profitability, the view of the operator may be an important factor but is not determinative: *Freyberg* at para 73.

[98] In support of their contention that the 7-25 Well was shut in because production was uneconomical due to the drop in gas prices and the higher processing costs attributable to the 7-25 Well, the respondents relied on the evidence of Allan Seredynski, Nexen's production engineering manager for Canadian oil and gas; Ronald Watson, 7-25 Well's reservoir and exploitation engineer during the years at issue; and Wazir Seth, a professional engineer. The appellants' evidence on this issue came principally from their expert Cameron Six, also a professional engineer. Both Mr. Seth and Mr. Six were qualified to give opinion evidence as experts in the evaluation of oil and gas properties and reservoir engineering.

[99] The trial judge accepted Mr. Seth's opinion that the decision to shut in the 7-25 Well was justified and appropriate. The decision was commercially prudent given that its cumulative cash flow was negative and it was producing at a loss; estimates of the remaining reserves in the Wabamun formation were minimal; gas prices were low; and the net price of sulphur was negative.

[100] With respect to the reactivation, Mr. Seth and Mr. Six agreed that when capital is needed to recomplete a well, a producer would normally want attractive or acceptable returns, "hurdle rates", before proceeding. The trial judge preferred Mr. Seth's opinion on what hurdle rates were typically used by the industry at the relevant time.

[101] Overall, the trial judge accepted Mr. Seth's opinion that it was justified and appropriate for the operator of the 7-25 Well to shut in production from the Wabamun formation in July 1995 and it was not economical or commercially prudent for the operator to reactivate the well in the Wabamun formation during the 1995 to 2001 time period. Recompletion of the BQ formation would have met the industry's minimum hurdle rates by January 2000. However, the economics were not yet compelling so given the risks and uncertainties involved, it would not have been commercially prudent to take initial steps to recomplete the BQ zone until the third or fourth quarter of 2000: para 467.

[102] The trial judge observed that by the summer of 2000 Triquest began a program to recomplete the BQ zone, making offers to purchase and issuing an independent operations notice in November 2000. The final step in the process occurred in January 2001 and the recompletion program began approximately two weeks later. The trial judge found that the well owners reactivated the BQ zone shortly after it became economical and prudent to do so: para 468.

[103] The appellants' main submission to this court is that the trial judge erred in her determination that it was not economical and profitable to recommence production prior to 2001. They say that the respondents' own evidence supports a finding that recompletion of the BQ zone for the 7-25 Well was economic and profitable some time in 1999. As the lessees failed to recommence production within 90 days, all of the leases would have terminated before January 2001.

(b) Necessity of Expert Evidence

[104] Prior to addressing the merits of this ground of appeal I address a preliminary issue. During the shut-in period the respondents did not complete an annual economic analysis of the 7-25 Well. For the purposes of trial they relied upon the expert evidence of Mr. Seth to look back over the period and opine on whether there continued to be a lack of or intermittent economical and profitable market. The appellants submit that the trial judge erred in admitting expert evidence when there was a sufficient factual basis to determine the issue.

[105] The lay evidence demonstrated why the operator shut in the well. The respondents took no steps to produce any economic analysis to ensure that they continued to be entitled to rely on the third proviso. The appellants contend that there was no need to admit expert evidence on what a prudent operator would have done, as Nexen failed to meet the test of a prudent operator.

[106] It is the appellants' position that an operator that has demonstrably not met the test of a prudent operator cannot lead expert evidence to justify conduct after the fact. The appellants rely upon this court's observation in *Freyberg* that expert evidence is not necessary when there is a sufficient factual basis to determine an issue: para 87. There the majority concluded that there was sufficient lay evidence regarding an economical and profitable market and the trial judge erred in admitting expert evidence on that point.

[107] Here there was little lay evidence on an issue for which the respondents had the burden of proof. Indeed, at trial, the appellants closed their case without introducing any expert evidence, although they had exchanged expert reports in accordance with the *Alberta Rules of Court*, Alta Reg 124/2010. The appellants read-in from the discovery evidence of the respondents who acknowledged that they had not performed any analysis between 1995 and 2000 to determine if there was an economic and profitable market.

[108] The appellants took the position that there was no need for expert evidence and objected to the respondents being permitted to introduce their experts. In a mid-trial ruling, the trial judge concluded that the respondents were entitled to adduce the expert evidence. Rather than allowing

the appellants to call their experts in rebuttal, she permitted the appellants to re-open their case to introduce their expert witnesses: 2012 ABQB 87. She indicated that her ruling would not preclude the appellants from raising objections to the expert evidence later in the trial. The appellants raised their objection again. The trial judge ruled that the issue upon which the expert evidence was tendered was unlike in *Freyberg*. She concluded that the expert evidence tendered by the respondents focussed on the more objective questions of whether a prudent lessee would have foreseen profitability during the shut in period. She found that in the circumstances, the expert evidence was relevant and necessary: para 353.

[109] This was an issue within the discretion of the trial judge who was familiar with the case and with the evidence which had been adduced up to that point. She was in the best position to determine whether the expert evidence was relevant and necessary; see generally, *R v Mohan*, [1994] 2 SCR 9, 114 DLR (4th) 419.

[110] Although a different conclusion might also have been available given the evidence that off-setting wells were producing in the same pool and the independent operations notice referred to at paragraph [127] below, I find no reviewable error in the trial judge's decision to admit the expert evidence.

(c) Standard of Review – Expert Evidence

[111] The application of a legal test to the facts is a question of mixed fact and law, and reviewed on the standard of palpable and overriding error: *Housen v Nikolaisen*, 2002 SCC 33 at para 36, [2002] 2 SCR 235.

[112] When the issue on appeal involves the trial judge's preference for the opinion of one expert over another the issue is one of the standard of appellate review: *Pedherney v Jensen*, 2011 ABCA 9 at para 19, 499 AR 216. It is not an error for a trial judge to choose one expert over another because this is precisely what a trial judge is obliged to do: *Nova, an Alberta Corp v Guelph Engineering Co*, 1989 ABCA 253 at para 10, 100 AR 241. This court can interfere only if the trial judge's choice is unreasonable or patently wrong: *Bell v Tilden Car Rental Inc*, 1996 ABCA 318 at para 10, 44 Alta LR (3d) 152. When "a trial judge is presented with competing explanations or conclusions from expert witnesses, there is no reversible error when he makes a reasoned choice between the two": *Labbee v Peters*, 1999 ABCA 246 at para 19, 237 AR 382.

(d) Did the Expert Evidence Meet the Respondents' Evidentiary Burden

[113] As the respondents led no lay evidence regarding when the 7-25 Well became economical and profitable, their case rested largely on the evidence of their expert, Mr. Seth. He opined that to consider a well economical, a lessee would want to meet the following hurdle rates: (a) a profit to investment ratio greater than two; (b) a rate of return of 15 per cent; and (c) a payout in two to four years. He opined on the hurdle rates for each of the shut in years. The trial judge accepted Mr.

Seth’s evidence that as of January 1, 1999, recompletion of the BQ zone was economical but not “sufficiently” profitable.

[114] Mr. Seth’s evidence was that by January 2000 the project had a profit to investment ratio of greater than two; a rate of return of about 25 per cent; and payout in a little less than two years. In other words, all the industry hurdle rates were met no later than January 1, 2000. Mr. Seth conceded that he had not run any cash flow analysis to indicate when during 1999 the project may have met the economic criteria.

[115] The appellants say that this evidence is capable of only one interpretation: recompletion of the BQ zone for the 7-25 Well would have been economical and profitable at some point in 1999 but in any event no later than January 1, 2000.

[116] When asked in cross-examination why, when all internal profitability indicators and hurdle rates had been met by January 1, 2000, production did not recommence, Mr. Seth replied (with emphasis added):

> You could have turned it on, yes, sir. The only caveat here is that, if you’re a small company that has 50 wells, you would have jumped on it, but in this case you would look at escalating price during the first half of 2000, and $3 by itself is not compelling economics, right? <u>You’ve just met the minimal hurdle. It’s not compelling economics. So once you’re going through this, you say, When was the compelling economics?</u> Certainly by Q3 it was <u>compelling</u>. It’s <u>very profitable</u>.

[117] Mr. Seth also confirmed in cross-examination that:

> APPELLANTS’ COUNSEL: It was certainly within reasonable control of the operator and certainly the economics were all in place for a prudent operator to reactivate – or, sorry, recomplete and turn the well on as of January 1, 2000, correct?
>
> MR. SETH: I mean, profitable to do that, <u>it would have met the minimum criteria but I wouldn’t consider it a compelling economics yet</u>.
>
> APPELLANTS’ COUNSEL: And when you talk about compelling economics, what you’re really talking about is the level of profitability that a company might want to achieve, correct?
>
> MR. SETH: Yes.
>
> APPELLANTS’ COUNSEL: Not whether it’s profitable but the level of profitability, correct?

> MR. SETH: ... we're not talking about 15 percent rate of return, sir. We're talking about 60 to a hundred percent.

[118] The trial judge found at para 473:

> Mr. Seth testified that his January 2000 cash flow analysis showed that the project met the economic criteria, in that it showed a profit investment ratio of more than two, a positive rate of return and payout in two years. In his view, it met the minimum hurdle level. However, this was not the whole picture. While these economic runs showed a more or less positive net worth, a well owner would have to have some confidence that natural gas prices were sustainable and increasing. He testified that the focus was not just on economics but also on commodity prices. In his view, producers would be starting to look at the gas price in the fourth quarter of 1999. Most producers would be looking seriously at the price in the first half of 2000, and in the second and third quarters, many companies would have been making decisions to go ahead with projects. Given that some leeway time is reasonable, Mr. Seth was of the opinion that the case for reactivation of the 7-25 Well in the BQ zone became compelling in the third quarter of 2000. He noted that it was in this time period when Triquest began proceedings to obtain the necessary approvals to drill and operate the 7-25 Well.

[119] The appellants submit that this conclusion is not supportable in law or on the facts. The test is whether, based on the information available at the time, a prudent lessee would have foreseen profitability: *Freyberg* at para 72. They contend that the trial judge added another factor to the test: that the economics must be compelling (see reasons paras 467-68). They say that she further compounded the error when she concluded at para 466 that although the recompletion of the BQ formation would have generated positive cash flow (presumably by January 1, 2000 given the evidence) it would not have been commercially prudent to take the initial steps to recomplete the BQ zone until the third or fourth quarter of 2000. She found that the well owners had reactivated the 7-25 Well in the BQ zone shortly after it became economical and commercially prudent to do so.

(e) Evidence of ExxonMobil and Imperial Oil Landman

[120] The appellants also point to the testimony of a landman with ExxonMobil and Imperial Oil, who was asked in the summer of 2000 to assess the 7-25 Well. He testified that he noticed that the well had not produced for five and a half years. As part of his review he looked at the Jefferson SW1/4 lease and production from the 7-25 Well. He testified that since the well had not produced and had been shut in and previously producing at a pretty high rate, he was concerned that "perhaps we had a problem with our lease." Given the historical production information, he assumed that this was a good rate of production and that it should be economic to produce the well. He expressed doubt about the validity of the lease but suggested a lawyer review it.

[121] In November 2000, the same landman requested a technical evaluation of the 7-25 Well in order to determine whether ExxonMobil should participate in the Triquest reestablishment of the well. In the form generated to give background, he said: " ... as the well had been shut in since 1995, there is a possibility that the freehold leases have terminated for lack of production. If [ExxonMobil] elects to participate, seek Law's opinion re: leases. New leases may be required." He raised his concern with a joint venture representative, who later advised that the well had been shut in due to high fees that would make the well uneconomic. The landman testified that this allayed his concerns but left a "slight cloud" in his mind about whether shutting-in a well for economic purposes would keep the lease in good standing. He also raised his concern with a landman from Triquest, and suggested to him that if the leases were not valid, new leases would be required.

(f) Conclusion on the Validity of all but the Scurry Leases

[122] In light of the respondents' evidence two questions arise. Was it open to the trial judge to interpret the third proviso as requiring "compelling" economics, in excess of the industry's hurdle rates? Alternatively, was it open to the trial judge to, in effect, extend the time period within which the lessee must take action or the lease terminates once the ameliorating conditions ("lack of or intermittent economical and profitable market" or "beyond the reasonable control of the lessee") have expired?

[123] The respondents say the trial judge was entitled to balance the interests of the parties and we should defer to her determination. In other words, her application of the facts to the wording of the *habendum* clauses in the leases was reasonable.

[124] Contractual interpretation post-*Sattva* invites an assessment of contextual factors. However, absent evidence to the contrary, the surrounding circumstances or contextual factors must be commercially reasonable <u>as between the parties</u>.

[125] The trial judge was entitled to conclude that the market for the produced substances must be economical or profitable. However, she erred in principle when she assessed profitability solely from the perspective of the lessees without giving equal weight to what was commercially viable and sensible from the lessors' perspective. As was said in *Freyberg* and *Omers*, lessors would not agree to tie up land when it was no longer commercially viable from their perspective.

[126] I conclude that on the evidence of the respondents' own expert, it was profitable for a prudent operator to recomplete the 7-25 Well no later than January 1, 2000. In January 2000, by all objective measures (i.e., the three hurdle rates referred to earlier), it became economical and profitable to resume production. The fact that it was not yet "compelling" or "very" profitable (to use the words of the trial judge's preferred expert) from the perspective of these particular lessees, under-emphasizes the commercial objectives of the lessors.

[127] Further support for the conclusion that the 7-25 Well ought to have been put back on production earlier is the independent operations notice served by Triquest Energy (now Bonavista)

on Nexen. When another producer is prepared to produce a well that is a clear signal that the well has become economic or profitable. An owner of mines and minerals is entitled to find a producer that is prepared to produce the minerals if the current lessee does not see any economics or profitability in producing.

[128] As noted earlier, the ameliorating provisions and the shut in clauses suspended the 90-day cessation of production period. Once the ameliorating provisions no longer applied, it is reasonable to interpret these leases as requiring the lessee to bring the 7-25 Well back into production within 90 days. On the expert's evidence, the hurdle rates were met in January 2000. Extending the 90-day period also over-emphasizes the lessees' commercial interests at the expense of the lessors.

[129] In conclusion, I find that the trial judge erred in determining that the Jefferson SW1/4 lease, the Union NE1/4 lease and the Imperial NW1/4 lease had not terminated (the Scurry leases are discussed in Part B). The two ameliorating conditions in the third proviso ceased to have effect when production became economical and profitable on January 1, 2000. According to their terms, the leases terminated.

[130] This conclusion has implications for the caveat registered by Esprit (now Pengrowth) and further discussion on that point is in Part G.

B. Validity of the Scurry Leases (Scurry NE1/4 Lease and Scurry SE1/4 Lease)

[131] The trial judge refused to make declarations about the validity of the two Scurry leases because there was evidence that doing so might affect the interests of Snell and Wheatland, which were not parties to the litigation. A very late application for standing in this appeal was denied: *Wheatland Farming Co Ltd v Stewart Estate*, 2014 ABCA 296, [2014] AWLD 4297.

[132] The trial judge's conclusion involves questions of law, reviewed for correctness; findings of fact, reviewed for palpable and overriding error; and an exercise of discretion, reviewed for reasonableness.

1. The Scurry Lands' History (Jerome Developments, Snell, Wheatland and the Jerome Group)

[133] As noted previously, Merville Stewart executed two leases: the Scurry SE1/4 in 1964 and the Scurry NE1/4 in 1967.

[134] On March 2, 1972, Merville Stewart transferred to his company, Jerome Development Limited, his entire fee simple interest in the mines and minerals other than coal and petroleum on the Scurry SE1/4 land. At the same time he transferred half his fee simple interest in the mines and minerals other than coal on the Scurry NE1/4 land.

[135] Certificates of title dated May 1974 indicate that Jerome Development is the owner of the lands and all mines and minerals, other than coal, in the SE1/4 and an undivided half interest in the NE1/4 of Section 25.

[136] There is no evidence that the lessees were advised of the transfers or that the two Scurry leases were assigned to Jerome Development.

[137] On March 1, 1977, Merville Stewart executed two pre-printed "Indentures" assigning each of the leases to Snell Farms Ltd, a company apparently controlled by Mr. Stewart's lawyer, Mr. Gregg.

[138] Correspondence in June 1977 between Mr. Gregg and Scurry confirms that Scurry received the Indentures, and from 1977 to 1982 paid royalties to Snell. In 1982, Mr. Gregg advised the lessees that the royalties should be paid to Wheatland.

[139] Upon Mr. Stewart's death in 1984, his one-half interest in the mines and minerals on the NE1/4 was transmitted to his heirs, the Jerome Group. On January 5, 2012, they transferred their interest to Jerome Development Limited.

[140] There was no evidence that any of the Jerome Group raised concerns about the fact that no royalty payments were received under the Scurry leases from 1977 onward. No witness from Snell or Wheatland was called at trial. In an affidavit for permission to intervene, Wheatland's deponent stated that it was unaware of the litigation until the trial judge's reasons issued.

[141] The appellants challenge the trial judge's refusal to grant the declaration on two bases. First, they challenge the validity of the 'Indenture' assignments. Their second submission concerns the conclusion that their failure "to name Snell Farms and Wheatland as parties to this action is a fundamental and fatal flaw in their case with respect to the Scurry NE/4 Lease and the Scurry SE/4 Lease": para 174.

2. Validity of the Assignments

[142] The appellants' main contention at trial was that they were entitled to rely upon the certificates of title. Since the assignments were not registered on the certificates of title, the appellants say they are entitled to rely upon the principle of indefeasibility of title. Although the trial judge was inclined to the view that the Jerome Group appellants were volunteers who did not rely upon the certificate of title and therefore were not protected by the principle of indefeasibility (see *Lanstrom Developments Ltd v Passburg Petroleums Ltd* (1984), 53 AR 96, 30 Alta LR (2d) 379 (CA)), she determined that this was an issue which could not be decided in the absence of Snell and Wheatland.

[143] The appellants also contended that because Snell and Wheatland had not filed caveats to protect their interests, the assignments were invalid. The trial judge found that this was not an issue that could be decided without input from Snell and Wheatland.

[144] The appellants further submitted that the assignments were hearsay evidence introduced by agreement of counsel but not for the truth of their contents. The trial judge acknowledged that there were ambiguities arising from the wording of the form used, but she was reticent to make a finding on the proper interpretation of the assignments without input from Snell and Wheatland.

[145] Another challenge to the assignments' validity was the assertion that Merville Stewart had no interest to assign when he entered into the assignments, as he had already disposed of his fee simple to Jerome Developments Limited.

[146] All these arguments and the nature and extent of the assignments are now the subject of litigation between Wheatland and Jerome Development Limited (Queen's Bench Action No 1401-08856). Wheatland alleges that it holds the freehold oil and gas interests in the Scurry SE1/4 and half of the Scurry NE1/4 by virtue of the 1977 assignments. Wheatland also asserts that it is the sole legal and beneficial owner of the oil and gas and the Jerome Group knew or ought to have known of the assignments, despite the title never having been amended.

[147] The trial judge did not determine these issues nor did she conclude that the Jerome Group appellants had no interest. I agree with her approach. Accordingly, another court will determine the rights as between those parties in that lawsuit. Given that the litigation is extant, it would not be appropriate to say more about the validity of the assignments or the rights of Snell/Wheatland, Jerome Development Limited and the Jerome Group.

3. Standing Given the Purported Assignments

[148] The second part of the appellants' standing submission is slightly different. Did the trial judge err in concluding that the dispute between Snell/Wheatland and Jerome Group about their respective rights meant she could not make a declaration about the leases' validity in the absence of Snell/Wheatland?

[149] The appellants assert that the trial judge erred in placing the onus upon the appellants to add Snell and Wheatland to the lawsuit. They raise procedural arguments given that the respondents did not plead the issue involving Snell and Wheatland. Finally, they contend that the trial judge erred in her assessment of the need for Snell and Wheatland's presence in order to make the declaration they sought.

[150] As the Jerome Group had pleaded that they were the registered owners of the minerals <u>and</u> lessors under the leases, and sought a declaration that the Scurry leases had terminated, the trial judge was concerned about granting a declaration in the absence of Snell and Wheatland. The trial judge made her determination in the context of whether a declaratory judgment could be made in the absence of interested parties.

[151] The appellants had the burden of demonstrating that the parties before the court were the only interested parties: Sarna, *The Law of Declaratory Judgments*, 3d ed (Toronto Ont: Thomson Carswell, 2012) at 98. This court in *Alberta (Treasury Branches) v Ghermezain*, 2000 ABCA 228

at para 15, 226 AR 170, described the purposes of the general rule that all parties to the contract must be before the court to enable it to fully address the issues, with citations omitted:

> As a general rule, all parties to a contract must be before the court to enable it to fully adjudicate the issues in question .... The purpose of this rule is to ensure: (i) no injustice is done to any party to an action or other interested persons; (ii) the parties are not prejudiced by not having all proper parties before the court; (iii) all interested parties will be bound by the decision so there is no risk of subsequent proceedings by persons not before the court and thus avoid the need for multiple suits; and, (iv) the court will be able to effectively adjudicate all issues in question.... The court must be "perfectly certain that no injustice is done, either to the parties before it, or to others who are interested in the subject matter....

[152] The appellants assert that the declaration was not the only relief they sought. It is true that the appellants sought other relief but it hinges upon a finding that the leases had terminated. The declaration is the lynch pin for all of the other relief and that declaration potentially affects Snell and Wheatland.

[153] The trial judge thoroughly addressed each of the appellants' arguments in relation to what is described as the Snell Wheatland issue. Some arguments were procedural, such as the failure of the respondents to raise this issue in their pleadings. She found that the appellants had sufficient notice of the issue as it arose relatively early in the litigation. She observed that the possible error in pleadings did not address the prejudice to third parties and the possibility of injustice. In my view, her conclusion is entitled to deference.

[154] In summary, I conclude that this was an exercise of the trial judge's discretion. She considered each of the appellants' arguments but was concerned about the absence of Shell and Wheatland given the significant effect the appellants' claim might have on their interests. The appellants have not persuaded me of any misapprehension of the evidence or error in principle.

[155] I dismiss this ground of appeal. While it is conceivable that my reasoning regarding the other leases' termination might apply to the Scurry leases, it would not be appropriate to say more.

C. At What Point in Time are the Appellants Entitled to a Remedy?

[156] My colleague O'Ferrall JA concludes that the appellants consented to the respondents' continued production until they issued their Notices to Vacate and the Statement of Claim on August 9, 2005. Consent is sometimes referred to as leave and licence.

[157] The respondents did not specifically plead "leave and licence" but they did plead that the plaintiffs by their conduct had waived any right they had to relief and that by accepting royalties and shut-in well payments, they were estopped from claiming relief. They specifically pleaded

estoppel, acquiescence, waiver and the *Limitations Act*: Amended, Amended, Amended Statement of Defence of Nexen and Exxon at paras 23 and 24.

[158] The trial judge analyzed this as an issue of limitations. She found that with the exercise of due diligence the appellants had all the necessary information to advance a claim prior to 2003. She held that the appellants' claims were barred by the two-year limitation period in section 3(1)(a) of the *Limitations Act*. The trial judge did not address leave and licence except for a short period after the filing of the statement of claim with respect to one group of appellants. I discuss this later in this judgment at Section V, Part D.

[159] I am unable to adopt the approach advanced by my colleague that the respondents were given leave and licence to continue production until the issuance of the statement of claim. No argument was made in this court on this issue. The trial judge made no findings on this issue and other findings that she made contradict the notion that somehow the appellants consented to the continued trespass by the respondents from 2003 to 2005: See paras 220 to 225 of the reasons and in particular her finding at para 222 that the appellants "did not have the requisite knowledge prior to that time [2005] to establish either estoppel or acquiescence."

[160] The interpretation of the *Limitations Act* and the test for when a claimant "ought to have known" are issues of law reviewable on a standard of correctness: *Laasch v Turenne*, 2012 ABCA 32 at para 9, 522 AR 168. The application of the limitation provision to the facts, as a question of mixed fact and law, is reviewed on the standard of palpable and overriding error: *Housen* at para 36.

[161] The lynch pin of the appellants' case is the declaration that the leases terminated. Declaratory relief is not a "remedial order" and therefore not barred by the limitations provisions in section 3 of the *Limitations Act*. However, the real remedy sought is monetary and potentially barred by the Act.

1. What is the Nature of the Wrong?

[162] Principles of contract, property and tort law are all in play when considering the nature of an oil and gas lease. It is not a traditional lease because it grants a *profit à prendre*, rights to minerals *in situ* below the surface. Traditional notions of occupation and possession are not an exact fit.

[163] As the trial judge noted, the tort of trespass is not available to a landlord claiming against an over-holding tenant: para 584. She commented that the applicability of the tort of conversion is also not free from doubt: para 585. She also considered unjust enrichment as a potential cause of action. The trial judge did not reach a definitive characterization of the applicable cause of action but found that "an energy company that extracts resources from land owned by another without a valid lease violates a property right of a person": para 586.

[164] What is the cause of action in such a case? There are at least three possibilities: trespass, conversion, and unjust enrichment.

[165] The party in possession of land may sue someone trespassing on that land. When the owner of land has granted a lease and the lessee tenant has taken possession of the land, the tenant has exclusive possession and can sue for trespass. Professor Nigel Bankes suggests that an over-holding tenant does not commit trespass in a conventional lease: Nigel Bankes, "Termination of an Oil and Gas Lease, Covenants as to Title, and Assessment of Damages for Wrongful Severance of Natural Resources: A Comment on *Williston Wildcatters*" (2005) 68: Sask L Rev 23 at 52-53. As Professor Bankes also noted, some courts have applied the principles of landlord and tenant law to resolve disputes between oil and gas lessees and lessors whereas other courts have declined to draw the analogy. Professor David R. Percy, Q.C. and David McGillivray in their article "Overlapping Remedies and the Unexpected Termination of Oil and Gas Leases" (2011) 49: 2 Alta L Rev 251, write that "the majority of Canadian cases treat the continued occupation of land after the termination of a mineral lease as a trespass": para 37. An excellent example is *Williston*, also a case involving the termination of an oil and gas lease where the lessee continued to produce mines and minerals after the date of the lease's termination.

[166] There is a variation on the claim for trespass to land: trespass on a lessor's reversionary interest. A reversioner (here the lessor) has the necessary standing to sue in trespass when there is damage to the property which the reversioner will in time gain the right to possess or the injury is of such a permanent nature as to be necessarily prejudicial to the reversion: *Mayfair Property Co v Johnston*, [1894] 1 Ch 508; *Jones v Llanrwst Urban District Council*, [1911] 1 Ch 393. Technically the claim by the reversioner in such cases is not identical to a claim for trespass to land since the reversioner will allege that the defendant has injured the reversion rather than the land. More recently, these authorities were discussed in *HSBC Rail (UK) Ltd v Network Rail Infrastructure Ltd (Formerly Railtrack Plc)*, [2005] EWCA Civ 1437 at para 22, [2006] 1 All ER 343:

> These authorities, together with *Transcontainer Express Ltd v Custodian Security Ltd* [1988] 1 Lloyds Rep 128, 137, justify the proposition in *Clerk and Lindsell Torts* (18th ed) para. 14-143:
>
> > The action for reversionary injury lies, it is suggested, in respect of any act which would, but for the problem of the claimant's lack of title to sue, amount to [trespass] negligence [or conversion], provided it has the effect of depriving him either temporarily or permanently of the benefit of his reversionary interest whether because the goods are destroyed or seriously damaged or because they are wrongfully disposed of by a transaction whereby the disponee acquires a good title, so preventing recovery of them. But actual damage is necessary . . .
>
> [square] brackets in original

[167] "If the trespass has caused permanent damage, then a person with a reversionary interest would have a right to sue in trespass to obtain redress for the permanent, physical harm to the property, since he will eventually suffer the consequences of such harm": *340909 Ontario Ltd v Huron Steel Products (Windsor) Inc* (1992), 10 OR (3d) 95, 35 ACWS (3d) 309.

[168] Additional justification for this approach exists when the interest granted is a *profit à prendre*, i.e., the lessee's right to go on the land for the limited purpose of severing the minerals and making them its own. The holder of the profit does not own the minerals *in situ*. They form part of the fee. What the holder of the profit owns are mineral claims and the right to exploit them through the process of severance. When the right to go on the land and sever the minerals has terminated but severance nevertheless continues, the reversioner has been deprived of its fee interest, which constitutes the trespass of the reversion.

[169] Conversion is a positive and intentional act of interference with a person's legal possession or right to the immediate possession of goods: Lewis N Klar, *Tort Law,* 3rd ed (Toronto: Thomson Canada, 2003) at 88. The immediate right to possession takes priority over title or ownership: *ibid*. It consists of handling, disposing or destroying a chattel with the intention of denying or negating the title of another person to that chattel. Timber (*Harshenin v Bayoff* (1991), 49 CPC (2d) 55, 27 ACWS (3d) 508, (BC SC)) and crops (*Duck Lake Feed Processors v Badowsky* (1983), 26 Sask R 46, (QB), available on CanLII, varied on other grounds (1987), 54 Sask R 296, 3 ACWS (3d) 72 (CA)) have been held to be chattels. As Ballem points out, conversion is also more responsive to the situation when a lease that has been pooled has terminated: at 399.This was the principal cause of action recognized in *Freyberg* and in the *Freyberg* remedies decision.

[170] There is an added complication in this case, given my conclusion that in the absence of Snell and Wheatland, the court ought not to make a determination regarding the validity of the Scurry leases. The 7-25 Well is located on the Scurry SE1/4 lease lands. It was suggested by the respondents that in the absence of a finding with respect to the Scurry SE1/4 lease, it is not open to the court to find trespass with respect to the remaining leases. Given my colleagues' conclusion that all of the leases terminated, it is not necessary that I opine on this. However, I disagree with the respondents' position. There are certainly instances when the lessor of mineral rights is distinct from the holder of the surface rights, and courts have not had difficulty concluding that when the mineral lease terminated, the lessor has a cause of action in trespass: *Freyberg* and *Williston*. Trespass to the reversion would still be available, and the lessors would still be liable in conversion.

[171] These circumstances may also give rise to a claim for unjust enrichment. Given that the remedy would be the same (disgorgement), for the purposes of this appeal, I conclude that the appellant lessors have a right of action in trespass and conversion, and the remaining analysis proceeds accordingly.

2. New Actionable Wrong

[172] The tort of trespass is a continuing tort and results in a new actionable wrong each day: *Williams v Mulgrave (Town) and Canadian National Railway Co*, 2000 NSCA 24 at paras 23-33, 183 NSR (2d) 147. Conversion in the context of the continued exploitation of the leased substances is also a continuing tort.

[173] A similar result obtains "in the case of periodic payments, such as the royalty payments ... a separate limitation period arises with respect to each missed payment": *Canadian Natural Resources Limited v Jensen Resources Ltd*, 2013 ABCA 399 at para 40, 566 AR 76; see also *Meek (Trustee of) v San Juan Resources Inc*, 2005 ABCA 448 at paras 48-9, 52 Alta LR (4th) 1.

[174] Accordingly, leaving aside for the moment the question of discoverability, the appellants' claim for the two years preceding the statement of claim (August 9, 2005) is not statute-barred.

3. Discoverability

[175] Going back further is problematic. The appellants submit they did not discover that there was a potential issue over the validity of their leases until late 2003 when Mr. Oneil met with counsel and received advice regarding the leases. They sued within two years of that date. However, lack of knowledge of the law giving rise to the right to sue is not a sufficient reason to excuse a claimant's lack of due diligence. "Generally speaking, discoverability in Alberta law refers to facts, not law ... error or ignorance of law, or uncertainty of the law, does not postpone any limitation period": *Salna v Awad*, 2011 ABCA 20 at para 28, 499 AR 264. "Discoverability relates to issues of fact, not questions of law, and any difficulties in interpreting the documents does not extend the limitation period": *Jensen Resources Ltd* at para 43.

[176] The trial judge found that the appellants or their predecessors in interest would have known that production under the leases had ceased shortly after July 1995 when they stopped receiving monthly production royalty cheques and received annual rental payments: paras 193, 197. By the end of November 1995, the appellants ought reasonably to have known that production had ceased for more than 90 consecutive days; thus, they knew or ought to have known all the facts necessary to advance their claim that the leases had terminated in accordance with their terms. Further, she held that even if the appellants did not know a fact material to the injury because they did not necessarily know the reason for cessation of production, they were obliged to exercise due diligence in determining the reason for the cessation of production: para 200. They were not entitled to ignore the issue until they were ultimately notified by the respondents that the well was shut in because it was uneconomical to continue. The trial judge further found that if some knowledge of the reason for cessation was necessary, such knowledge could reasonably have been obtained within a year.

[177] The trial judge found no evidence that the appellants exercised reasonable diligence in discovering their injury until Mr. Oneil consulted counsel in December 2003 when he was unhappy with some of the lessees over an entirely different issue: para 203. She concluded that the appellants had all the necessary information for their claim prior to 2003. It made no difference whether the cause of action arose when the shut in period began in July 1995, 90 days later or at the end of the shut in period in January 2001 as the claim was not filed until August 9, 2005, more than two years after the shut in period ended.

[178] The appellants raise many arguments challenging the trial judge's conclusion that they ought to have known that they suffered an injury that warranted bringing proceedings in 1995. They contend that not receiving royalty cheques and receiving shut in payments would not have put them on notice, particularly when the trial judge also found the respondents did not know that the leases had terminated. As well, the evidence was that not all of the appellant lessors received royalties. Moreover, Nexen's policy was to issue rental payments regardless of whether the well was producing. They further submit that the trial judge wrongly imputed too high a level of knowledge about the interpretation of leases for those not involved in the oil and gas industry. They say that absent clear information to show improper payment, interest holders are not obliged to take positive steps to ensure they are being correctly paid.

[179] These are arguments based on the trial judge's findings of fact and reviewable for palpable and overriding error. In my view it is unnecessary for the disposition of this appeal to comb the record for palpable and overriding error.

[180] Moreover, at least two of the lessor groups had actual knowledge. As regards the Jefferson SW1/4 lease, the Oneil group knew they were receiving royalty payments again and that the well was producing again in March 2002, and Ms. Baxter Gilmour on behalf of Bowen Family Properties testified that her mother had written to Nexen in 2002 asking why no royalties had been paid when it appeared that the well was producing. With respect to the Union NE1/4 lease Ms. Cardiff made two inquiries of Coastal in March 2001 and May 2002, which confirmed that she knew the well was producing. Accordingly, there was ample evidence on the record to support a finding that by 2002 the Jefferson and Union appellants knew that they had suffered an injury which warranted commencing a proceeding.

[181] No similar evidence exists with respect to the Imperial NW1/4 lease. Robert Copley testified that when his father (the original lessor) died, he and his siblings set up a professionally-managed trust. They gave no thought to the issue of whether the Imperial NW1/4 lease may have terminated "because everything went through Compushare and we're ... waiting for the cheques": Transcript at 604/29-33. It was not until Mr. Oneil contacted him in 2003 that he gave the issue of the lease's validity any thought. Although this group of lessors may not have had actual knowledge, this court's interpretation of the *Limitations Act* "calls for 'reasonable diligence' on the part of the claimant": *Jensen Resources Ltd* at para 41. In conclusion, these appellants did not exercise reasonable diligence.

[182] Given my findings about the two Scurry leases (see Part B), the issue of discoverability as regards those two leases is not relevant. Further, my conclusion (in Part F) that 108 had no right to claim a remedy independently of the appellant lessors means I need not consider it in the limitations context.

4. Conclusion

[183] In the result, the *Limitations Act* is a defence to the appellants' claims before August 9, 2003.

D. Leave and Licence to Occupy the Property – Union NE1/4 Lease

[184] Consent or "leave and licence" is a defence to an action in trespass. "If a defendant enters in circumstances which amount to trespass, the subsequent conduct of the plaintiff may reveal that he has acquiesced in such entry, to the extent that as a consequence, his permission to enter can be said to have been given *ex post facto"*: GHL Fridman, *The Law of Torts in Canada*, 2nd ed (Toronto: Thomson Canada Limited, 2002) at 5.

[185] In the context of the grounds raised in this appeal, in my view, the only question of leave and licence relates to the Union NE1/4 lease and the Irwin Group lessors. Although the trial judge concluded that the respondents were not trespassers, she discussed this issue very briefly in her reasons.

[186] The three individuals in the Irwin Group, whose interest in the Union NE1/4 lease descended from Jean Ella Irwin, knew little about the Section 25 lands until Ms. Irwin's death in April 2005. The Irwin Group were initially named as <u>defendants</u> in the litigation. In the summer of 2005, Freehold Solutions contacted Ms. McLaren, granddaughter of Ms. Irwin, to explain the litigation. The members of the Irwin Group agreed to the top lease and on December 5, 2005 were added to the statement of claim as <u>plaintiffs.</u> Ms. McLaren testified that until the 2005 meeting with Freehold Solutions, she had no concerns about the performance of Coastal, Union's successor, and never contacted Coastal. However, by October 7, 2005 when the last of the Irwin Group appellants entered into the top lease agreements with Freehold Solutions, they knew of the rights giving rise to their claims.

[187] The Irwin Group continued to receive royalty payments after they became plaintiffs in the litigation and cashed some of the cheques. On January 12, 2007, their counsel sent a letter to Coastal demanding that it stop production from the well. On March 19, 2007, the parties entered into an agreement which addressed how the royalty payments would be treated in the context of the litigation. The royalty payments by Coastal to the Irwin Group following service of the statement of claim would not constitute any form of acceptance, acquiescence, condonation or waiver by the royalty payees; nor, would it prejudice or affect Coastal's allegation that payment and acceptance of royalties prior to service of the statement of claim constituted acceptance,

condonation and waiver such that the Irwin Group were estopped from challenging the lease: A591.

[188] The trial judge concluded that there had been no leave and licence prior to October 2005. However, by continuing to accept royalty payments, she found that the Irwin Group implicitly gave leave and license to Coastal from the time they entered into the top lease agreements in October 2005 until January 12, 2007, when they demanded that Coastal stop producing from the 7-25 Well: para 668.

[189] The appellants submit that the trial judge erred in finding that the Irwin Group had given Coastal leave and licence. They say that they merely cashed some royalty cheques until advised not to do so in 2007. Coastal knew of the amended statement of claim by December 5, 2005 and would have received notice to vacate and cease operation around September 2005. These appellants submit that the innocent cashing of a few royalty cheques in these circumstances did not constitute leave and licence to continue producing gas under an expired lease. They also point out that Coastal led no evidence to suggest it believed its lease had been affirmed by the Irwin Group.

[190] In *Williston*, the court set out the indicia necessary to establish leave and licence. One factor is particularly relevant in these circumstances: was there tacit consent implied from conduct?

[191] In *Williston*, the decisive factor was two letters sent to the lessee; the first sought information about the suspected termination of the lease. The second letter said the lessors considered the lease terminated but also stated that the lessors did not require the lessee to vacate the property. The court found that the inescapable conclusion was this constituted consent, tacit or express, that the lessees could remain in possession and pay the royalty pending the determination of the validity of the lease.

[192] The conduct which is said to amount to tacit consent in this case is cashing the royalty cheques. In the *Freyberg* remedies decision the trial judge concluded that the mere fact that Lady Freyberg accepted the royalty payments after she filed her claim was "not enough" to find leave and licence. Unlike *Williston* at no time did Lady Freyberg or anyone on her behalf acknowledge the lease, encourage the defendants to continue production, or give implied or express consent to continued production: para 133. Nor was the absence of a formal demand to stop producing determinative: para 135. It was determinative in the *Freyberg* remedies decision that there was no finality about the lease's validity until the Supreme Court denied the lessees' permission to appeal the Court of Appeal's decision that the leases had terminated.

[193] In my view the trial judge erred in part when she concluded that the Irwin Group gave leave and licence from the date they entered into the top lease (October 7, 2005) to January 12, 2007. I prefer to adopt the reasoning in the *Freyberg* remedies decision. Once a claim is filed and pursued, and absent any implied or express encouragement to continue production, the mere fact that royalty payments are taken and no formal demand to stop producing is made are not determinative and do not equate to granting leave and licence. The respondents were on notice that the suit was

pending and the lessors were asserting their reversionary rights. In my view, there is no leave and licence in these circumstances. Accordingly, from the addition of the Irwin Group as plaintiffs in December 5, 2005 to January 12, 2007, there was no leave and licence.

[194] However, I find no error with respect to the trial judge's conclusion that there was leave and licence in the period before the statement of claim was amended to include the Irwin Group as plaintiffs. The nature of the Irwin Group's claim was not clear, particularly as they had been named as defendants in the lawsuit.

[195] In conclusion on this issue, the Irwin Group gave Coastal leave and licence to continue production from the time they became aware that the leases had arguably terminated in October 2005 until they became plaintiffs in the action against Coastal, in December 2005. Thereafter, there was no leave and licence.

E. Remedy

1. Background

[196] By way of introduction, case law and academic commentary demonstrate that remedies for trespass in the context of removal of a resource range along a continuum based on courts' perceptions of what is just and equitable in the face of the trespasser's conduct. If a trespasser's conduct warrants punishment, it may be required to disgorge the entirety of the benefit gained from the trespass with little or no allowance for costs incurred in earning that benefit or improvements made to the property. This is the so called "harsh" rule. The harsh rule is designed to deter wilful trespass. At the other end of the spectrum, when the trespass is not tainted by fraud or bad faith, is the "mild" rule which requires the trespasser to disgorge the revenues less certain expenses, but with no allowance for profit to the trespasser. There has been a further refinement to the mild rule. 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.

[197] The trial judge provisionally assessed damages on the basis of the royalty method. In so doing, she followed *Williston* and the *Freyberg* remedies decision: reasons at para 663:

[198] Damages awards should only be interfered with if the trial judge applied a wrong principle of law or the overall amount is a wholly erroneous estimate: *Andrews v Grand & Toy Alberta Ltd*, [1978] 2 SCR 229, 83 OLR (3d) 452. Palpable and overriding error applies to findings and inferences of fact concerning the assessment of compensatory damages: *de Montigny v Brossard (Succession)*, 2010 SCC 51 at para 27, [2010] 3 SCR 64.

2. Damages vs Disgorgement

[199] The appellants seek damages based upon the harsh rule—disgorgement of profits with no allowance for the costs incurred in production.

[200] The appellants submit that the trial judge erred by adopting the royalty method which they characterize as "nominal" damages. They assert that the only appropriate remedy was disgorgement because the trial judge was bound by the Supreme Court's decision in *Sohio*. As to *Williston* and the *Freyberg* remedies decision, they say those cases are distinguishable and to the extent they conflict with *Sohio*, they should not be followed. The appellants rely upon *Hill Estate v Chevron Standard Ltd*, [1993] 2 WWR 545, 83 ManR (2d) 58 (CA), and submit that restoring lost profits is an equitable result that accords with the object and principles underlying the law of restitution.

[201] They also say that the trial judge's concern that the top lessees would share in the profit was an irrelevant consideration as she found no champerty or maintenance.

[202] Finally, they contend that the trial judge erred in law by treating disgorgement as a remedy suitable only for punitive purposes. They submit that *Sohio*'s *ratio* is that a trespasser who converts another's property in the face of a lawsuit and demand to vacate will be held to account for its profits. This is not punishment but rather, without disgorgement, there is positive incentive to profit from trespass and conversion.

[203] The starting place for considering the remedy is *Sohio*. There, the parties' lease (Sohio as lessee and Weyburn as lessor) lapsed according to its terms in 1959 but a mutual mistake about the meaning of the *habendum* clause resulted in the lessee producing until 1966, when the lawsuit commenced. The Supreme Court upheld disgorgement of the lessee's "benefits" from the date the suit was served on the lessee but refused to award that remedy from the time the lease terminated until the lawsuit commenced. The court held at page 88 (with emphasis added):

> The [lessor] requested that the judgment of the Court of Appeal be varied in so far as it dealt with the date from which the [lessee] should be required to account to the [lessor] for production taken from the leased lands. The [lessor] contends that the date should be October 28, 1959, the date on which the lease terminated, <u>subject to an allowance for expenses</u> incurred by the [lessee]. This phase of the matter was dealt with in the following passage from the judgment of the Court of Appeal:
>
>> The [lessor] also sought an accounting of all petroleum, natural gas and related hydrocarbons removed from the land by the [lessee], or damages in lieu thereof. The court has jurisdiction to grant this relief on terms which will be just and equitable to all parties involved. The [lessee] proceeded under a mistake as to its rights, and did not knowingly take an unfair advantage of the [lessor's] lack of appreciation of its legal rights. The [lessees] were first aware that their position was challenged when the writ

> of summons was served upon them. At that time the revenue which they had received from the sale of the production exceeded the amount they had expended. Under the circumstances, it would appear just and equitable to order the [lessee] to account for all benefits from production received by them after the date of service of the writ of summons upon them.

[204] To summarize, the Supreme Court upheld the following remedy: from 1959 (when the lease terminated unbeknownst to either party) until the lawsuit commenced in 1966, the lessor received royalty payments according to the terms of the lease. Thereafter, the lessor was entitled to "all benefits from production."

[205] In the course of the *Williston* litigation, the Saskatchewan Court of Appeal noted that an "examination of the exhibits filed at the *Sohio* trial reveals that [the lessor] received approximately 30% of the net benefits from production": *Montreal Trust Co v Herc Oil Corp*, 2004 SKCA 116 at para 99, 243 DLR (4th) 317 (emphasis added).

[206] The respondents reiterate that they are innocent tortfeasors and, relying on the *Freyberg* remedies decision and *Williston*, say *Sohio*'s *ratio* is circumscribed by the phrase "[u]nder the circumstances" emphasized in the quote above. They argue this means the Supreme Court was not establishing any sort of general rule about remedies for trespass.

[207] I do not read *Sohio* so narrowly. It is a binding precedent which sets out the basic principle for determining the remedy here. *Williston* is not binding, and in any event, for the policy reasons discussed below, I do not reach the same conclusion as did the *Williston* court. I also find that the trial judge erred when she concluded that disgorgement should only apply when circumstances are such that more punitive measures are appropriate. As discussed below, the disgorgement principles can also apply to an innocent tortfeasor. Accordingly, I examine the possible remedies afresh.

a. The Royalty Approach

[208] Given that in *Sohio* the lessors received 30% of the net benefits from production, the phrase "all benefits" as used in *Sohio* must mean something more than the royalty method. As the following commentary demonstrates, there are also important policy reasons militating against the royalty method.

[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.

[210] A factor that has been decisive in selecting the royalty approach is the lessor's inability to realize the benefit the lessee derived in the course of its trespass. As Ballem points out, this approach inevitably leads to a different result depending upon the circumstances of the lessor. If the lessor is a person with no oil and gas operating experience or capability, the damages are limited to royalty and bonus. If the lessor is an oil industry entity, the damages may well be the revenue less the cost of production.

[211] This approach also requires the court to speculate on a lessor's intentions. The fact that the mineral owner may not be personally involved in the oil and gas industry does not preclude the hiring of an independent contractor to produce the minerals. The trial judge viewed the lessors' arrangements with the top lessee and their subsequent settlement agreement with the owner of a nearby gas storage facility as evidence of the lessors' intention not to exploit the resources themselves. It seems to me that this underemphasizes the important point that it was the appellants' property to exploit. They ought to be able to choose to do so and should not be penalized for not having the immediate ability to do so. In any event, the subsequent settlement agreement required the appellants to monetize their interest otherwise than through the receipt of royalties. This is indicative of an intention not to be restricted to receiving royalties alone**.**

[212] The concern with requiring that the lessor be able to exploit the resource is well summarized by Professor Bankes in his case comment on *Williston*:

> cases that adopt the royalty approach are inconsistent with the bulk of authority in this area. ... it is hard to imagine many resource severance cases (with the possible exception of the forestry sector) in which the plaintiff/owner will be able to make a credible argument that it would have exploited the resource itself. This will have the anomalous result that the tortfeasor without title will generally be in exactly the same position as a lessee with title.

[213] The rejection of the royalty approach in a tort case is similar to the approach used in determining remedies for actions in contract. In contract the presumptive rule is that the claimant is entitled to be put in the position it would have been in had the contract been performed (i.e., damages) but when circumstances call for a different measure, disgorgement of defendant's benefit is a potential remedy: see *Bank of America Canada v Mutual Trust Co*, 2002 SCC 43 at paras 31-33, [2002] 2 SCR 601; see also *Nunavut Tunngavik Inc v Canada (Attorney General)*, 2014 NUCA 2, 580 AR 75.

[214] The disgorgement approach therefore accords with the law of remedies in both tort and contract. This is a desirable result, see generally *BG Checo International Ltd v British Columbia Hydro and Power Authority*, [1993] 1 SCR 12 at 38, 99 DLR (4th) 577.

[215] In the result, I reject the royalty approach.

b. The Harsh Rule

[216] As already mentioned, in *Sohio* the lessors received 30% of the net benefits from production. In my view, the phrase "all benefits" as used in *Sohio* must mean something less than the harsh rule, which would permit recovery of 100% of all, not merely net, benefits from production.

[217] Although said in the context of purely economic torts, one of the four principles governing tort law in *A.I. Enterprises Ltd v Bram Enterprises Ltd*, 2014 SCC 12, [2014] 1 SCR 177 provides guidance. The common law "has generally promoted legal certainty for commercial affairs. That certainty is easily put in jeopardy by adopting vague legal standards based on 'commercial morality' or by imposing liability for malicious conduct alone": para 33. This statement rings true as regards the harsh rule, which is "generally used in a punitive manner where the trespasser takes a course of action with knowledge that they are committing a wrong, or where the conduct is sufficiently negligent or reprehensible that it warrants such treatment": reasons at para 596.

[218] Even if "all benefit" as used in *Sohio* could, on plain reading mean "revenue", the law of disgorgement has evolved since *Sohio* was decided in 1971. Even wrongdoing fiduciaries are generally entitled to set-off expenses associated with earning their wrongful gains: see e.g., *Strother v 3464920 Canada Inc*, 2007 SCC 24 at paras 88-9, [2007] 2 SCR 177. In some cases they may be entitled to an allowance for their special skills, expertise and effort: *Strother* citing *Warman International Ltd v Dwyer* (1995), 128 ALR 201, 182 CLR 570 (Aust HC).

[219] On my reading of *Sohio*, *A.I. Enterprises Ltd* and *Strother*, these cases support the conclusion that disgorgement of revenue with no set-off for expenses incurred in earning that revenue (the harsh rule) should no longer be available to remedy a trespass of this nature. That remedy does more than award disgorgement of the tortfeasor's gain; it imposes a punitive sanction.

[220] There may be cases when the tortfeasor's conduct warrants punitive damages: see *Bowen Contracting Ltd v BC Log Spill Recovery Co-operative Association*, 2009 BCCA 457, 313 DLR (4th) 498; and *Georgian Bluffs (Township) v Moyer*, 2012 ONCA 700, 298 OAC 121.

[221] Punitive damages require malicious, oppressive and high-handed misconduct that offends the Court's sense of decency, or is extreme in its nature and such that by any reasonable standard it is deserving of full condemnation and punishment: see generally, *Vorvis v Insurance Corporation of British Columbia*, [1989] 1 SCR 1085 at 1105-6, 58 DLR (4th) 193; *Whiten v Pilot Insurance Co.*, 2002 SCC 18, [2002] 1 SCR 595. In my view, rather than make an overall assessment of the total sum which combines disgorgement and punitive damages, it is helpful to make an assessment under each head (disgorgement and punitive damages). This itemized approach for awarding damages was developed by the Supreme Court in *Andrews* for the purpose of making the analytical process used for calculating damages more explicit. As the Supreme Court stated, this is desirable

"in light of general considerations such as the awards of other courts in similar cases and an assessment of the reasonableness of the award": at 233.

[222] The appellants ask that we apply the harsh rule. First, as I stated earlier, in my view the harsh rule imposes a remedy best left to the realm of punitive damages. In any event, I would not impose it here. The appellants urge us to sanction the respondents' conduct in the face of knowledge that the leases had terminated. They rely particularly upon the evidence of the landman who thought the leases may have expired and made further inquiries in that regard. The trial judge thoroughly reviewed this evidence. She was not persuaded that the respondents would be anything other than innocent tortfeasors. She observed that the issue of the validity of the leases was not clear cut, and that neither party would have known for a period of time that the leases had terminated. She noted that the absence of Snell and Wheatland from the litigation meant that the respondents may have had obligations to third parties that may have been breached if they had stopped production.

[223] In conclusion, in my view use of the harsh rule for torts of this nature should be abandoned. The trial judge's conclusion that the conduct of the respondents did not warrant punishment is a finding of fact. It is supported by the evidence and I discern no reviewable error.

[224] This leaves the mild rule.

c. The Mild Rule

[225] This court has upheld the imposition of the mild rule: *Signalta Resources Limited v Dominion Exploration Canada Ltd*, 2008 ABCA 437 at para 39, 173 ACWS (3d) 1222. The trial judge in that case had provisionally determined that the remedy was calculable on the basis of revenue less drilling, operating costs and royalty expenses: *Signalta Resources Limited v Dominion Exploration Canada Ltd*, 2007 ABQB 636 at para 304, 62 ACWS (3d) 497.

[226] Professor Bankes writes that the lessor should be entitled to "make a gains-based claim to the value of the resource and further, that the tortfeasor should be able to make deductions for improvements which add value to the resource. It follows that the defendant must adduce evidence as to what those costs actually were, but the defendant should also be able to claim for pre- and post-severance costs ...": *ibid*; see also Ballem.

[227] On my reading of *Sohio*, although the courts did not refer to it as such, the result upheld by the Supreme Court reflects the mild rule. Since it was decided, the Supreme Court has acknowledged that even wrongdoing fiduciaries may be entitled to an allowance for their special skills, expertise and effort: *Strother*.

3. Conclusion on Remedy

[228] I conclude that neither the royalty approach nor the harsh rule are consonant with *Sohio*. In my view, the harsh rule is punitive and should be abandoned unless the trespasser's conduct

warrants punitive damages. In my view, the trial judge's conclusion that punitive damages were not justified is entitled to deference.

[229] I would base the disgorgement on the "Agreed Statement of Facts Pertaining to Revenues, Expenses and Royalties" (A19ff) from August 2003 through January 2011. These sums can "fairly be allocated by lease" by applying the formula prescribed in para 11 of the Agreed Statement of Facts.

[230] The starting point for the calculation is "net operating income" as set out in the Agreed Facts from which shall be deducted the sums paid to the lessors, whether in the form of royalties or otherwise. To be clear the cost to recomplete the well ought not to be deducted as this was never a cost attributable to the lessors.

[231] Given my conclusion on leave and licence granted by the Irwin Group to Coastal (Part D), those lessors are not entitled to disgorgement from October to December 2005, but are entitled to the royalty payments they earned during this period, as they would have received them in any event.

[232] As reflected in Part B, I conclude that no remedy is available to the Scurry lessors.

[233] I will discuss the impact of my conclusion on the gross overriding royalties paid to Esprit in Part G.

[234] This leaves consideration of 108's independent claim for damages.

F. 108's Independent Claim for Damages

[235] Bowes, Freehold Solutions and 108 will be referred to in this part as the top lessee. The top lessee's relationship with the lessors is two-fold: a top lease on each quarter section and a 50 percent interest in the outcome of this litigation.

[236] The trial judge found that the top lessee's claim against the lessees was based in trespass, conversion and unjust enrichment or, alternatively, wrongful interference with economic rights: reasons at paras 177,179. The top lessee claimed an independent right of action and damages for loss or delay taking possession and producing the leased substances.

[237] The trial judge held that the top lessee had no independent right to pursue a claim for several reasons. First, the top leases do not become effective until there has been a determination that the original leases have terminated so there was no basis for the claim for loss or delay. Second, the top lessee could not claim trespass since that remedy is only available to a party in possession, and there was no evidence that the top lessee had such a right. Third, the top lessee could not have advanced a claim for unjust enrichment since its interest was at best contingent and might never come into effect.

[238] The appellants submit that the trial judge erred in failing to find the top lessee had an independent right to damages. They say that the top lessee suffered a loss because the respondents maintained their caveats and prevented it from producing the 7-25 Well. They submit all the elements of unjust enrichment are met.

[239] The agreements between the top lessee and the lessors include two relevant provisions: the top lessee's right to possession is "contingent upon and deferred until there is a determination that the Original Lease has terminated" (cl 2) and the lessors shall pay to the Top Lease Group "out of the proceeds of any settlement or judgment, a fee equivalent to fifty percent (50%) of the value of any payments or other valuable consideration which are received resulting from or arising out of such settlement or judgment" (cl 4(c)): A538-39.

[240] Given cl 2, I find no reviewable error in the trial judge's conclusion that the top lessee had no independent claim or right to a remedy. Its rights are contingent upon a determination that the leases have terminated.

[241] A general rule in tort law prohibits double recovery: *Ratych v Bloomer*, [1990] 1 SCR 940, 69 DLR (4th) 25; *Bedard v Amin*, 2010 ABCA 3, 469 AR 322. Were I to award the top lessee a remedy <u>in addition to</u> what they are entitled to by clause 4(c), the rule against double recovery would be infringed.

[242] I therefore dismiss this ground of appeal.

G. The Liability of Esprit

1. History of Esprit's Involvement with Section 25

[243] Esprit is the successor in interest to Canadian 88, which at one time held interests in the NE1/4, the SE1/4 and the NW1/4 of Section 25. When it disposed of its primary interest in Section 25, Esprit (now Pengrowth) reserved to itself a 10 percent gross overriding royalty of production from or allocated to the 60.5 percent pooled interest in the BQ formation in the Section 25 lands. The effective date of that agreement is June 1, 2000.

[244] Esprit was <u>not</u> a working interest participant in the BQ formation during the period relevant to this action. Esprit obtained its interest shortly after the 7-25 Well was suspended in August 1995 and sold its working interest to Triquest in May 2000. In short, Esprit had no working interest from 2001 (when the 7-25 Well resumed production) to January 2011 (when the 7-25 Well was shut in by order of the Court of Queen's Bench).

[245] The CAPL 1997 Overriding Royalty Procedure, attached as a schedule to the royalty agreement, provides that Esprit may either take its royalty share in kind or the royalty payor (Bonavista) will act as Esprit's "agent ... for the handling and disposition" of its royalty share of the gas and Bonavista will "be as a trustee" for Esprit.

[246] It is not disputed that Esprit did not take its royalty share in kind: Tab E of the Agreed Statement of Facts Pertaining to Revenues, Expenses and Royalties.

2. Trial Judge's Reasons

[247] Esprit argued at trial that it was not liable for conversion in the oil and gas context, as conversion occurs at the point of extraction. Only working interest owners may be liable in conversion. It contended that it could not be liable jointly or severally for trespass or conversion because joint and several liability among working interest owners requires a wrongful act, mutually performed by the defendants and in furtherance of a common purpose: *Freyberg* remedies decision at para 154. It was not a working interest owner and did not participate in conversion, and therefore had less of an interest in and connection to the Section 25 lands. It submitted that it could not be liable for unjust enrichment as it did not receive a benefit at the appellants' expense. Any alleged deprivation of the appellants corresponds to the alleged enrichment of the working interest owners. To claim the same loss against working interest owners and those who received payments from them would constitute impermissible double counting.

[248] The trial judge provisionally concluded that, had she found that the leases terminated and damages other than on a royalty basis were appropriate, she would not have found a sufficient degree of proximity to make Esprit liable. The trial judge relied on the *Freyberg* remedies decision which she found stood for the proposition that collusion is necessary to find minority working interest owners liable in trespass and conversion. She concluded that not only did Esprit have no control over the production of gas, its interest as a working interest owner ended in 2000 and the damages claimed in disgorgement relate to the period after that.

[249] The appellants raise two grounds of appeal: the trial judge erred by not finding that Esprit's caveat should be removed and that it was not jointly and severally liable.

3. Should Esprit's Caveat Be Discharged?

[250] The appellants submit that the trial judge erred in failing to find Esprit's interest did not terminate with the leases. They submit that Esprit no longer has an interest in the leases and can no longer protect them with a caveat. Accordingly, its caveat, registered against the Imperial NW1/4 lease (Pengrowth) should be discharged.

[251] Given my conclusion that the Imperial NW1/4 lease terminated, Esprit's caveat should also be discharged. I note as well that Esprit's royalty interest was granted three months after the leases had terminated so Triquest had no interest to convey to Esprit in June 2000.

4. Should Esprit Be Held to Account For Royalties Earned from Production?

[252] As a preliminary matter, I agree with the trial judge that there is no basis for holding Esprit jointly and severally liable. The trial judge's fact findings regarding the degree of proximity

between the lessors and Esprit are entitled to deference and there is no suggestion that she applied the incorrect legal test. In my view, the appellants have not demonstrated any error warranting intervention in this regard.

[253] Accordingly, the most the appellants can claim is disgorgement of the royalties Esprit earned from August 2003 to January 2011. Is Esprit entitled to retain those funds or must it disgorge them?

[254] The appellants' primary submission on appeal is that Bonavista was Esprit's agent. They say that since a principal is liable for the torts of its agent, Esprit is liable for Bonavista's trespass. Esprit contends the relationship is one of trustee and beneficiary.

[255] The appellants rely on Clause 2.03A of the CAPL 1997 Overriding Royalty Procedure. That clause appoints Bonavista the agent of Esprit for the "<u>handling and disposition</u> of the Overriding Royalty Share" of production (emphasis added). This is the only factor that points to an agency relationship.

[256] The same clause goes on to say that all acts of Bonavista under the clause in the handling and disposition of the production and the receipt of the proceeds of sale will be as <u>trustee</u> of Esprit (emphasis added).

[257] When there are two possible constructions of a legal relationship (agency or trust), the predominant relationship must be determined in order to assess the extent of the principal/beneficiary's liability for the agent/trustee's actions. Assuming no extricable legal error, this is a question of fact: *Trident Holdings Ltd v Danand Investments Ltd* (1988), 64 OR (2d) 65, 49 DLR (4th) 1 (CA).

[258] The question of whether Esprit was, in fact, the principal behind Triquest and later Bonavista is a question of fact, entitled to deference. There is nothing to suggest that Esprit exerted any control over Bonavista. Bonavista merely disposed of the produced substances from the 7-25 Well in the ordinary course and paid Esprit its gross overriding royalty.

[259] I recognize that it is not always easy to draw the line between trust and agency. That is why the analysis of the facts is so important. This was the domain of the trial judge. She took into account Clause 2.03 which was the only factor that supported an agency relationship. She was not satisfied that there was sufficient control of Bonavista by Esprit. I find no palpable and overriding error in her conclusion.

[260] I have therefore concluded that the trial judge did not err in finding that Esprit had no liability for the actions of the lessees. Nor can I discern any policy reasons to warrant imposition of liability on Esprit. For the purposes of this analysis, its position is not much different than that of other royalty recipients.

[261] In conclusion, I find that Esprit is not liable to the lessors.

VI. Conclusion – Appeal and Cross-appeal

[262] I would allow the appeal in part and dismiss the cross-appeal.

[263] To summarize, my conclusions on the appeal are as follows:

a. The trial judge's interpretation of the leases' third proviso of the *habendum* clause to include the qualifier that there must be a lack of or intermittent economical or profitable market was reasonable. Her interpretation of "beyond the lessee's reasonable control" was also reasonable.

b. I am unable to sustain the trial judge's conclusion that the lessees' met their burden of proving that the third proviso applied after January 2000. This conclusion is unreasonable because marketing production thereafter would have met or exceeded the industry's objective hurdle rates according to the expert whose evidence the trial judge preferred. The expert testified that small companies would "have jumped on" producing the 7-25 Well in January 2000 but these lessees required more "compelling" economics and required the 7-25 Well to be "very" profitable. This subjective approach, which favoured the lessees' interest over those of the lessors, was an unreasonable interpretation of these leases.

c. On my interpretation of these leases, the lessees had 90 days after January 1, 2000 within which to recomplete the 7-25 Well. They did not do so. Therefore, all but the Scurry leases terminated according to their terms.

d. The trial judge made no reversible error in refusing to make a declaration as to the Scurry leases' validity because there were parties that arguably had an interest in those leases that were not present at trial. Given they were also denied status on appeal, I am in no better position than the trial judge. The present litigation between the Scurry appellants and the parties with an arguable interest will determine their respective interests. These reasons *may* be of assistance thereafter.

e. Given my conclusion that all but the Scurry leases terminated, the nature of the wrong (trespass of the reversion and conversion) and the limitations issue are relevant. The trial judge erred in her provisional assessment of the lessees' limitations defence. These were continuing torts. The statement of claim was filed August 9, 2005 and the lessors are entitled to a remedy beginning two years before that, August 9, 2003.

f. An exception to the forgoing arises in regard to the Irwin Group. Accepting royalty payments and failing to issue a formal notice is not determinative of implied consent to the trespass once a claim has been filed and diligently pursued. Accordingly, I conclude that the provisional leave and licence conclusion at trial is not sustainable. However, from October 7, 2005 (when the Irwin Group appellants agreed to pursue the lessor, Coastal, as part of the suit) until their position changed from defendant to plaintiff on December 5

2005, I agree with the trial judge's conclusion that they granted Coastal leave and licence. As a result, this period is not compensable for these appellants.

g. As regards remedy, on my reading, the Supreme Court's decision in *Sohio* is binding and stands for the proposition that lessors' whose leases have terminated are entitled to recover the net benefits enjoyed by lessees after termination. Disgorgement of all the benefits (i.e., gross revenue disgorgement or the "harsh" rule) is not supported by *Sohio* and imposes a punitive sanction against a lessee that is best left to the realm of punitive damages. In my view, the finding by the trial judge that punitive damages were not warranted is entitled to deference. Part E of Section V provides my view of how disgorgement should be calculated.

h. In my view the trial judge made no reversible error in concluding that 108 had no independent claim against the lessees and is therefore not entitled to a remedy. Given my conclusion on remedy and 108's agreements with the lessors that it is entitled to 50 percent of any remedy awarded, the rule against double recovery now applies.

i. As to Esprit's liability jointly and severally with the other respondents, there is nothing to suggest that it can be jointly and severally liable given the fact that it had no working interest in the 7-25 Well at the relevant time. There is no basis to direct that it should account to the appellants for the royalties it earned from its gross-overriding royalty interest.

[264] If the parties are unable to agree on costs, they may make written submissions of a maximum of ten pages. The appellants should do so within 60 days of the date of this judgment and the respondents within 15 days after the appellants' submissions.

Appeal heard on September 11, 2014

Memorandum filed at Calgary, Alberta
this 19th day of November, 2015

Rowbotham J.A.

Reasons for Judgment Reserved
of the Honourable Justice J.D. Bruce McDonald
Concurring in the Result

I. Introduction

[265] I have had the opportunity to read both the Reasons for Judgment Reserved of my colleague Madam Justice Rowbotham and the Reasons for Judgment Reserved of my colleague Mr. Justice O'Ferrall. I am in agreement with the Reasons for Judgment Reserved of Madam Justice Rowbotham save and except for the following five issues:

(a) What is the proper termination date for the freehold petroleum and natural gas leases in question?; [paras 64 – 129]

(b) What is the proper standard of review to be employed by this court in reviewing the trial judge's interpretation of the leases?; [paras 54 – 63]

(c) What is the nature of Esprit's liability? [paras 252 – 261]

(d) What is the nature of the proper remedy to be accorded to the appellants given the facts of this case; [paras 216 - 230]?; and

(e) Did the trial judge err in law failing to grant to Jerome Development Limited as the registered owner of the mines and minerals of the SE1/4 and the south portion of NE1/4 given the absence at trial of Snell and/or Wheatland? [paras 142 – 155]

[266] With respect to the first issue above, namely when did the leases terminate, I adopt the reasoning contained in the Reasons for Judgment Reserved of my colleague Justice O'Ferrall. [paras 385 - 407] Likewise, regarding the liability of Esprit I also adopt his reasoning [paras 464 - 468].

[267] As discussed below, in my opinion the proper standard of review to be applied by this court in reviewing the trial judge's interpretation of the leases is correctness. As regards remedy, given the facts of this particular case, I hold it to be disgorgement but based upon the so-called harsh rule. Furthermore, in my view, the trial judge erred in law in failing to grant to Jerome Development, as the registered owner of the mines and minerals, the relief sought in the trial below i.e. a declaration that the petroleum and natural gas leases registered against their title are invalid.

[268] Finally, I agree that the cross-appeal is to be dismissed for the reasons of my colleague Mr. Justice O'Ferrall.

II. Standard of Review

[269] As my colleague states in her Memorandum of Judgment commencing at para 54 regarding the standard of review, the Supreme Court of Canada recently rendered its decision in *Sattva* holding that, generally speaking, on issues involving contractual interpretation, reasonableness is the appropriate standard of review. *Sattva* has been discussed and considered in a number of subsequent decisions of this court including: *CDM Direct Mail v Centre for Immigration Policy Reform*, 2015 ABCA 168 at para 16, 254 ACWS (3d) 837; *Fontaine v Canada (Attorney General)*, 2015 ABCA 132 at para 17, 253 ACWS (3d) 317; *Bighorn (Municipal District No. 8) v Bow Valley Waste Management Commission*, 2015 ABCA 127 at para 5, 251 ACWS (3d) 508; *Ledcor Construction Ltd v Northbridge Indemnity Insurance Co*, 2015 ABCA 121 at para 12, 386 DLR (4th) 482; *Van Camp v Chrome Horse Motorcycle Inc*, 2015 ABCA 83 at para 17, 381 DLR (4th) 721; *Tien Lung Taekwon-Do Club v Lloyd's Underwriters (cob Sutton Sportscover)*, 2015 ABCA 46 at para 20, 249 ACWS (3d) 194; *Nafie v Badawy*, 2015 ABCA 36 at para 60, 381 DLR (4th) 208; *911502 Alberta Ltd v Elephant Enterprises Inc*, 2014 ABCA 437 at para 9, 588 AR 296; *Equitable Trust Co v Lougheed Block Inc*, 2014 ABCA 427 at paras 16, 59, 588 AR 258; *Echino v Munro*, 2014 ABCA 422 at para 11, 588 AR 211; *Alberta Teachers Association v Buffalo Trail Public Schools Regional Division No. 29*, 2014 ABCA 407 at paras 11, 40, 588 AR 179; *Deagle v 1678452 Alberta Ltd*, 2014 ABCA 406 at para 12, 588 AR 129; *AMT Finance Inc v Saujani*, 2014 ABCA 385 at para 14, 247 ACWS (3d) 94; *Clarke v Syncrude Canada Ltd*, 2014 ABCA 362 at para 12, 584 AR 332; *Access Mortgage Corp (2004) Limited v Arres Capital Inc*, 2014 ABCA 280 at para 52, 584 AR 68; *Vallieres v Vozniak*, 2014 ABCA 290 at para 12, 580 AR 326; *Modry v Alberta Health Services*, 2015 ABCA 265 at para 152, 388 DLR (4th) 352; *Iona Contractors Ltd v Guaranteed Co of North America*, 2015 ABCA 240 at para 61, 387 DLR (4th) 67; *Burch v Intact Insurance Co*, 2015 ABCA 229 at para 15, 255 ACWS (3d) 725, *HOOPP Realty Inc v Guarantee Co of North America*, 2015 ABCA 336 at para 11.

[270] This court in *Vallieres* recently considered the proper standard of review, in light of *Sattva*, when considering a trial judge's interpretation of a standard form real estate sale and purchase agreement. In the course of so doing it summarized *Sattva* as follows (para 12):

> The Supreme Court recently considered the standard of review for the interpretation of contracts in ***Sattva Capital Corp. v Creston Moly Corp.***, 2014 SCC 53. ***Sattva*** was an appeal from the decision of a commercial arbitrator, and the Court concluded:
>
> (a) Evidence of the circumstances surrounding the formation of the contract can be considered in interpreting the contract. Such evidence will not conflict with the parole evidence rule so long as it is ". . . used as an interpretive aid for determining the meaning of the written words chosen by the parties, not to change or overrule the meaning of those words": para. 60.

> (b) Because the ultimate objective of contractual interpretation is to determine the intention of the parties, and because evidence of surrounding circumstances can be considered, the interpretation of a contract is a mixed question of fact and law: para. 50.
>
> (c) Since appeals from an arbitrator were only allowed on a question of law, and since no extricable question of law had been shown, no appeal was possible respecting the arbitrator's decision on the interpretation of the ***Sattva*** contract: para. 66. That was sufficient to dispose of the ***Sattva*** appeal.
>
> (d) Characterization of the interpretation of contracts as a question of mixed fact and law also has an impact on the standard of review. Deference was appropriate, particularly on the factual component of the analysis. Extricable questions of law are still reviewed for correctness: paras. 51-4. A number of factors were listed as indicating when appellate intervention was warranted:
>
> (i) the intervention of appellate courts is appropriate in "cases where the results can be expected to have an impact beyond the parties to the particular dispute": para. 51.
>
> (ii) a key difference between a question of law and a question of mixed fact and law is "the degree of generality (or "precedential value")": para. 51.
>
> (iii) other errors of law arise from "the application of an incorrect principle, the failure to consider a required element of a legal test, or the failure to consider a relevant factor": para. 53. Failure to construe the contract as a whole is such an error: para. 64.

This court went on to hold that a trial judge's interpretation of a standard form real estate sale and purchase agreement should be reviewed by an appellant court on the basis of correctness.

[271] As pointed out in *Vallieres*, the reasons in *Sattva* must be read having regard to the context in which that case was decided. *Sattva* was an appeal from the decision of a commercial arbitrator under the British Columbia *Arbitration Act*, RSBC 1996, c 55, which limits appeals to questions of law. On the other hand, appeals from the Court of Queen's Bench of Alberta to the Alberta Court of Appeal can be brought on any basis.

[272] This court went on to state in its later decision in *Ledcor* at para 13 as follows:

> Clearly all contracts have "surrounding circumstances" and are made within a certain "context". They are described in ***Sattva*** at para. 60 as "facts known or facts that reasonably ought to have been known to both parties at or before the date of contracting". ***Sattva*** does not alter the core parole evidence rule: the test for "context" is objective, and the parties are still not allowed to testify as to their

> subjective understanding of "what the contract really means or was intended to mean". ***Sattva*** recognizes the traditional legal techniques of interpreting contracts, and provides at para. 50 that "the principles of contractual interpretation" (the legal component) are applied to the words of the written contract, "considered in light of the factual matrix" (the factual component). Thus, the interpretation of the contract is a question of mixed fact and law reviewable for reasonableness, although extricable errors of law are still reviewed for correctness.

This court held that correctness was the appropriate standard of review when reviewing the trial judge's interpretation of a standard insurance policy.

[273] Where the parties involved are actually negotiating a contract, obviously one can explore the known surrounding circumstances to determine their intention as expressed in the wording of the contract. However, in cases dealing with contracts of adhesion (such as these leases), I agree that any search for the intention of the parties in the "context" is merely a legal fiction.

[274] The history of the freehold petroleum and natural gas lease as it has evolved in Western Canada is discussed at length in John Bishop Ballem, Q.C., *The Oil and Gas Lease in Canada*, 4th ed (Toronto: University of Toronto Press, 2008). As pointed out by Ballem, very early versions of oil and gas leases in Canada became irrelevant with the importation into Canada of a particular type of American lease generally described as the Producers 88.

[275] Ballem indicates that following the Leduc discovery in 1947 the former, rather casual approach, to mineral leasing was no longer appropriate; efficiency demanded a standardized form and one that could be completed by the land agent in the field: 10.

[276] The lease that resulted was a printed standard form agreement largely based upon the Producers 88 lease. While certain minor changes were made over time, the essential aspect of the freehold petroleum and natural gas lease in Western Canada has largely remained the same for the past 60 years or more.

[277] It is true, as Ballem points out, that in Alberta slightly in excess of 80% of the minerals are owned by the Crown and much of the balance owned by corporations, or their successors e.g. CPR. That said, there are still thousands of privately owned mineral titles in Alberta.

[278] Any notion of a search for the intention of the parties in the "context" of the case at bar is vitiated by a simple review of the leases. A specific review of the Jefferson SW1/4 lease discloses a printed form that stipulates a 10 year primary term and a gross royalty of 12.5 percent. There are only two "blank spaces" that represent points of negotiation between the parties. The first, which is contained in the *habendum* clause, allows the parties to agree as to the amount of consideration to be paid to the lessor by the lessee for the lease itself.

[279] The second area of negotiation is contained in the first proviso wherein the amount of the "delay rental" is agreed upon by the parties. That is it. Other than these two items, it is a clear contract of adhesion. A review of the other petroleum and natural gas leases involved in this case disclose a similar lack of any room for negotiation between the lessor and lessee, save as noted above.

[280] This in principle is no different than the standard form real estate sale and purchase agreement considered by this Court in *Vallieres*. There are some small items to be negotiated but the overall contract has been "predetermined".

[281] The following comments of this Court in *Vallieres* apply with equal force and effect to the standard petroleum and natural gas lease (para 13).

> The findings of fact in the decision presently under appeal are entitled to deference. In this case, the appropriate standard of review on the interpretation of the contract is correctness. It is a "standard form" contract developed by the Alberta Real Estate Association. It is used continuously by vendors, purchasers, and realtors in Alberta. Its interpretation is of general importance beyond this dispute, any decision on its proper interpretation has great precedential value, and the primary objective should be certainty. It is untenable for this contract to be given one interpretation by one trial judge, and another by a different one. The standard of review analysis in ***Housen*** does not anticipate or require that kind of uncertainty or variability. Attempting to inject the circumstances surrounding the formation of the contract into the analysis, or any attempt to identify the intention of the parties, is nothing but a legal fiction. These parties were content to adopt the standard form agreement prepared by the Association, and essentially it is the intention of the committee that drafted it that prevails.

[282] Furthermore this court in *Omers Energy Inc v Alberta (Energy Resources Conservation Board)*, 2011 ABCA 251 at paras 30-2, 513 AR 292 held that when it reviewed a decision of the Energy Resources Conservation Board (as it then was) interpreting the phrase "capable of producing the leased substances", that it should be done on a correctness standard.

[283] Over the years, the standard form petroleum and natural gas lease (with its minor variations) has been the subject of considerable judicial scrutiny. This is not the occasion to even begin to review the case law interpreting the various clauses of the standard lease. In *Ledcor*, this court pointed out that is was "untenable" for insurance policy wording to be given one interpretation by one judge and another by a different one: para 17. Needless to say these same considerations apply to the leases in question. As has been stated in another context, "certainty and predictability are in the interest of both the [industry] and their customers": *Co-operators Life Insurance Co v Gibbens*, 2009 SCC 59 at para 27, [2009] 3 SCR 605.

[284] In *Freyberg v Fletcher Challenge Oil & Gas Inc*, 2005 ABCA 46, 363 AR 35, this court reviewed the trial judge's interpretation of a petroleum and natural gas lease on a standard of correctness. As my colleague points out at paragraph 63 of her Memorandum of Judgment, even when being reviewed for correctness, this court discussed contextual factors. This, of course, is appropriate and there has been reported jurisprudence dealing with the proper meaning of such phrases as "Lack of or Intermittent Market" and "Beyond The Lessees' Reasonable Control": see also this court in *Omers* at para 32.

<u>III. The Trial Judges' Refusal to Grant to Jerome Development the relief it sought</u>

[285] At trial, the Jerome Group (as that term is utilized in the Reasons for Judgment Reserved of Madam Justice Rowbotham) was the registered owner of the minerals in the relevant property and alleged that they were the lessors under the Scurry leases. The Jerome Group sought a declaration that the Scurry leases had terminated.

[286] Neither Snell nor Wheatland had any interest registered against those mineral titles.

[287] As pointed out by the appellants in their factum (at para 116), the respondents failed to raise as a defense the appellants' standing to bring the within action as regards the Scurry leases. There was no pleading at all with respect to the SE1/4 and the only pleading on point were the defences of the respondents, Bonavista and Coastal, which pled only that royalties were paid pursuant to an alleged assignment of the NE1/4 lease to Snell.

[288] Whatever the rights may be as between Snell and Wheatland on the one hand, and the Jerome Group on the other, it simply has no bearing on the issue of the validity of the Scurry leases. The presence of Snell and/or Wheatland in this action was not required given the fact that the Scurry leases had clearly terminated in accordance with their own terms back in 1995. The leases did so without the need for the actions or interventions of any party: *East Crest Oil Co Ltd v Strohschein and Strohschein*; *Canadian Superior Oil of California, Ltd v Kanstrup*; at page 105 quoting from *East Crest Oil Co Ltd*. The issue as to what entitlement Wheatland, Snell, and the Jerome Group may have as amongst themselves to the resultant proceedings will be determined in the action referred to in the Reasons for Judgment Reserved of Madam Justice Rowbotham at para 147.

[289] Furthermore, as my colleague Mr. Justice O'Ferrall points out at paras 458-460, it is indeed incongruous to require the lessees to account to the mineral owners of the W1/2 of Section 25 and the remaining portion of the NE1/4 and yet not require the lessees to account to the mineral owners (whomever they may ultimately prove to be) for the SE1/4 and the north portion of the NE1/4.

[290] Accordingly, I would allow this ground of appeal and grant the Jerome Group the relief it sought at trial.

IV. Remedy

[291] I agree with my colleague Madam Justice Rowbotham, and for the reasons she has stated, that the trial judge erred in accessing the remedy in damages based upon the royalty approach. I agree with my colleague that the proper remedy in this case is disgorgement. However, I disagree that it should be the mild rule but rather on the facts of this case, I believe that the so-called harsh rule should be applied.

[292] In coming to her decision that had she found the leases in question to be invalid (which of course she did not), the trial judge held that the respondents were "innocent tortfeasors who acted in the mistaken belief they were acting lawfully": reasons at para 662.

[293] The trial judge went on to explain in para 663 in part:

> (b) although this may result in a profit for the defendant tortfeasors, they did not act in bad faith, but with the mistaken belief that the leases were valid.

In my view, in coming to this conclusion, the trial judge made palpable and overriding errors as the evidence simply does not support this conclusion.

[294] There are certain key aspects relevant to the question of bad faith. Most significantly is the memo dated July 11, 1995 from Allan Seredynski to Dan Richer - both of Canadian Occidental Petroleum Ltd (CanadianOxy), the predecessor to Nexen and the operator of the 7-25 Well - wherein the former indicated to the latter that CanadianOxy's interest in the well had in effect a nil value. Specifically, Mr. Seredynski in his memo concluded:

> CanadianOxy's share of Crossfield sales gas reserves left in the ground would be less than 15 Mmcf. The well was originally a BQ producer before the [Wabamum] zone was completed in 1981. The small amount of remaining BQ reserves (COPL share: 100mmcf), makes a recompletion uneconomic. Logs have been reviewed by the Area Team and they concur that no uphole potential zones are present and that CanadianOxy's WI should be offered to our partners or Amoco for the abandonment liability. The well abandonment, surface reclamation and pipeline abandonment cost is estimated at $165M (COPL net: $19.8M).

[295] Indeed, as pointed out in the reasons of my colleague Mr. Justice O'Ferrall the 7-25 Well was in effect abandoned and certain equipment removed from it.

[296] As this court has stated in *Omers*, a lessee is not entitled to hold onto a lease for speculative purposes. Therefore, if it concludes that there is no value remaining, then the lease should be surrendered to the freehold owner. This was not done in this case.

[297] Also of importance however, is the memo of June 20, 2000 from Randy Thomsen, then with ExxonMobil Canada Ltd., when he raised very serious concerns regarding the validity of the Jefferson SW1/4 lease.[1] Mr. Thomsen was a very senior and experienced landman at the time.

[298] Mr. Thomsen's memo was in response to an Independent Operations Notice received from Triquest. This engaged a Right Of First Refusal in favour of ExxonMobil.

[299] After his investigation, Mr. Thomsen wrote the following memo (emphasis added):

> I examined the contract file and have found that the ROFR notice accurate as to the interest and as to the 30 day notice period. The contract appears to be a non cross-conveyed pooling, each party contributing a lease continuing to be responsible for his own rental and royalty payments. I examined the lease that Mobil contributed, being ptn SW25, lease dated Jan. 8/68. The shut in clause states that the well may be shut in due to lack of or intermittent market. According to Accumap, the only well on the lands, 7-25, has not produced since 1995, last production being 500 mcf/day +/-. <u>As there is no lack of or intermittent market, I believe our lease is dead due to failure to produce</u>. I have not examined the other leases, but most freehold leases of the 60's have similar language.
>
> If Mobil is contemplating on exercising on the ROFR, I suggest that a lawyer examine the leases to determine if they remain in effect.

[300] That there was no lack of or intermittent market was underscored by the fact that all the adjacent wells in the same zone (i.e. Wabamun), continued to produce throughout this entire time period.

[301] When questioned about his memo in cross-examination, Mr. Thomsen gave the following response:

> Q: Well, based on all the information you had at that time, you formed the view that your leases – your lease was dead due to failure to produce; correct?
>
> A: Based on the information I had at the time yes.

(Transcript at 1806/24/26)

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[1] At all relevant time, Nexen and ExxonMobil were 50% working interest owners under that lease

[302] Counsel for the appellants then asked Mr. Thomsen if ExxonMobil consulted a lawyer with respect to the validity of the leases. This line of questioning was objected to by counsel for ExxonMobil and the trial judge directed that Mr. Thomsen could not even be asked if the in house legal department had been consulted on this issue.

[303] Also, in response to receiving the Independent Operations Notice, a request for technical evaluation was made. In the document requesting that evaluation, Mr. Thomsen wrote:

> As the well has been shut in since 1995, there is a possibility that the freehold leases have terminated for lack of production. If [ExxonMobil] elects to participate, seek Law's opinion releases. New leases may be required.

[304] Mr. Thomsen acknowledged that he had raised his concerns with his superiors. Furthermore, on December 22, 2000, Mr. Thomsen had a telephone conversation with Jim Morrice of Triquest and made the following notes of that conversation at the time: "I expressed my concern over the validity of the leases given that there has been no production since '95. Suggested that we may need new leases. Jim will examine leases."

[305] In cross-examination Mr. Thomsen admitted that when there was a "cloud" over a lease, that it was "best practices for a landman" to go out and negotiate a new lease:

> Q: And, indeed, you indicated earlier that you felt that there was a cloud over this because there was uncertainty as to whether or not the leases had terminated given the economics; right?
>
> A: Yes.
>
> Q: And, sir, you – did you understand that there was a general custom and practice in the industry that if there was a problem with the validity of the leases, the solution was for the landman to go back and renegotiate new leases with the lessors?
>
> A: Yes.
>
> Q: And so that was pretty much standard practice for you as a landman in that time period; correct?
>
> A: I hadn't been personally involved in doing that sort of thing, but it was practice in the industry, I believe.
>
> A: And, based on all of your experience and your capital training, you would call that best practices for a landman; correct?
>
> A: Yes. (Transcript 1801 lines 11-28)

[306] Due to the position taken by counsel for the respondent, there was no evidence before the trial judge as to whether ExxonMobil's legal department was consulted as recommended by Mr. Thomsen; nor if it was consulted, what was the advice that was given. All that we are left with is that there was no evidence before the trial judge as to any legal advice obtained by ExxonMobil at the relevant time i.e. the latter half of 2000.

[307] In addition, it must be remembered that all the adjacent/off-setting wells continued to be produced during the time period in question. It is impossible other than to conclude that there was a market for the production from this well during the relevant time period.

[308] Indeed, the trial judge herself acknowledged that the respondents (defendants) never advanced the suggestion that there was no market for the gas produced from the 7-25 Well: reasons at para 515.

[309] In my view, the facts of this case bring it within the purview of the Supreme Court of Canada's decision in *Sohio Petroleum Co et al v Weyburn Security Co Ltd*, which was an appeal from the Saskatchewan Court of Appeal reported at [1969] 7 DLR (3d) 277. In *Sohio*, both parties had initially proceeded based upon the mutual mistake that the lease was valid. Subsequently, the lessor determined that it was not likely valid and thereafter commenced legal proceedings.

[310] The Saskatchewan Court of Appeal stated (at 283) as follows:

> The appellant also sought an accounting of all petroleum, natural gas and related hydrocarbons removed from the land by the respondents, or damages in lieu thereof. The Court has jurisdiction to grant this relief on terms which will be just and equitable to all parties involved. The respondent Sohio proceeded under a mistake as to its rights, and did not knowingly take an unfair advantage of the appellant's lack of appreciation of its legal rights. The respondents were first aware that their position was challenged when the writ of summons was served upon them. At that time the revenue which they had received from the sale of the production exceeded the amount they had expended. Under the circumstances, it would appear just and equitable to order the respondents to account for all benefits from production received by them after the date of service of the writ of summons upon them.

[311] On appeal to the Supreme Court of Canada, Martland J for the court wrote with respect to the above statement: "I am in agreement with the conclusion. In my opinion, the appeal should be dismissed with costs": 89.

[312] In my opinion, the phrase "all benefits from production" means the gross sale revenues received by the respondents for the sale of the production realized on the sale of the 7-25 Well for the period commencing two years before the date the Statement of Claim was issued.

[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.

[314] In my view, by no stretch of the imagination could it be said the lessees were acting in good faith when they re-commissioned the well in 2001, and as such should be subject to exactly the remedy that was upheld by the Supreme Court of Canada in *Sohio*. The decision in *Sohio* may not be extensive but it is binding on this court.

[315] In *Sohio*, the costs of completing the well had been fully recovered in the period prior to the writ being served. Obviously, the costs incurred in re-commissioning the well were incurred in 2001 after the time that Mr. Thomsen had raised his concerns regarding the validity of the leases but more than two years before the Statement of Claim was issued.

[316] The respondents either knew that the leases were at best questionable if not dead altogether or they certainly ought to have known that these were in all likelihood dead. Nonetheless, they continued to produce in the face of the dark cloud hanging over these leases. This contrasts with the situation in *Sohio* where the lessor and lessee had for some considerable period of time each mistakenly believed that the lease was valid.

[317] Given the facts of this case, and in particular the egregious behaviour of the respondents, I would direct that the respondents disgorge the full amount of the revenue obtained from the subject leases, without any deduction for operating or other costs, for the period commencing two years prior to the issuance of the statement of claim.

[318] In my opinion, the harsh rule is not only fully warranted but is consistent with the law as enunciated by the Supreme Court of Canada in *Vorvis v Insurance Corporation of British Columbia*, [1989] 1 SCR 1085, 58 DLR (4th) 193; *Whiten v Pilot Insurance Company*, 2002 SCC 18, [2002] 1 SCR 595.

Appeal heard on September 11, 2014

Memorandum filed at Calgary, Alberta
this 19th day of November, 2015

McDonald J.A.

Reasons for Judgment Reserved of
the Honourable Mr. Justice O'Ferrall

I. Introduction

[319] This is an appeal by the owners of certain petroleum and natural gas rights.

[320] The owners sought a declaration that the petroleum and natural gas leases they or their predecessors-in-title granted to a number of different oil companies had terminated in accordance with their terms. They also sought damages on the basis of a disgorgement of either the gross proceeds of the sale of production from a well drilled on their lands or the net income the lessees received from producing the well after it was alleged the leases in question had terminated.

[321] The lessors' claims were dismissed. The trial judge held that the leases had not terminated in accordance with their terms. The trial judge also held that if she was in error in not declaring the leases terminated, she would have awarded the lessors an amount equal to the sum of what they might have received by way of a signing bonus had they chosen to enter new leases plus the royalties they would have received on production by new lessees. That is, the trial judge would not have awarded damages based on a disgorgement of profits.

[322] For the reasons given below, I would allow the lessors' appeal of the trial judge's declaration that the petroleum and natural gas leases in this case had not terminated in accordance with their terms. In my view, they had clearly terminated according to their terms.

[323] With respect to damages, I would have directed that the respondent oil company lessees account to their lessors for the revenue or income stream out of which their royalties were carved. In other words, instead of receiving 12 1/2% of the "amount equal to the current market value on the said lands" of the leased substances "produced, saved and marketed from the said lands" (to use the words of the royalties clauses of the leases to which the parties agreed), the lessors would be entitled to 100% of the current market value of the well's production "on the said lands." The phrase "on the said lands" has been interpreted to permit the lessee to deduct costs incurred to render the leased substances marketable in order to determine their current market value "on the said lands."

[324] The measure of damages I would award accords with the terms of the leases and with the late Justice Martland's decision in *Sohio Petroleum Co et al v Weyburn Security Co Ltd*, [1971] SCR 81, 13 DLR (3d) 340 where an oil and gas lease had terminated in accordance with its terms because of a lack of production and yet the lessees continued to produce. The Supreme Court required the lessees to "account for all benefits from production received by them after the date of service of the writ of summons upon them." Therefore, I would have held that the lessors were

entitled to that amount after the Statement of Claim and Notices to Vacate were served on their lessees in September of 2005.

[325] I would dismiss the appeal by the top lessee of the trial judge's dismissal of its claim for damages. The trial judge found that the top lessee had standing, but dismissed its claim for damages because the top lessee's right to produce the gas did not arise until there was a determination that the underlying leases had terminated and because the lessors had sued for the same loss the top lessee was suing for. I would endorse the trial judge's reasoning in this regard.

[326] I would dismiss the cross-appeal by the respondents, ExxonMobil Canada Ltd, Nexen Inc and Coastal Resources Limited. These three lessees had counterclaimed for damages on the basis that the appellants' lawsuit smacked of champerty and maintenance. I would uphold the trial judge's dismissal of that counterclaim. The trial judge was correct. Neither the top lessee's maintenance of the action or its sharing in the proceeds was champertous.

II. Termination of the Leases

[327] The pivotal issue in this case was whether or not the leases had terminated. In general, there are two things which govern the termination of a natural gas lease: the terms of the lease and the conduct of the lessee in exercising its rights under the lease, which conduct is often dictated by the performance of the well.

A. The Terms of the Lease

[328] All the leases in this case were entered into in the 1960s (1961, 1964, 1967 and 1968). The leases covered all four quarters of Section 25, Township 27, Range 1, West of the 5th Meridian (25-27-1-W5M), a section of land north of Airdrie, Alberta.

[329] In all of the leases, the leased substances included natural gas and related hydrocarbons. Three of the leases also included petroleum as a leased substance, but no petroleum was encountered. All of the leases contained a grant of the exclusive right to win, take, remove and dispose of the leased substances.

[330] The right to win, take, remove and dispose of the leased substances granted by the leases were to be enjoyed by the lessees for a primary term of 10 years and "so long thereafter as the said substances...are produced from the said lands." The 10-year primary term had long since expired when the events giving rise to this lawsuit took place. However, it is conceded by all that the rights granted to the lessees continued to be enjoyed beyond the 10-year primary term by virtue of production of the leased substances from a natural gas well in the SE 1/4 of Section 25 (the 7-25 Well). The dispute is over whether the rights granted eventually terminated because of a cessation of production.

[331] The leases conferred upon the lessees the right to pool the leased lands with other lands to form a production spacing unit which, in the case of natural gas production, is one section of land or roughly 640 acres. Production of the leased substances from a well on any part of the production spacing unit was agreed to have the effect of continuing all the leases. The leased lands in this case were in fact pooled to form the required production spacing unit for natural gas (i.e., the one section referred to above).

[332] In all of the leases, there were provisos which continued the leases even if the leased substances were not being produced. In order to properly construe the effect of the proviso in issue, one has to have regard to all of the provisos. They were all conditional.

[333] The first proviso provided that if drilling was not commenced within one year of signing the lease, the payment of annual rentals would confer the privilege of deferring the drilling of a well.

[334] The second proviso provided that if a well drilled during the 10-year primary term quit producing, the lease would continue, but only if the lessee drilled a further well or paid the annual rentals agreed to in the first proviso.

[335] The third proviso provided that if following the expiration of the 10-year primary term the leased substances were not being produced, the lease would not terminate so long as further production operations were commenced within 90 days after cessation of such production and so long as such resumed production operations were prosecuted with no further cessation of more than 90 days.

[336] The third proviso incorporated what was, in effect, a fourth proviso which provided that in calculating the aforesaid 90-day duration of cessation of production, no account was to be taken of any suspension, interruption or non-production caused by a lack of or an intermittent market or any cause whatsoever beyond the lessee's reasonable control. There were slight variations in the wording of this proviso in the five leases in question but nothing turns on those variations in this case.

[337] To summarize, there could be no cessation of production for more than 90 days, but if production was "interrupted or suspended" as a result of a lack of or an intermittent market or any cause whatsoever beyond the lessee's reasonable control, the duration of such interruption or suspension was not to be counted as a period of non-production for the purposes of the 90-day limit on such cessations of production.

[338] A failure to produce as a result of a lack of or an intermittent market or any other cause whatsoever beyond the lessee's reasonable control did however trigger the lessee's obligation to pay the lessor an annual rental (shut-in payment) at the expiration of the year in which that failure to produce took place. Such shut-in payments were made in this case so nothing turns on this

requirement. The issue was whether or not the lessees could rely on the fourth proviso to continue the leases in the face of a five and one-half year cessation of production.

B. Strict Construction of Petroleum and Natural Gas Leases

[339] Strict construction is the rule when it comes to interpreting petroleum and natural gas leases. Not all petroleum and natural gas leases are the same. But they are sufficiently similar that their interpretation calls for a "correctness" standard for the reasons given by my colleague, Justice McDonald, in his reasons for judgement.

[340] Having said that, one must keep in mind that the petroleum and natural gas lease is very much an evolving and changing document. Because the printed forms of petroleum and natural gas leases look almost identical, one must be cautious in applying prior jurisprudence because their terms can and do vary. There is no such thing as a standard oil and gas lease. And often changes were made with a view to reversing a prior interpretation by the courts. To quote the late John Ballem, Q.C., *The Oil and Gas Lease in Canada*, 4th ed (Toronto: University of Toronto Press, 2008) at 110, "Virtually every lease now contains language that has been revised in an attempt to repair...judicial ravages".

[341] Ballem also makes the point that the strict construction approach adopted by the Supreme Court of Canada had its genesis in the decisions of Alberta courts on the oil and gas lease:

> It should be noted that the line of Supreme Court cases that evolved the strict and literalistic approach to the lease upheld, rather than overturned, decisions of the Alberta courts. In other words, the strict approach of the Supreme Court was not imposed on the Alberta Appellate Division but was consistent with its own judgments. Accordingly, Alberta courts would be only following their own example if they continue to interpret the lease strictly. (110)

[342] Literal interpretation is particularly appropriate in this case because most of the original lessors are dead and most of the original lessees are no longer in existence. The leases in this case were executed in 1961 through 1968. Literal interpretation involves interpreting the words of the lease as they might have been objectively understood by an informed person reading them when they were executed, not how they would be read today. As my colleague Justice McDonald was heard to say, "All bets are made on the first tee." This maxim calls for caution in applying oil and gas lease cases decided since then unless, of course, those decisions were interpreting identically worded leases executed in or about the same time.

C. The Lessees' Conduct

[343] But enough about the terms of the leases and their construction. This case turns more on the actions of the lessee in response to the 7-25 Well's performance than it does on the interpretation

of the terms of the leases. The terms of the leases are straight-forward and, for the most part, were properly construed by the trial judge. But applying the terms of the leases to the facts is the critical task. And before the terms of the leases can be applied to the facts, the facts must be properly understood. A misapprehension of the facts can lead to an erroneous result.

[344] In this case, the dispositive facts are found, almost entirely, in the evidence of the two witnesses for the lessee (Nexen) which operated the well at the relevant time: Allan Seredynski and Ronald Watson. At trial, there was a lot of after-the-fact evidence given by experts about economics, profitability, "hurdle rates" of return on investments, profit to investment ratios and payout periods. That evidence may have been useful in providing context for the conduct of production operations at the 7-25 Well but it ought not to have been determinative. What ought to have been determinative is what the lessees did in the face of the well's declining performance.

[345] I agree with what this Court said in *Freyberg v Fletcher Challenge Oil and Gas Inc*, 2005 ABCA 46 at para 87, 363 AR 35: expert evidence is not necessary where there is sufficient factual basis to determine an issue. The issue is not that the trial judge admitted the evidence or that she preferred the evidence of the lessees' expert to that of the lessors' expert. The issue was the trial judge's reliance on *ex post facto* expert evidence when there was sufficient factual basis to decide the issues without reference to the experts.

[346] The jurisprudence is clear: a lessee, by its conduct, can cause a lease to terminate. Indeed, given the unilateral nature of the terms of most natural gas leases, that is pretty much the only way such leases can terminate.

[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 in issue in this case.

[348] Ballem called this "Involuntary Termination". But I think even he would argue that such terminations are not really involuntary. Leases are deliberately drafted to permit lessees to unilaterally decide when the lease is over. As a consequence, the lessee's conduct must be carefully scrutinized in light of the terms of the lease to determine whether, by its conduct, the lessee has caused the lease to terminate, deliberately or otherwise, in accordance with its terms.

[349] The leases in question were entered into in the 1960s (1961 to 1968). The leases covered all but six acres of Section 25 (a railway right of way is excepted out of the SW1/4). The registered owners of the hydrocarbon rights underlying the four quarters of Section 25 were different. Five leases were entered into with four different lessees. Three of the leases were petroleum and natural gas leases. The other two were leases of natural gas only, the only difference being the leased substances.

[350] Section 25 is located in the Crossfield Field north of Airdrie on west side of Highway 2 (the Queen Elizabeth II Highway). The "Crossfield Field" is a designation given to the gas field by the old Oil and Gas Conservation Board in the mid-1950s when the field was first discovered. It is a geographic designation and should not be confused with the geologic designations referred to below.

[351] The lessees of the natural gas notionally underlying[2] Section 25 anticipated the lands to be productive of natural gas and so, relying on the provision in their leases which permitted same, the lessees pooled their interests to form a one-section production spacing unit for a gas well.

[352] In the fall of 1968, within the 10-year primary term of the first lease signed, the lessees drilled a well in Legal Subdivision 7 of SE 25-27-1-W5M. This well will be referred to as the 7-25 Well. The targeted formation was the Crossfield Member of the Stettler Formation which is a formation within the Wabamun Group productive of sour natural gas. The 7-25 Well encountered the targeted formation and it was productive of sour natural gas. Because it contained lethal levels of hydrogen sulphide, the gas required processing prior to marketing. That is, it had to be flowed from the well to a processing facility (a gas plant) to remove the hydrogen sulphide and other impurities (notably, CO_2) before it would be accepted into a sales line.

[353] The 7-25 Well also encountered another gas-bearing formation: the Basal Quartz[3] which was productive of sweet gas. For various reasons, including processing issues which will be discussed later, the lessees were not able to produce the targeted Crossfield Member sour gas at the outset. So the 7-25 Well was initially completed in the BQ formation, which was a single-well pool containing only sweet gas. The well produced from that formation and that pool from 1971 to 1980. Around 1978, the well was completed in the Crossfield Member, but it was not produced from that formation for another two years because the lessees were still producing the well out of

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[2] I say "notionally underlying" because the fluid beneath the surface may not underlie the entire section or may extend beyond the boundaries of the section and yet be captured.

[3] More properly described as the "Lower Cretaceous Basal Quartz Member, Ellerslie Formation, Mannville Group", hereinafter referred to as the "BQ formation".

the BQ formation. Simultaneous production out of both zones was out of the question because of the different characteristics of the raw gas.

[354] The natural gas encountered in the Crossfield Member extended beyond the boundaries of Section 25. This was not a single-well pool. There were other wells drilled into the Crossfield Member and producing from it. Completion of the 7-25 Well into the Crossfield Member permitted the lessees to share in that production, but that sharing did not commence until after production from the BQ formation was discontinued in 1980. From the time the well was drilled in 1968 until it was produced, gas from the Crossfield Member was being drained from other wells in the pool. Thereafter, for a period of roughly 14 years, from 1981 to 1995, the 7-25 Well was produced from the Crossfield Member. However, in July of 1995, production ceased and the well remained shut in for five and one-half years.

[355] Near the end of that five and a half-year period, the respondent, Triquest Energy Corp. (now Bonavista Energy Corp.), a successor in title to an original lessee, served an independent operations notice on the operator of the well and the other lessees advising of its intention to re-enter the 7-25 Well and re-complete it in the BQ formation with a view to resuming production from that formation. An independent operations notice permits a non-operating owner of a well to take over operating the well. The reason for the independent operations notice in this case was that Nexen, the operator of the well on behalf of the lessees, had failed or refused to re-complete the well. In any event, as a consequence of the independent operations notice, the well was recompleted in the BQ formation and put back on production in February of 2001.

[356] The 7-25 Well then produced sweet gas from the BQ formation from February 2001 to January 2011 when it was shut in by a court order unrelated to the within litigation. The order was made pursuant to an interim injunction obtained by the operator of a nearby gas storage facility who alleged that the 7-25 Well was draining its storage gas.

[357] The facts surrounding the 1995 cessation of production from the Crossfield Member are important because the main issue in dispute is whether the impugned natural gas leases had terminated in accordance with their terms as a result of the cessation of production in 1995. This was the issue the trial judge decided and her decision on this issue was the subject of this appeal.

[358] In order to determine whether the leases terminated in 1995, an understanding of why production ceased in 1995 is necessary. As previously indicated, such understanding comes directly from the evidence of the two Nexen engineers who were responsible for the 7-25 Well during the years in question. Their evidence, which was accepted by the trial judge, was summarized at paragraphs 227 to 323 of the trial judge's lengthy judgment: *Stewart Estate v TAQA North Ltd*, 2013 ABQB 691 ("reasons"). The two engineers were Allan Seredynski, Nexen's production engineering manager, and Ronald Watson, a reservoir and exploitation engineer with CanOxy, Nexen's predecessor, who was the supervising engineer for the Crossfield area from

1988 to 1991. Prior to being the supervising engineer for the Crossfield area, Mr. Watson had been the plant engineer at CanOxy's Petrogas plant just north of Calgary. This plant will be hereinafter referred to as the Balzac plant indicating its geographic location. We refer to it by its geographic location because that geographic location is important to understanding why Nexen operated the 7-25 Well the way it did on behalf of itself and the other lessees.

[359] In short, the evidence of the two Nexen witnesses disclosed that the processing of sour gas from the 7-25 Well was problematic right from the outset because of the well's location relative to sour gas processing and because of the well's ownership.

[360] Dealing first with the well's location. There are two major sour gas fields north of Calgary: the Calgary Crossfield Field and the East Crossfield Field. (These are geographic designations given the two gas fields by the provincial energy regulator and are not to be confused with the Crossfield Member of the Stettler Formation which is a geologic designation.)

[361] The Calgary Crossfield Field is just north of Calgary and mostly east of Highway 2. Processing of sour gas from this field takes place at the Balzac plant north of the airport and east of Highway 2. This plant was owned and operated by one of the working interest owners of the 7-25 Well, Jefferson Lake Petrochemicals of Canada Ltd., then Canadian Occidental Petroleum Ltd. (CanOxy), and then Nexen. Jefferson Lake Petrochemicals, CanOxy and Nexen were successive lessees of the natural gas underlying the SW 1/2 of Section 25 and operated the 7-25 Well throughout the well's life on behalf of the other lessees.

[362] The other sour gas field north of Calgary is the East Crossfield Field. This field is predominantly north of Airdrie and mostly east of the Town of Crossfield. Some of the East Crossfield Field, including the subject well, is west of Highway 2. Processing of gas produced from this field took place at Amoco's (now TAQA's) East Crossfield sour gas plant just south of the Town of Crossfield west of Highway 2.

[363] The 7-25 Well was located north of Airdrie on the west side of Highway 2, just south of the East Crossfield Gas Unit operated by Amoco, and much closer to the East Crossfield gas plant than it was to the Balzac plant. The location of the 7-25 Well just outside the East Crossfield Gas Unit and some distance from the Balzac plant proved problematic.

[364] Dealing next with the well's ownership, the 7-25 Well was, for the most part, owned by parties other than those who had ownership positions in the East Crossfield gas plant. Indeed, for most of its producing life, the 7-25 Well was operated by the companies which owned and operated the Balzac plant.

[365] In order for the owners of the 7-25 Well to have the well's sour gas processed, one of their options was to arrange for processing by the owners of the nearby East Crossfield Gas Unit. But those owners were producing competitively from the same pool. Accordingly, they had little

incentive to process the 7-25 gas. The 7-25 lessees' alternative was to build a sour gas pipeline across and under Highway 2 to tie in to the Balzac plant to the south. However, there were impediments to this alternative which will be discussed later. So although the 7-25 Well initially encountered production in the targeted sour gas formation, the lessees were compelled to commence production from the upper sweet gas formation because less processing was required to get the gas from that formation into a sales line and off to market. However, during this roughly 10-year period (1971 – 1980), sour gas from the Crossfield Member underlying Section 25 was slowly being drained by offsetting production from nearby East Crossfield Gas Unit wells which had ready access to sour gas processing.

[366] The 7-25 Well lessees were, however, not without a means of having their sour gas processed. They could seek a common processor declaration, declaring the East Crossfield plant a common processor of gas, thereby requiring the owners of that plant to process the 7-25 Crossfield production on a non-discriminatory basis along with other production from the East Crossfield Gas Unit. The 7-25 Well owners did apply to the Energy Resources Conservation Board for a common processor declaration. However, such applications are often contested and are not always successful. On the other hand, if successful, such declarations can have adverse financial consequences for the owners of the facility declared to be a common processor. So, eventually a settlement agreement was reached whereby the owners of the East Crossfield gas plant agreed to process gas from the 7-25 Well. However, the rates at which they agreed to take and process production from the 7-25 Well were less than optimal. At times, it was only on a "best efforts" basis. Nevertheless, the 7-25 Well was produced from the Crossfield Member from March of 1981 to July of 1995, a period of 14 years. So it was a profitable well for a considerable period of time.

[367] Production from the 7-25 Well was intermittent throughout this 14-year period because of processing, marketing and operational constraints. That is, the 7-25 Well was not produced without interruption. There were interruptions from time to time as a result of causes beyond the reasonable control of the lessees. That is, there were processing, marketing and operational constraints which caused production to be interrupted. The fourth proviso in the natural gas leases permitted such interruptions. I mention these interruptions only because these interruptions or suspensions are to be contrasted with the cessation of production which took place in 1995.

[368] With respect to markets, the lessees' evidence was that they sold the gas they produced from the 7-25 Well to TransCanada, as did other producers in both sour gas fields. However, during the time in question, TransCanada was encouraged by the energy regulator (at the urging of the City of Calgary) to purchase preferentially from the owners of the wells closer to Calgary in order to deplete the sour gas reserves in areas where the city had expansion plans. Indeed, some of these reserves and wells were within the city limits. That preferential purchasing, and therefore preferential production, had the effect of filling the Balzac plant to near capacity, thereby presenting an impediment to the processing of the lessees' gas at that plant.

[369] In the late 1980s and early 1990s, the 7-25 Well began to experience deliverability problems. That is, its rates of production were declining. Because of well deliverability constraints, the 7-25 Well was only capable of delivering relatively small volumes of gas relative to other wells in the area producing from the same formation. For a while, this allowed the well owners to flow the well year-round and to sell as much gas as the well could produce. But deliverability constraints are never good news to owners of gas wells.

[370] Soon, the 7-25 Well's deliverability constraints impacted not only the amount the well was capable of producing on a sustained basis, but also the owners' ability to market the well's production. Gas purchase contracts are typically based on well deliverability. As a well's deliverability declines, the maximum daily contract quantity which TransCanada takes (purchases) under the producer's gas sales contract is reduced. This happened at least twice to the 7-25 Well in the early 1990s. As a result of deliverability tests performed on the 7-25 Well in December 1992 and November 1993, TransCanada twice reduced the amount of gas it was prepared to purchase from the well's production in February 1993 and in June 1994. This was not a marketing constraint. This was a well performance constraint. The owners of the well, having considered it, deliberately decided against stimulating the well which might have increased its deliverability. The owners' reluctance to incur the costs of stimulation to increase deliverability was because the well was perceived as being near the end of its life. Reservoir pressure was low and declining and the cost of stimulation was deemed to be prohibitive.

[371] By 1994 - 1995, the working interest owners were faced with a situation where the 7-25 Well was becoming uneconomic. According to Mr. Seredynski, the well was only capable of producing a half a million cubic feet of natural gas per day. By mid-year 1995, the 7-25 Well was losing money in the order to tens of thousands of dollars a month. That is when Mr. Seredynski sent his July 11, 1995 memo, entitled "Well Suspension and Abandonment," recommending "suspending" the well. The memo used both the words "suspend" and "abandonment" but what is clear from Mr. Seredynski's memo is that the well was expected to be in a "negative cash flow position...for its remaining life of less than 5 years." In other words, the well was predicted to be incapable of production in five years and the rates at which it was capable of producing in the interim were uneconomic or not profitable (A423). Indeed, Mr. Seredynski, in seeking the approval of the province's Energy Resource Conservation Board to suspend the well, gave as a reason that the well was "uneconomic to produce at this time".

[372] It is important to distinguish between interrupting or suspending production from a well capable of production and ceasing production from a formation which is no longer commercially productive. It is important to make this distinction because the fourth proviso in the lease provides some relief only for production operations which are "interrupted or suspended". In 1995, production from the Crossfield Member was not being interrupted or suspended. Production was being brought to an end and the producing formation abandoned. Subsequent events and the fact that the lessees never resumed production from the Crossfield Member bear this out.

[373] A lack of or an intermittent market was not the cause of the cessation of production from the 7-25 Well. Continued production was simply uneconomic and there was no foreseeable prospect of that situation changing. From that point forward, the lessors were simply holding on to a lease which had terminated in accordance with its terms.

[374] In *Omers Energy Inc v Alberta (Energy Resources Conservation Board)*, 2011 ABCA 251 at para 95, 513 AR 292, where the issue was whether the well in question was capable of production (and not the lessee's entitlement to shut the well in), this court said in *obiter*, "[i]t was never intended that the shut-in well clause could allow a lessee to hold a property for purely speculative purposes". In the case of the 7-25 Well, it was not even clear that the lessees were holding onto it for "speculative purposes". They appeared to be holding on to it because they could not agree on getting rid of it, as discussed below. The ratio of *Omers* and its relevance to this appeal is that the energy regulator (then the Energy Resource Conservation Board), for its purposes, held that there must be a well on the leased lands capable of producing the leased substances in "meaningful" quantities in order to prevent the termination of a petroleum and natural gas lease. On appeal, this court held that in order to find a well capable of production, production revenues must exceed production expenses. That test was not being met by the 7-25 Well in the summer of 1995.

[375] In *Freyberg v Fletcher Challenge Oil and Gas Inc*, *supra*, the lessee's well had been shut in for 21 years and, like the case at bar, offsetting wells were being produced and their production marketed. In those circumstances, this court held that the natural gas lease in question terminated. The court held that holding onto a lease for speculative purposes does not prevent its termination even where the terms of the lease permitted the lessee to shut in a well because of "uneconomic or unprofitable market". The court said that the test for determining whether there is an economic or profitable market is whether, based on information available at the time of cessation of production, a prudent lessee would have foreseen profitability. If not, the lease is over. Clearly the lessees in Section 25 did not foresee profitability, but it was not because there was no economic or profitable market for the gas.

[376] According to Mr. Seredynski, the cessation of production at the 7-25 Well was "due to its low raw gas production rate of $< 7.0\ E^3M^3/d$ and the high field gathering fee charged by Amoco which has caused the well to be in a negative cash flow position in 1995 and for its remaining life of less than 5 years." Assuming $< 7.0\ E^3M^3$/day of raw gas production (as opposed to saleable gas), this well was only capable of producing less than $3.0\ E^3M^3$/day of natural gas when the shrinkage for CO_2 and H_2S was taken into account: see paragraph 255 of the trial judge's reasons where Mr. Seredynski gave evidence with respect to shrinkage. And quite apart from the CO_2 and H_2S shrinkage calculations, Mr. Seredynski testified that the well's actual production was roughly a half a million cubic feet per day of sales gas. At that level of production, the lessees, as represented by Nexen, did not consider this well to be capable of economic production.

[377] Mr. Seredynski also testified that even if the field gathering and plant processing fees charged by Amoco were reduced, it would not have made a difference to the decision whether or not to cease production because, even at the lower processing fees available to a plant owner (i.e., an owner of the East Crossfield gas plant), the well was not economic.

[378] Significantly, Mr. Seredynski also stated that the small amount of remaining reserves in the BQ formation (the sweet gas formation) made recompletion in that zone uneconomic. In other words, in 1995, the 7-25 Well was deemed incapable of economic or profitable production from either of the two prospective zones encountered more than 25 years earlier. Finally, according to Mr. Seredynski's 1995 memo, a review of logs by an "Area Team" of geologists identified no other uphole potential.

[379] It is important to note that none of the processing and other issues which made production from the Crossfield Member uneconomic had any application to production out of the BQ formation. The lessees' own expert was of the opinion that even in 1995 recompletion in the BQ formation would have generated positive cash flow (i.e., production revenues would have exceeded production expenses as per this court's ruling in *Omers*). However, the evidence of Nexen's engineers was that production from the BQ formation would not have generated positive cash flow.

[380] The ultimate recommendation was to offer the 7-25 Well to Amoco, the operator of the East Crossfield Gas Unit, in return for Amoco paying the costs of well and pipeline abandonment and surface reclamation, which was estimated to be $165,000. This recommendation was not accepted by all of the lessees, but to even be contemplating such an offer was not the conduct of a lessee proposing an "interruption or suspension" of production, which the leases permitted. This was the conduct of a lessee which no longer considered the well capable of economic production.

[381] Mr. Seredynski testified that the 7-25 Well was shut in, not because there was no market for the gas, but because the well was not economic: reasons at para 279. The well was not economic because there was not enough production from it to cover the costs of production, field gathering and processing, not because of marketing considerations. It was simply a case of production declining to uneconomic levels. Of course, even low levels of production can, with the effluxion of time, become economic or profitable if the price of the product gets high enough, but that was not foreseen in 1995 when the well was shut in as demonstrated by what happened next.

[382] What happened next was that the 7-25 Well was shut in a tubing plug and inhibitor set, and the wellhead locked. Surface equipment necessary to produce the well from any formation was removed. The well owners cancelled their gas processing agreement with the owners of the East Crossfield gas plant, thereby giving up their share of the East Crossfield gas plant's processing capacity. Their contract operating agreement with Amoco (also operator of the East Crossfield Gas Unit and the East Crossfield plant) was cancelled. They also released their firm transportation

capacity with Nova or TransCanada. The well's maximum daily contract (purchase) nominations were cut by TransCanada to zero. And, significantly, in light of what happened later, even the sweet gas gathering line which had been used to take away production from the BQ formation was abandoned. Further production from the BQ formation was not contemplated in 1995.

[383] No further "drilling or working operations" were undertaken on the leased lands for five and a half years. Five and a half years later, with gas prices at unheard-of high levels, Nexen, as operator of the 7-25 Well, still had not put the well back on production. However, another working interest owner, Triquest, saw potential in the well. As a consequence, Nexen received an independent operations notice from Triquest in which Triquest gave notice that it wished to recomplete the well in the BQ formation. As a consequence, the well was recompleted and, in February 2001, began producing from the BQ formation, a formation which the lessees had written off and failed to produce from for five and a half years.

[384] To complete the story, four years after the well was recompleted in the BQ formation and put on production, a number of the lessors, owners of the hydrocarbons underlying Section 25, served a Notice to Vacate and issued a Statement of Claim seeking a declaration that the leases were no longer valid on the basis that there had been no production of the leased substances for five and a half years between 1995 and 2001. The Notice to Vacate and the Statement of Claim were served in September 2005. Notwithstanding the Notice to Vacate and Statement of Claim, the lessees continued to produce until January 2011 when the well was shut-in by court order for a reason unrelated to this lawsuit.

<u>III. Analysis of the Validity of the Leases</u>

[385] Subject to the so-called third proviso and the payment of shut-in rentals, the right to produce a well under a natural gas lease continues only if the well is continuously produced following the expiration of the primary term. The 7-25 Well did not produce after 1995. So only if the proviso applied could the lease continue.

[386] The so-call third proviso (which contained the fourth proviso) permitted continuation of the lease when there had been an "interruption" in production or production had been "suspended". It did not permit continuation of the lease when there had been a complete cessation of production until some indefinite time in the future when the lessee unilaterally decided that a resumption of production was economic or profitable.

[387] The proviso states that the <u>duration</u> of the interruption or suspension of production as a result of a lack of or an intermittent market or any other cause beyond the lessee's reasonable control may not be counted against the lessee in determining whether or not there has been a cessation of production for more than 90 days. Contrary to what was argued, it is not the lack of or intermittent market or a cause beyond the reasonable control of the lessees which has the effect of

continuing a lease. What continues the lease is the resumption of production operations within 90 days. But in determining whether the production operations have resumed within 90 days, any interruption or suspension of production caused by the lack of or an intermittent market is not to be counted as being part of that 90-day cessation of production which is permitted under the lease.

[388] The duration of the interruption or suspension of production is simply a period of time not to be counted in determining whether there has been more than the permitted 90-day cessation of production. In the 1960s, when these leases were entered into, neither the lessors or the lessees could be taken to have intended that the third or fourth proviso would permit a five and a one-half-year suspension of a 90-day period of permitted production cessation. The lessors obviously would not have intended to permit an indefinite cessation of production which yielded them royalties. Neither would the oil company lessees have intended to be bound to resume production operations at some indefinite time in the future. The whole reason for the "so long thereafter as" and the "subject to earlier termination" clauses in the granting or *habendum* clause of the leases was to permit the oil companies to cease production and walk away from their leases whenever they deemed fit. Without the conditional grant, oil company lessees risked being compelled by their lessor to produce leased substances they did not wish to produce.

[389] But more importantly, on the facts of this case, there was no interruption or suspension of production which would trigger the proviso. There was, in fact, a complete cessation of production. An interruption or a suspension of production must necessarily be followed by a resumption of production in order to maintain a lease. There never was a resumption of production of natural gas from the producing formation. The hard-rock mining ballad of "Big John", says it all:

> *They never re-opened that worthless pit.*
>
> *They just placed a marble stand in front of it.*

The lessees never re-opened (re-completed) the well in the Crossfield Member. Nor did they perforate the well bore in any other zone for five and one-half years. Even more recent forms of petroleum and natural gas leases, which are continued beyond their primary terms by the mere presence of a well on the leased lands, require that such well be adequately perforated, stimulated and treated to obtain production from one or more zones. In other words, if all zones are abandoned, which was the situation in the case of the 7-25 Well in 1995, the lease is subject to termination. As discussed later, after the expiration of the primary term, there must always be a well capable of production in order for the lessee to have the right to rely on the terms of the lease permitting a suspension or interruption of production. In 1995, the 7-25 Well, like the collapsed mine in the Jimmy Dean ballad, was considered to be a worthless pit.

[390] In the summer of 1995, there was a wholesale abandonment of the Crossfield Member and no "drilling, working or production operations" taken for five and a half years to produce the well

from another formation. Five and a half years later, a complete re-working of the well to produce from the BQ formation was required because it too had been abandoned 20 years earlier. A new completion five and a half years after the well last produced when circumstances, which were not foreseeable, had fortuitously changed cannot be considered a resumption of production operations following an interruption or suspension for causes beyond the lessees' control or because of a lack of or intermittent market.

[391] The circumstances which this case presents are analogous to those in which a well ceases to produce in commercial quantities (in the vernacular, the well goes "dry" or "waters out"). No one would argue that a lessee in those circumstances could do nothing for half a decade and then expect to rely on a proviso in the lease similar to the subject leases.

[392] The only factual distinction between the hypothetical and the case at bar is that, in the case at bar, a new well did not have to be drilled. But the 7-25 Well did have to be recompleted in an entirely different zone at a cost of about a half million dollars. A drilling rig had to be brought onto the lease to recomplete the well in the BQ formation. A pipeline to take away the production from the well had to be constructed (or the previously-abandoned production pipeline unplugged and recommissioned). Firm transportation on TransCanada had to be obtained and either a new gas purchase contract entered into or an existing one amended with respect to contract quantities.

[393] The natural gas leases in this case did not permit the leases to continue once the lessees ceased production. A failure to produce a well because it is uneconomic and unprofitable results in the termination of a natural gas lease of the type we are dealing with. A failure to produce a well because such production is uneconomic or not profitable results in termination if that failure takes place after the expiration of the primary term and no steps are taken to resume production or drilling operations. The payment of annual rentals would only prevent termination following the expiration of the primary term if the failure to produce was the result of an interruption or suspension of production because of a lack of or an intermittent market. The production engineering manager responsible for this well testified that a lack of or an intermittent market was not the reason for cessation of production. His evidence clearly demonstrated that there was no "interruption" or "suspension" of production. There was a complete cessation of production, an "abandonment" to use one of the words he used.

[394] Mr. Seredynski's evidence, which was accepted by the trial judge, should have been the end of the matter. Clearly there was a market for the gas when the well was shut-in. Gas continued to be produced, processed and sold from the Crossfield Member in both the East Crossfield and Calgary Crossfield fields. The trial judge read into the lease the requirement that the market be economic or profitable. I do not believe she erred in so doing, but there could also be no doubt that a market for the gas existed and that it was profitable. Offsetting wells were selling gas into that market. What was not considered profitable or economic by the lessees was producing sour gas from this well because of its low flow rates. And the reason producing the well was not considered

profitable or economic was the cost of producing, gathering and processing the gas. But these are not market issues. These are well capability issues which have been faced by many an old well at the end of its economic life. The lessees simply could not produce the well at rates which made economic sense to them. The natural gas leases in this case did not permit the lessees to refrain from "drilling, working or production operations" until an unforeseen circumstance at some indefinite time in the future transpired to make the well economic again. If that were the law, natural gas leases of the type entered into in this case would continue indefinitely despite a lack of production. And whatever else might be said about the parties' intentions back in the 1960s when these leases were entered into, neither party contemplated that the leases would continue indefinitely in the absence of production.

[395] Under the leases in question, there is the right to shut-in, cap, suspend or otherwise not produce a well following the expiration of the primary term if the shut-in, suspension or cessation of production is the result of a lack of or an intermittent market or a cause beyond the lessees' reasonable control. But as Ballem stated in his book, and this is important, there must still be a well capable of producing the leased substances for that right to exist: Ballem at 210. A lessee cannot be said to have "shut-in" a well if the lessee is of the view there is nothing to shut-in. A lessee cannot "cap" a well if there is nothing to cap. A lessee cannot "otherwise not produce" a well if there is nothing to produce.[4] In this case, there was no well capable of producing the leased substances for five and a half years. The leases expired in accordance with their terms when the only formation then capable of being produced was abandoned and the decision was taken not to recomplete the well in the only other formation which, as it turned out, was capable of production (even though it was thought not to be capable of economic production at the time of abandonment). Once a lessee concludes that a well is not capable of economic production, such lessee must within 90 days commence drilling, working or production operations to either stimulate the existing formation or complete the well in another formation. The fourth proviso is simply inapplicable to a circumstance where there is no well capable of producing the leased substances in commercial quantities.

[396] The trial judge apprehended the case as one where the lack of an economic or profitable market for the gas or other causes beyond the lessees' reasonable control permitted the lessees to interrupt or suspend production. This, of course, was the lessees' argument. The issue, as the trial judge saw it, revolved around whether the market for the leased substances (primarily natural gas) was economic or profitable. However, the validity of the leases in this case did not depend upon whether the lack of or an intermittent market for the natural gas produced from the 7-25 Well or

[4] A natural gas well may be assigned a "shut-in", "capped" or "suspended" status by the energy regulator, but the leases the parties entered into contemplated only the shutting in, capping or suspending of a well capable of production.

whether other causes beyond the lessees reasonable control permitted an interruption or suspension of production. The validity of the leases turned on whether or not there had been a cessation of production due to the declining productivity of the well. There was no consideration given to this argument advanced by the lessors.

[397] Declining production or the inability of a well to produce in quantities in which revenues exceed expenses triggers termination. It was not the economics or the profitability of existing gas markets which killed this well. It was the perceived economics and profitability of the rates of production which the well was physically capable of sustaining which killed it. Pick whatever phrase you wish from the decided cases, the 7-25 Well was considered by the lessees to be incapable of producing the leased substances in "meaningful", "paying", "commercial" or "economic and profitable" quantities.

[398] This was not a new argument. It was put before the trial judge and was advanced on appeal in the appellants' factum. The lessors argued before us and below that,

> At some point, every gas well's costs exceed the value of the gas it is capable of producing. Because gas pools are finite, at some point all gas wells peter out and become uneconomic. If the words, 'beyond a lessee's reasonable control' includes the situation where a well becomes uneconomic because costs exceed revenues, then every gas lease is capable of indefinite continuation...

I agree.

[399] The trial judge accepted the evidence that the decision to shut-in the 7-25 Well was justified and from the commercial perspective of the lessees it may have been justified. But from the perspective of the survival of the leases, the real issue was why the shut-in took place. Was it because of a lack of or an intermittent market for production capable of satisfying that market or some other cause beyond the reasonable control of the lessees? Or was it because the well was no longer capable of economic production? The latter issue does not appear to have been canvassed by the trial judge. The evidence required that it be canvassed. A well no longer capable of economic production may be due to causes beyond the reasonable control of the lessee. In that event, only the timely commencement of "drilling, working or production operations" (that is, meaningful activities directed at bringing the well back onto production) will prevent termination of the lease. In the words of the mining ballad, "[w]ith jacks and timbers," the lessee must "start back down".

[400] Much was made of the coincidental interests of lessors and lessees in realizing a profit from production in order to justify an interpretation of the lease which would permit continuance when the market for production is not profitable. The respondents argue that the interpretation of the fourth proviso should have regard to the fact that it is not in either the lessee or the lessor's interest to have a well produced at a loss. While that may be true, it does not mean the lease is continued.

The lessee may be compelled to discontinue uneconomic production. But having discontinued production in those circumstances, the lessee cannot simply do nothing. If a well is no longer considered by the lessee to be capable of economic production and the lessee doesn't do something to remedy that situation in a timely fashion, the lease terminates and the lessor resumes control of its hydrocarbons.

[401] This court in *Omers* stated that it strains common sense to think that a lessor would tie up its land past the primary term for a well which lacked commercial viability: para 95, referencing *Freyberg* at para 50. The goal of both parties is to develop the resource to make a profit. However, when that is not possible or not considered to be possible by the lessee, the lease terminates in accordance with its terms.

[402] The first clue that this case was not about the lack of an economic or profitable market for the leased substances, but rather was about a well no longer capable of producing in economic quantities, came when the lessors' expert started giving evidence about "hurdle rates" of return on investment, profit to investment ratios and payout periods.

[403] These were all financial measures or economic indicators which took into account the capital expenditures which the lessees were required to make in order to either continue producing natural gas out of the Crossfield Member or recommencing production out of the BQ formation.

[404] With respect to the Crossfield Member, the lessees' expert's evidence was that the lessees were looking at a costly fracture stimulation. The cost was in the neighbourhood of several hundreds of thousands of dollars. To abandon the Crossfield Member and recomplete in the BQ formation the lessees were looking at a cost of $460,000.

[405] So the hurdle rates proffered were the lessees' desired rates of return on these capital costs or investments. The profit to investment ratios and the payout periods were also related to these capital costs. All of these financial measures are tremendously relevant if the issue is one of the well's economics. But it has nothing to do with the fourth proviso which provides for suspensions or interruptions of production as a result of the lack of a market or other causes beyond the reasonable control of the lessees.

[406] And the reason these economic indicators had nothing to do with the fourth proviso is that, under the leases, the lessors were indifferent to those capital costs. Lessor royalties are not subject to any of the costs of bringing the leased substances to the surface. If one examines the Agreed Statement of Facts Pertaining to Revenues, Expenses and Royalties, nowhere to be found is the cost of abandoning the well in 1995 or the cost of recompleting in the BQ formation in 2001. Just as the lessors are not concerned about the capital cost of drilling the well in the first instance, they also are not concerned about the costs of stimulation, abandonment or re-completion. Those are costs borne by the lessees and are not expenses incurred to render the gas marketable and are therefore not taken into account in calculating the lessors' royalties. Nor are the lessors concerned

about the risks associated with these production operations, which risks played a prominent role in the lessees' expert's opinion that continued production of the well was not economic. The lessors' only concern is that the revenue from sales of the natural gas exceeds the costs of rendering it marketable.

[407] The costs and the risks associated with getting the hydrocarbons out of the ground are borne by the lessees. These costs and the risks may very well determine whether a well is economic or considered capable of producing in commercial quantities. But if they dictate that the well is not economic or not considered capable of producing profitably, then the lease is over, absent a re-working of the well. The lessees in this case did not have the right to maintain leases in circumstances where they shut in a well they considered uneconomic at a time when there was a market for the leased substances being produced from the same formation by four offsetting wells[5]. The well's revenues might not have exceeded the lessees' hurdle rates of return on investment, but that fact is only relevant to the economics of continued production. Failing to meet or exceed targeted rates of return or investment or desired pay-out periods is not relevant to the issue of whether or not profitable or economic markets for the leased substances exist. And while a well's inability to satisfy the lessees' hurdle rates may be beyond a lessee's control, that is not a circumstance to which the fourth proviso applies. And since the fourth proviso is not applicable, the leases terminated in this case.

IV. Remedy

[408] Having found that the leases terminated according to their terms, the issue then becomes one of whether the lessors are entitled to a remedy and, if so, what form that remedy should take.

[409] The issue of whether the lessors are entitled to a remedy arises because even though the leases terminated in accordance with their terms in 1995, shut-in rental payments continued to be made by the lessees and accepted by the lessors. Furthermore, when production resumed in February or March of 2001, the payment and acceptance of royalties from that production also resumed. However, in 2003, lessees discovered what they considered to have been a substantial over-payment of royalties to the lessors. That led to a demand for repayment which caused some of the lessors to more closely examine the state of their leases.

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[5] Two of the offsetting wells which continued to produce were wells of the operator of the subject wells (Nexen) which brings to mind this court's decision in *Freyberg* where the lessee in that case took steps to prefer its other vicinity wells on Lady Freyberg's lands. When production from those wells began to decline, they were successfully stimulated.

[410] Ultimately the lessors received advice that their leases had terminated in accordance with their terms and in September of 2005 they served their lessees with a Statement of Claim and Notices to Vacate demanding that Nexen immediately cease production from the 7-25 Well and turn it over to them. The stated basis for this demand by the lessors was the cessation in production. The Statement of Claim sought a declaration that the leases had terminated following the 1995 cessation of production. It claimed that natural gas had been improperly taken from the leased lands and sought an order directing the lessees to account for the profits they had received from producing the well from March 2001.

[411] With respect to the issue of entitlement to a remedy, I am of the view that the acceptance of shut-in rentals while the well was shut-in and the acceptance of royalties once the well was recompleted and production resumed did not revive the terminated leases. However, the acceptance of royalties could affect the lessors' entitlement to damages, the quantum of damages they were entitled to and the period over which they were entitled to damages.

[412] In *Sohio*, where production had been wrongly taken following a petroleum and natural gas lease which had expired, the Supreme Court of Canada adopted a ruling by the Saskatchewan Court of Appeal that the lessees "account for all benefits from production received by them after the date of service of the writ of summons upon them": at 89, citing *Weyburn Security Company v Sohio Petroleum Company* (1969), 7 DLR (3d) 277 at 283, 69 WWR 680 (Sask CA).

[413] I would propose to follow that prescription in this case; although it should be made clear that the appropriate measure of damages for wrongful production following the termination of a natural gas lease may vary with circumstances. I articulate no general principles here.

[414] There are two aspects to the ruling in *Sohio*. The first is that the measure of damages is "all the benefits from production received by them [the lessees]". The second is that it is the benefits from production received after the date of service of the writ of summons on the lessees which must be accounted for.

[415] I interpret the "benefits of production received by them" to mean the net revenue received by the lessees after certain expenses incurred in obtaining that production and rendering it marketable have been deducted. That interpretation accords with the terms of the leases wherein the parties agreed that the lessors' royalties would be based on the "current market value on the said lands" of the leased substances "produced, saved and marketed". Those terms suggest that certain production, gathering and processing costs ought to be deducted and, indeed, they were deducted in calculating the lessors' royalties. If the lessors were prepared to have those costs deducted before their 12 1/2% royalty shares were calculated, it seems appropriate to deduct those costs after they became entitled to 100% of the value of the produced substances.

[416] The *Sohio* measure of damages makes sense in this case because the court is not simply compensating for trespass.[6] It is also compensating for a wrongful conversion.[7] 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.

[417] Disgorgement of net benefits, while not a particularly "mild" rule, is also not necessarily punitive as has been suggested. Disgorgement can also be compensatory.

[418] The Supreme Court adopted disgorgement in *Sohio* where the oil company was found to have proceeded under a mistake as to its rights. Disgorgement is all the more appropriate in cases where there is no doubt about the lack of consent by the owner of the hydrocarbon rights to the production of them by another following service of a Statement of Claim or a Notice to Vacate.

[419] While natural gas in the ground can have value (gas in place is bought and sold by oil companies all the time), ascertaining its value *in situ* can be difficult and any value estimated is subject to debate. But the value of natural gas which has been severed from the ground at a particular point in time is susceptible to valuation, particularly when there has been actual sale of the leased substances as there were in this case.

[420] But in order to sell the leased substances, costs must be incurred to flow it, treat it, process it (if processing is required) and dispose of valueless by-products, etc. Thankfully, the parties, though they did not agree on entitlement, did agree on the quantum of revenues received and the

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[6] The debate over whether there can be a trespass to mines and minerals should be put to bed. Mines and minerals are interests in land. To quote GHL Fridman, *The Law of Torts in Canada*, 2nd ed, (Toronto: Thomson Canada Limited, 2002) at 43, "The expression 'land', at least for the purposes of the law of trespass, not only includes the surface, i.e., the topsoil, but may extend to cover the earth below and air above the surface". To suggest that the registered owner of the mines and minerals underlying Blackacre lacks possession, and therefore cannot sue in trespass because he is not actually mining the mines and minerals, is to suggest that a farmer owning unused, vacant land hasn't sufficient possession to sue in trespass. Mines and minerals, like vacant land, can be trespassed upon in a variety of ways. Subject to the rule of capture, minerals can also be wrongfully converted when a party without authority reduces them to possession by severing them from the subterrain. Also, the principle that an overholding tenant cannot be sued in trespass loses its validity when the overholding tenant refuses to vacate when given proper notice to do so.

[7] See note 6.

expenses incurred by the lessees while the 7-25 Well was producing from 2001 to 2011. And, of course, the parties also agreed on the royalties paid on that production to the lessors. I see no reason not to base the "benefits from production" received by the lessees on the parties' agreement as to exactly what the net operating income from the well's production was.

[421] Like my colleagues, I am of the view that the royalty-plus-bonus measure of damages is not appropriate on the facts of this case. Quite apart from encouraging lessees from wrongfully continuing production after their leases have terminated, knowing that it may not cost them much more than they are currently paying, the royalty-plus-bonus approach has all sorts of other problems associated with quantifying it which the net benefits or net income approach does not have in this case.

[422] First, to apply the royalty-plus-bonus approach, one has to determine an appropriate royalty rate upon which the damages will be based. This can be difficult and may require complicated reservoir evaluations and market assessments. An arbitrary topping up of the traditional 12 1/2% royalty may not be appropriate. In the case at bar, the lessors and their top lessee agreed to a royalty rate of 20%, but it was a reviewable rate depending on market considerations.

[423] Even if an appropriate royalty rate can be determined, complicated and often controversial calculations still have to be made to determine the actual amount of the royalty payment. Different lessees have different ways of calculating royalties. Even oil companies can disagree among themselves as to what constitutes legitimate costs of production to be deducted from the proceeds of sale of the gas in order to determine royalty payments.

[424] Determining the bonus the lessor might expect to receive on the execution of a new lease is also fraught with hazards. In this case, for example, the top leases appear to indicate that a mere $100.00 was paid as a bonus. But, of course, the stated amount of the bonus ignores the agreements which were made for funding this litigation and the sharing in recovery.

[425] So for these reasons and ones which follow, the appropriate measure of damages in this case ought to be disgorgement by the lessees of the net benefits of production received by them.

[426] The other important principle endorsed by the Supreme Court in *Sohio* is that the accounting for net benefits runs from the service of the notice to vacate. This is particularly appropriate in this case.

[427] What was being litigated here was the termination of a long and mutually-beneficial relationship between lessors and lessees. Unlike some of the cases cited, the oil company lessees in this case did not enter the lands of the lessors as trespassers. They obtained the right to do so. And they paid for that right. Furthermore, they produced a well on the lands from one formation for roughly 10 years and then from another formation for a further 14 years and they paid the lessors

royalties on all of that production. Then they ceased production and paid shut-in rentals. No lessor objected or took the position that the leases had terminated according to their terms. This does not mean the leases had not terminated in accordance with their terms. It simply means that the lessees were justified in believing that they had the lessors' consent to remain. An oil company does not need a petroleum and natural gas lease to maintain a well on another's land. All an oil company needs is the consent of the owner of the minerals (and the consent of the surface owner if not the same). Such consent, of course, can be revoked at any time and that is why oil companies prefer the tenure which executed and registrable petroleum and natural gas leases provide. But that does not detract from the fact that a fee simple owner can simply consent to the taking of his minerals if he chooses.

[428] The Saskatchewan Court of Appeal's very thorough review of the law of trespass and the *indicia* necessary to establish consent (leave and licence) in *Montreal Trust Co v Williston Wildcatters Corp*, 2004 SKCA 116, 243 DLR (4th) 317 [*Williston Wildcatters*] is helpful. The bottom line is that landowners and/or mineral owners are free to grant rights to others to come onto their lands to exploit their minerals. And they can grant such rights by any means they choose. They do not need to execute a lease. They are free to manage their holdings as they see fit. But manage them they must. Fee simple ownership requires management, supervision and engagement. Fee simple ownership has its privileges but it also has its responsibilities.

[429] I do not subscribe to the view that freehold lessors are necessarily at an informational disadvantage compared to oil company lessees. When the payment of royalties terminated, the lessors ought to have exercised due diligence in determining the reason. They ought to have made inquiries of their lessees. The lessees would then have been obliged to explain why production was being halted. Had they done so, the lessors might have consented to the cessation because there are any number of reasons why it might have been in their interests to consent to a cessation of production. And if the information the lessors received as a result of their inquiries was not satisfactory, there were plenty of petroleum consultants available to advise (land consultants, reservoir engineering consultants, geological consultants and even natural gas marketing consultants). Also, given the informational filing requirements of the province's energy regulator, there was also a wealth of information available free of charge at the energy regulator's offices, specific to the well and the gas field in question.

[430] The significance of the foregoing is that in the absence of any steps being taken by the lessors to exclude the lessees, the lessees were not trespassers following cessation of production in 1995. The lessees had initially come on the lands as a matter of right. They had produced the natural gas as a matter of right. They then lost that right. But at that point, in the absence of any steps being taken by the owners of the hydrocarbons, the lessees did not become trespassers. No action was taken by the lessors. Their acceptance of rentals and royalties, while it did not revive the terminated leases, did indicate that the lessors consented to the *status quo*. And, for their part, given their prior mutually-beneficial and lengthy relationship, the lessees were justified in

believing they could continue to conduct themselves on the assumption that the landowners took no objection to the resumption of production operations in March 2001. The legal fact that their leases were subject to termination in accordance with their terms is of no consequence if no steps are taken by lessors to eject their lessees.

[431] I daresay there are many freehold oil and gas leases throughout Western Canada which have expired according to their terms and are subject to termination; yet those lessees and lessors continue to conduct themselves as before. Indeed, top leasing is a practice built on identifying those "terminated" leases and persuading lessors to grant top leases. The fact that would-be top lessees are not always successful in persuading landowners with expired leases to grant them top leases is testament to the point being made. And that is, that until the lessors made it clear to their lessees that they no longer consented to continued production, the leases may have been subject to termination, but the lessors were not entitled to damages for trespass or conversion. The lessors had to make it clear that they were relying on that termination.

[432] But once the lessors served notices to vacate, the fact that they continued to accept royalties from the wrongful conversion of their hydrocarbons is of no consequence. Acquiescence in continued production of the well and acceptance of royalties was not indicative of consent. At that point, the lessors were simply accepting proceeds of the sale of a portion of the production which belonged to them and which the lessees persisted in wrongly converting in the face of a notice to vacate. The hydrocarbons were owned by the lessors. By continuing to accept royalty payments, the lessors were simply receiving a part of the benefit to which they were entitled by virtue of their ownership.

[433] Once served with the Notice to Vacate in September 2005, the lessees were not innocent tortfeasors who acted under the mistaken belief that they were acting lawfully. The lessees had been warned by at least one very experienced petroleum landman that their leases had terminated. It wasn't until several years later that they were served with notices to vacate. But, having been served and armed with the advice they had received, the lessees took the position that they were acting lawfully, knowing full well that their position might not be sustained. This is not the act of an innocent tortfeasor. This is the act of lessees who knew the risks and took them. They must now suffer the consequences of having converted to their own use the hydrocarbons of others. Nor should the lessees get any credit for their special skill, expertise and effort in wrongfully extracting the hydrocarbons following service of the notices to vacate. Nor is it appropriate in the circumstances of this case that the lessors be required to share the benefits of production with their lessees.

[434] The problem courts have perceived with the *Sohio* approach of requiring the trespassing lessees to account for "all of the benefits from production received by them" is that it can be a harsh rule. That harshness was recognized by the Saskatchewan Court of Appeal in *Williston*

Wildcatters, which is ironic because it was the Saskatchewan Court of Appeal which first articulated the approach which the Supreme Court adopted in *Sohio*.

[435] In order to justify upholding an award of damages based on the royalty-plus-bonus approach, the Saskatchewan Court of Appeal in *Williston Wildcatters* interpreted the Supreme Court of Canada's decision in *Sohio* as standing only "for the proposition that the courts are to grant just and equitable relief to all parties involved". To read more into *Sohio*, the Saskatchewan Court of Appeal said, would simply be incorrect. In order to justify its interpretation of *Sohio*, the Saskatchewan Court of Appeal appears to have gone to its own files to determine that "[a]n examination of the exhibits filed at the *Sohio* trial reveals that Weyburn Security [the lessor] received approximately 30% of the net benefits from production": para 99.

[436] Alberta courts too have found the "net benefits" approach inappropriate in certain circumstances: witness the so-called "Freyberg Remedies Decision", *Freyberg v Fletcher Challenge Oil & Gas Inc*, 2007 ABQB 353, 428 AR 102 and the decision of Justice Romaine in the instant case.

[437] Suffice it to say that damages are very much dependent on the facts. Sometimes the facts call for a strictly compensatory award. Sometimes the facts call for disgorgement which may be compensatory or punitive. And sometimes a clearly punitive award is called for, windfall or no windfall, to the successful plaintiff.

[438] In this case, I reject the respondents' submission that there is no authority for disgorgement in Canadian law. Clearly *Sohio* ordered disgorgement. There may be some doubt about what was ordered to be disgorged, but both the Saskatchewan Court of Appeal and the Supreme Court of Canada ordered a form of disgorgement. The respondents argue that a restitutionary or compensatory approach is preferable, as if disgorgement did not have a restitutionary or compensatory aspect. What constitutes restitution or compensation is something about which reasonable people can disagree, but what was wrongfully taken here was millions of cubic feet of irreplaceable molecules. To award to owners their severed value is, in my view, compensatory.

[439] In my view, the paramount consideration in assessing damages in these types of cases is what will promote "peace in the patch", which is no more than another way of articulating the "just and equitable" approach which the Supreme Court adopted in *Sohio*.

[440] Where the royalty-plus-bonus approach is likely to fail to deter oil companies whose leases have terminated from dealing unfairly with their lessors, that approach ought to be rejected. Yet the royalty-plus-bonus approach might be appropriate where it is not likely to have that effect.

[441] It is recognized that requiring the oil company which has wrongfully converted hydrocarbons to account for the net or gross income or benefits received from its wrongful conversion can result in damages being awarded to the owner of those hydrocarbons which are

well in excess of any benefit the owner would have received from such ownership. Such a result could tend to promote questionable litigation over lease validity because the rewards to be reaped from litigation could exceed the value which a mineral owner might reasonably expect for their minerals.

[442] So the damages must not only reflect compensatory principles but must also provide both sides with an incentive to deal fairly with one another. As indicated, the "just and equitable" approach adopted in *Sohio*.

[443] In this case, the royalty-plus-bonus approach provisionally adopted by the trial judge would simply encourage the lessees in similar circumstances to continue to produce knowing that the worst that could happen is that they might have to pay incremental royalties and an amount equal to prevailing bonuses being paid for hydrocarbon rights. It would simply be a cost of doing business.

[444] A royalty-plus-bonus approach is not appropriate where there has been a continuation of production in circumstances where the lessees knew that their leases had terminated and where the consent of the lessors to an indefinite or prolonged cessation of production was not clearly obtained. The lessees knew or ought to have known that their leases had terminated in accordance with their terms. They were advised as much by one of their petroleum landmen in no uncertain terms. A petroleum landman is trained to identify mineral title issues, including freehold petroleum and natural gas lease terminations. The lessees chose to ignore the landman's expert advice.

[445] On the other hand, would awarding the lessors the net benefits (the net income) received by the lessors from the 7-25 Well production from October of 2005 to January of 2011 give them more than they could have dreamed of ever realizing from their ownership of the minerals? Would we be stirring up trouble in the oil patch by awarding the net benefits of production received by the lessees?

[446] My answer to those questions is no. From the evidentiary record put before us, it does not appear that an award of the net income from production from October of 2005 to January of 2011 would amount to a completely unjustifiable windfall to the lessors, particularly when one has regard to the deductions which the parties have agreed the lessees can make from their gas sales revenues. I am cognizant of the principle that tortfeasors ought not to be entitled to retain or profit from their wrongful conduct. Also, there was authority cited which holds that when disgorgement is appropriate, it would be wrong to refrain from ordering it simply because the innocent party might receive more than it would had the wrongful conversion never taken place.

[447] The appellants ask that we direct that the respondents be held to account for their profits earned from producing the 7-25 Well from such date that we might direct and that judgment be entered for the amount determined by such accounting. I would hold the respondents to account for

their net operating income from October of 2005 to January of 2011 as disclosed in the parties' Agreed Statement of Facts Pertaining to Revenues, Expenses and Royalities. And for the reasons given below, I would hold Esprit Exploration Ltd. liable for the amounts received by it or Pengrowth by way of a gross overriding royalty on production from the 7-25 Well during this same period.

V. The Absence of Snell Farms Ltd. And Wheatland Farming Co. Ltd.

[448] Wheatland Farming Co. Ltd. claims to have been assigned the lessor's interest in the leases of the natural gas notionally underlying the SE1/4 (where the 7-25 Well was drilled) and in the lease of the natural gas notionally underlying the southerly 116 acres of the NE1/4.

[449] Wheatland doesn't claim to be the owner of the hydrocarbons underlying these lands. It simply claims to have been assigned the lessor's interest in some of the leases which are the subject matter of this appeal.

[450] The registered owners of the mines and minerals underlying these lands (i.e., the owners of the natural gas notionally underlying these lands who were plaintiffs in this action) dispute Wheatland's claim.

[451] The dispute is in litigation.

[452] That Wheatland was not a party to the within action is problematic. The trial judge, quite properly, was hesitant to declare the NE1/4 and SE1/4 leases invalid without hearing from a party claiming an interest in those leases.

[453] However, in my view, the dispute over who is the lessor of the natural gas notionally underlying these lands is no reason to decline to rule on the validity of these leases.

[454] First, the terms of those leases are virtually the same as the other leases and the conduct of the lessees in exercising their rights under those leases (i.e., the conduct of Nexen, the operator on behalf of all the lessees of natural gas rights in Section 25) is the same. And although an argument might be made that defences to lease termination could potentially be advanced based on the conduct of Wheatland or its predecessor, Snell Farms Ltd., as lesssors, the lessees have not pointed to anything which indicates that such evidence exists. The issue was whether the leases terminated because the lessees failed to produce the well or conduct operations for five and one-half years. There was no evidence or argument which Snell or Wheatland could point to which would have affected this issue. Certainly the acceptance of royalties would not have sufficed for the reasons given previously.

[455] And despite their dispute with the registered owners of the mines and minerals over who holds the lessor's interest under the leases in question, both Wheatland and Snell made it clear to this court in an affidavit in support of an application to intervene in this appeal that they support the

position of the appellants on the question of the validity of the leases. Indeed, one of the reasons their application for intervenor status was not granted was that they indicated that their position on the appeal would be the same as their adversaries in the other litigation.

[456] Assuming that Wheatland does hold the lessor's interest in the leases of the natural gas notionally underlying much of the E1/2 of Section 25, as lessor, Wheatland is deemed to have agreed to the pooling of the leased lands with other lands to form a production spacing unit. Wheatland is also deemed to have agreed that production from a well on the SE1/4 not only continues the lease of the natural gas notionally underlying the SE1/4, but it also continues the lease of the natural gas underlying that portion of the NE1/4 which Wheatland alleges was assigned to it. Likewise, a failure to produce the leased substances from the SE1/4 in accordance with the leases not only terminates the lease of the natural gas notionally underlying the SE1/4 but also terminates the lease of the natural gas notionally underlying that portion of the NE1/4 which Wheatland alleges was assigned to it. Production of the leased substances from a well on any part of the production spacing unit was agreed to have the effect of continuing all of the leases. The corollary is that a failure to produce the leased substances from any part of the production spacing unit has the effect of making the leases subject to termination.

[457] It would be hard to imagine a circumstance where the validity of a lease of a portion of pooled lands terminated for non-production and yet a lease of another portion of the pooled lands did not terminate. Even if the lessors of one or more of the pooled quarters consented to the resumption of production and the lessors of the other pooled quarters did not, the validity of the leases would not be affected. All of the leases would still have terminated in accordance with their terms. The only possible difference would be the remedy to which the respective lessors might be entitled.

[458] However, the Court cannot sever its declaration. If the leases of the natural gas notionally underlying the W1/2 of Section 25 have terminated for lack of production, then so have the leases of the natural gas notionally underlying the E1/2 of Section 25. The declaration of invalidity must apply to all leases.

[459] An argument might be made by the lessees that, having produced the leased substances without the authority of some, but not all, of their lessors, they should be entitled to account to their lessors differently. The lessees would account to those lessors who had not established that they had not consented to continued production on the basis that the lessees owed them nothing because, presumably, the lessees had already paid those lessors the royalties to which they were entitled under the leases. The lessees would account to the lessors who had established that they had not consented to continued production on the basis of the lessors' proportionate share of the net income from that production.

[460] However, such differential accounting would not respect the pooling which had taken place. It would not respect the lessor's agreement to permit pooling on the understanding that the lessor would receive such portion of the agreed-upon royalties as the surface area of the lessor's

lands bore to the total surface area of the pooled lands. In other words, the lessors agreed to pool their lands on the understanding that they would receive their proportionate share of the benefits of production, not a disproportionate share. Likewise the lessees agreed to pool their leases on the basis that they too would receive their proportionate share of production from the pooled lands. Giving one remedy to one set of lessors and a different remedy (really, no remedy at all) to another set of lessors ordinarily ought not to happen on pooled lands.

[461] Resolution of the dispute over who owns the hydrocarbons in the SE1/4 and NE1/4 of Section 25 will simply determine to whom the lessees must account. It will not affect the requirement to account. As indicated, it would be incongruous to require the lessees to account to the mineral owners in the W1/2 of Section 25 and the remaining portion of the NE1/4 and not require the lessees to account to the mineral owners (whomever they might be) in the SE1/4 and the north portion of the NE1/4 on the same basis. And it is of no consequence that the well in question is located on the SE1/4. Under the pooling agreement, which all of the lessors authorized, production from the well on the SE 1/4 is deemed to be production from all the quarters. Furthermore, production from the lands underlying each of the leased quarters or portions is deemed to be production from the other quarters, well or no well. Lack of production from the SE1/4 must therefore be deemed to be a lack of production from the remaining parcels. When the well ceased producing in 1995, the lands remained pooled. They had to remain pooled. Otherwise, production could not have resumed in 2001. Even if the lessors of the SE1/4 had supported the position of the lessees (which they did not), the SE1/4 lease would still have terminated in accordance with its terms when the well ceased producing in 1995 and the well was virtually abandoned.

VI. The Validity of the Lease of the North Portion of the NE1/4

[462] The appellants argue that the natural gas lease of a portion of the NE 1/4 did not terminate in September of 2005 when the Notice to Vacate and Statement of Claim were served on the lessees by counsel for some, but not all, of the lessors. That is, the Notice to Vacate and the Statement of Claim were not served by or on behalf of the lessors of the north 43 acres of the NE1/4 of Section 25. Indeed, the owners of the hydrocarbons underlying these lands were actually named as defendants in the initial Statement of Claim. However, within weeks of the service of the Notice to Vacate and Statement of Claim, these lessors had signed top leases and within a couple of months (December 2005) the Statement of Claim was amended to include them as plaintiffs seeking the same declaration as the others, namely that their natural gas leases had terminated. The trial judge found that if she were wrong in finding that the leases had not terminated, these lessors had implicitly given leave and licence to their lessee to continue to produce the well until 2007 when they made a demand of their lessee to stop producing the well.

[463] Within months of the issuance of the initial Statement of Claim, the defendant lessees were aware that the lessors of the north 43 acres of NE1/4 of Section 25 were taking the position that

their lease had terminated. Besides, as previously indicated, once the lease of any one of the owners of the natural gas underlying Section 25 terminated, the right of all lessors to produce natural gas under their leases terminated, including the lease of the natural gas notionally underlying the north portion of the NE1/4, because then there was no longer a production spacing unit. Having nevertheless produced, the lessees are bound to account to all the lessors for that production. The argument that the lessees should account for that production to different lessors on different bases should be rejected for the reasons given above. As a consequence, I am of the view that nothing turns on the fact that the lessees of the north 43 acres of the NE1/4 were not told to stop producing until 2007. Their fellow lessees were told to vacate in September of 2005 and by December of 2005 the lessees of the natural gas underlying the northerly 43 acres of the NE1/4 knew that their lessors took the same position. The lessee of the natural gas underlying the north 43 acres of the NE1/4 of Section 25 could not lawfully have produced the 7-25 Well after the Notice to Vacate and Statement of Claim were served on behalf of the other lessors in September of 2005.

VII. Esprit's Liability

[464] Under a purchase and sale agreement dated June 1, 2000, Canadian 88 sold its leasehold interest in the natural gas in the BQ formation notionally underlying a portion of the NE1/4 and all of the SE1/4 and NW1/7 of Section 25 to Triquest (now Bonavista). In selling its lessee's interest, Canadian 88 reserved to itself a 10% gross overriding royalty out of the production from or allocated to the interest that it once had in the pooled lands (roughly 60%).

[465] Determining what liability, if any, Esprit had requires an understanding of what an overriding royalty is. An overriding royalty, gross or otherwise, is a right to receive a portion of a revenue stream or a right to receive a share of the production of some commodity. The overriding royalty interest in this case was carved out of a lessee's working interest (i.e., out of its interest as a lessee). It was a right to receive a portion of the lessee's production revenue or a portion of the natural gas produced. It was therefore limited in duration to the life of the lease out of which it was carved. A gross overriding royalty is typically the right to receive a share of production or a share of the revenues from production without having to pay drilling or well operating expenses. But a gross overriding royalty and the right it confers are subject to extinguishment. An overriding royalty interest carved out of a lease expires once the lease out of which it is carved terminates. An overriding royalty carved out of the mineral owner's title is not so easily extinguished, but that is not the kind of overriding royalty we are dealing with in this case.

[466] Canadian 88 obtained a leasehold interest in some of the pooled lands after the 7-25 Well had ceased production. In other words, its lessee's interest in the NE1/4 and SE1/4 was acquired after the leases had terminated according to their terms. Arguably, Canadian 88 was not entitled to any of the production notionally underlying those parcels and therefore it could not have reserved itself a 10% gross overriding royalty out of that production when it sold its leasehold interest to Triquest (now Bonavista).

[467] But whether or not Canadian 88 had an interest to convey and a corresponding right to reserve a portion of that interest in June of 2000 when it sold its leasehold interest to Triquest, Esprit, to whom Canadian 88 conveyed the overriding royalty it reserved, became the recipient of a portion of the production which wrongfully took place between October of 2005 and January of 2011. When Canadian 88 conveyed to Esprit the gross overriding royalty, Esprit received a share of the production from or allocated to the 60.05% of the pooled lands. That is, Esprit received the value of a portion of the production coming out of the 7-25 Well. Esprit was paid that value rather than taking its gross overriding royalty share of production in kind. But Esprit was not entitled to that value because the lessees of those lands were not entitled to the natural gas produced. The leases had terminated and once the underlying lease terminates, the overriding royalty interest expires. This was a gross overriding royalty carved out of the lessee's interest. It was not a gross overriding royalty carved out of the mineral owner's ownership. Such overriding royalties may survive the termination of many leases. But since Esprit continued to receive an overriding royalty interest share of production from the 7-25 Well after the leases had terminated, it was obligated to account for that share of production which it received in the form of gross overriding payments. Esprit was not entitled to that share. It wrongly received a portion of the value of the natural gas which belonged to the lessors.

[468] The fact that Esprit, as an overriding royalty interest owner, was not a working interest owner meant only that Esprit could not be held jointly and severally liable for the value of all the natural gas wrongfully converted. But that does not absolve it from accounting for the royalty share of production it continued to collect following service of the lessors' Statement of Claim and Notice to Vacate on it. In the Agreed Statement of Revenues, Expenses and Royalties, Esprit's gross overriding royalties were deducted from the lessees' (Bonavista's) income from production. So either the lessees are not entitled to that deduction or Esprit is independently liable to the lessors for the royalties it received. That is a matter to be left to Bonavista and Esprit. The concern about double counting does not arise. We leave it to the parties to implement our direction, with any disputes to be settled by the trial judge or another judge of the Court of Queen's Bench.

VIII. The Lessees' Cross-Appeal (Champerty and Maintenance)

[469] The respondent lessees, ExxonMobil, Nexen and Coastal, counterclaimed for damages from the top lessee, 1088294 Alberta Ltd., and from the numbered company's principal, J. Timothy Bowes, on the basis that their involvement in the lessors' lawsuit against the lessees was champertous.

[470] Champerty and maintenance are actionable torts. Maintenance involves providing financial support to another to bring an action. Champerty involves not only providing financial support, but also sharing in the fruits of an action if damages are awarded.

[471] Both involve what is known as "officious intermeddling" or a "stirring up of strife" by a party with no interest in the litigation other than that which is derived from the champertous arrangement. In order for there to be an actionable tort, the tortfeasor must be a perfect stranger to the lawsuit.

[472] The leading case on champtery and maintenance is the Supreme Court of Canada's decision in *Frederikson v ICBC* (1986), 28 DLR (4th) 414, 3 BCLR (2d) 145 (CA), aff'd *Insurance Corporation of British Columbia v Fredrikson*, [1988] 1 SCR 1089. The Supreme Court, in this case, endorsed the judgment of then Madam Justice McLachlin of the British Columbia Court of Appeal in which she dismissed a challenge of an assignment of an insured's cause of action against his insurer to a person the insured had negligently injured in a motor vehicle accident. The insured's cause of action against his insurer was for an alleged failure by the insurer to property defend the insured. *Frederikson* confirmed a long-standing principle that if the person accused of champerty and maintenance had a legitimate commercial reason for prosecuting the litigation, then prosecuting, supporting or even sharing in the proceeds of the litigation will not be held to be champertous.

[473] This court, in *1773907 Alberta Ltd v Davidson*, 2015 ABCA 150 (available on CanLII), also recently dealt with this issue in the context of a challenge of an assignment of a cause of action by an insolvent company to the purchaser of its assets on a receivership on the basis that it smacked of champerty and maintenance.

[474] Again, the general principle articulated by this court is that if there is a legitimate commercial reason for the stranger to the lawsuit either maintaining it or sharing in any damages which might be awarded, the arrangement will not be considered champtertous.

[475] The trial judge in the case at bar was very familiar with champerty and maintenance having been the trial judge in *Silverado Oilfield Ventures Ltd v Davidson*, 2014 ABQB 218 (available on CanLII). She found that the top lessee did have a legitimate commercial interest, by virtue of the top leases, sufficient to save them from a charge of maintenance.

[476] The respondents argue that the "genuine concerns" expressed by the trial judge about the propriety of the conduct of the top lessee undermined her conclusion that there was no champerty or maintenance (i.e., no officious intermeddling or "stirring up strife").

[477] I see the trial judge's expression of her concerns as no more than an indication that she was alive to the fact that the top lessee promoted and directed the litigation, including indemnifying the lessors against an adverse cost award. She also found that some of the lessors would not have brought the litigation without the risk-free opportunity afforded by the top lessee. But, again, I do not see that as undermining her finding that there was no champerty or maintenance. She recognized that notwithstanding the arrangements for funding the litigation, the top lessee had a legitimate commercial interest in the litigation separate and apart from that funding arrangement.

[478] The top lessee had a legitimate commercial interest in obtaining a ruling as to the validity of the leases. The trial judge expressly recognized that. The top lessee's interest in obtaining the ruling was to determine whether the property interests the lessors conveyed to them, the petroleum and natural gas leases, had any validity. The law of champerty and maintenance is relatively clear. If there has been an assignment of a property right or interest and the cause of action is ancillary to that interest, the arrangement will likely not be found to be champertous.

[479] Here there was an assignment of a property interest to the top lessee. There was a granting of a contingent leasehold interest or *profit à prendre*. In order for the assignee, the top lessee, to enjoy that grant, it needed a declaration as to the validity of the leases previously granted.

[480] Nor was their sharing in the award of damages champertous. Once the Notice to Vacate had been served, the top lessee had reason to expect that it would become the lessee of the lessors' hydrocarbons. Instead, those hydrocarbons continued to be produced by another, thereby depriving the top lessee of the fruits of that production. In other words, the top lessee suffered a loss. The trial judge quite properly held that the top lessee did not have a separate right of action for those damages because lessors had sued for that same loss, but to share in any recovery was not champertous.

[481] The facts of this case are analogous to an ordinary commercial or residential lease situation in which a tenant overholds and the landlord cannot afford the cost or the hassle of eviction proceedings. A prospective tenant offers to incur the costs of eviction in return for a lease of the premises once the overholding tenant has been ejected. No one would argue that such an arrangement is not a *bona fide* business arrangement. A *bona fide* business arrangement is said to be one of the so-called "exceptions" to champerty and maintenance. It is not really an exception. The arrangement is simply not champertous to begin with.

[482] I would therefore dismiss the respondents' cross-appeal.

Appeal heard on September 11, 2014

Memorandum filed at Calgary, Alberta
this 19th day of November, 2015

O'Ferrall J.A.

Appendix 1

Section 25 Lands	**Current Registered Mineral Owners**	**Original Leases**	**Current Lessee(s) Under Original Leases**	**Current Registered Caveats re: Original Leases**
Mineral Title #031 041 856 NW1/4 of the section 25 Lands (153.98 acres more or less)	Robert Copley, Karen Nell Copley, Margaret Alice Demers, Mary Jane Biggar, Goldie Alberta Danielsen, each having an undivided 1/5 interest "**Copley Group**"	Lease and Grant dated December 13, 1961 between William Murdoch Copley, as Lessor and Imperial Oil Limited as Lessee **Imperial NW1/4 Lease**	Bonavista: 100% working interest	5005IJ (Pengrowth) 071 504 115 (Baytex/ Bonavista)
Mineral Title #051 489 889 SW1/4 of the Section 25 Lands (153.98 acres more or less)	Bowen Family Properties Ltd. as to an undivided 1/3 interest, Ronald B. Pole and Kevin R. Pole as joint tenants as to an undivided 1/3 interest, and Danny G. Oneil in his capacity as Executor of the Estate of Mabel B. Oneil (Deceased) as to an undivided 1/3 interest "**Oneil Group**"	Natural Gas Lease and Grant dated January 8, 1968 between Nellie B. Pole, as Lessor, and Jefferson Lake Petrochemicals of Canada Ltd., as Lessee **Jefferson SW1/4 Lease**	Nexen: 50% working interest ExxonMobil: 50% working interest	2609KB (Nexen) 314KJ (ExxonMobil) 071 286 693 (Bonavista)
Mineral Title #101 187 324 NE1/4 of the Section 25 Lands (portion) covering north 716 feet (43.39 acres more or less)	Edna Keam, Wilma Marshall and Laurel Lee McLaren (executrix for Betty Blanche Cardiff), each with an undivided 1/3 interest "**Irwin Group**"	Petroleum and Natural Gas Lease and Grant dated May 9, 1961 between Jean Ella Irwin, as Executrix of the Will of William James Irwin, Deceased, as Lessor and Union Oil Company of California, as Lessee **Union NE1/4 Lease**	Coastal: 100% working interest	1241IG (Coastal) 4523KU (Coastal) 071 286 692 (Bonavista)

Section 25 Lands	Current Registered Mineral Owners	Original Leases	Current Lessee(s) Under Original Leases	Current Registered Caveats re: Original Leases
Mineral Title #741 049 399 C SE1/4 of the Section 25 Lands (160 acres more or less)	Jerome Development Limited	Natural Gas Lease and Grant dated January 7, 1964 between Merville V. Stewart as Lessor and Scurry-Rainbow Oil Limited as Lessee **Scurry SE1/4 Lease**	Natural gas in BQ, Wabamun A and Elkton C formations Bonavista: 100% working interest ~~~~~~~~~~ All natural gas excluding natural gas in BQ, Wabamun A and Elkton C formations TAQA North 100% interest	446IZ (TAQA North) 071 047 005 (Baytex/ Bonavista) 071 287 614 (Bonavista)

Section 25 Lands	Current Registered Mineral Owners	Original Leases	Current Lessee(s) Under Original Leases	Current Registered Caveats re: Original Leases
Mineral Title #741 049 399 A NE1/4 of the Section 25 Lands (remaining portion) (116.61 acres more or less)	Jerome Development Limited as to an undivided 1/2 interest	Petroleum and Natural Gas Lease and Grant dated November 30, 1967 between Merville V. Stewart as Lessor and Scurry-Rainbow Oil Limited as Lessee **Scurry NE1/4 Lease**	Natural gas in BQ, Wabamun A and Elkton C formations Bonavista: 50% working interest Coastal: 50% working interest ~~~~~~~~~~ All Petroleum and Natural Gas excluding Natural Gas in BQ, Wabamun A and Elkton C formations TAQA North 50% interest Coastal: 50% interest	3241HI (TAQA North) 5504IJ (TAQA North) 7763JV (TAQA North, also in trust for Bonavista and Coastal) 071 287 615 (Bonavista) 071 465 493 (Baytex/ Bonavista)

Section 25 Lands	Current Registered Mineral Owners	Original Leases	Current Lessee(s) Under Original Leases	Current Registered Caveats re: Original Leases
Mineral Title #081 111 629 NE1/4 of the Section 25 Lands (remaining portion) (116.61 acres more or less)	James D. Stewart as to an undivided 2/12 interest, Lynda Calder as to an undivided 2/12 interest, Cody Stewart as to an undivided 1/12 interest and Morgan Stewart as to an undivided 1/12 interest	Petroleum and Natural Gas Lease and Grant dated November 30, 1967 between Merville V. Stewart as Lessor and Scurry-Rainbow Oil Limited as Lessee **Scurry NE1/4 Lease**	Natural gas in BQ, Wabamun A and Elkton C formations Bonavista: 50% working interest. Coastal: 50% working interest ~~~~~~~~~~~ All Petroleum and Natural Gas excluding Natural Gas in BQ, Wabamun A and Elkton C formations TAQA North 50% interest Coastal: 50% interest	3444H1 (TAQA North) 5505IJ (TAQA North, also in trust for Bonavista and Coastal) 071 287 616 (Bonavista) 071 465 494 (Baytex/Bonavista)

Appearances:

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R.C. Steele
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R.F. Steele
P.G. Chiswell
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C.A. Crang
for the Respondent/Cross-Appellant Costal Resources Limited

M.D. Aasen (no appearance)
for the Respondent TAQA North Ltd

Corrigendum of the Memorandum of Judgment

On Page 2 - 1(e) - the text will now read:

“Justice Rowbotham and Justice McDonald agree that the Irwin Group **did not give** leave and licence from December 5, 2005 to January 12, 2007”.