COURT FILE NUMBER	25-2332583 25-2332610 25-2335351
COURT	COURT OF QUEEN'S BENCH OF ALBERTA IN BANKRUPTCY AND INSOLVENCY
JUDICIAL CENTRE	CALGARY
PROCEEDINGS	IN THE MATTER OF THE NOTICE OF INTENTION TO MAKE A PROPOSAL OF MANITOK ENERGY INC. IN THE MATTER OF THE NOTICE OF INTENTION TO MAKE A PROPOSAL OF RAIMOUNT ENERGY CORP. IN THE MATTER OF THE NOTICE OF INTENTION TO MAKE A PROPOSAL OF CORINTHIAN OIL CORP.
APPLICANT	FREEHOLD ROYALTIES PARTNERSHIP
RESPONDENT	ALVAREZ & MARSAL CANADA INC, IN ITS CAPACITY AS RECEIVER AND MANAGER OF MANITOK ENERGY CORP.
DOCUMENT	**BOOK OF AUTHORITIES OF THE RESPONDENT**

ADDRESS FOR SERVICE AND CONTACT INFORMATION OF PARTY FILING THIS DOCUMENT

Norton Rose Fulbright Canada LLP
400 3rd Avenue SW, Suite 3700
Calgary, Alberta T2P 4H2 CANADA

Attention: Howard A. Gorman, QC and D. Aaron Stephenson

Telephone: +1 403.267.8144
Facsimile: +1 403.264.5973
howard.gorman@nortonrosefulbright.com
aaron.stephenson@nortonrosefulbright.com
File No. 1001023920
Box No. 39

Solicitors for the Respondent

TABLE OF AUTHORITIES

Tab	Document Title	Citation
1	*Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd.* (1977)	4 AR 251, 72 DLR (3d) 734 (QB), at paras 28, 32-33
2	*James H. Meek Trust v. San Juan Resources Inc.*	2003 ABQB 1053 at para 35, 39, 41-45
3	*Vandergrift v. Coseka Resources Ltd.* (1989)	95 AR 372, 67 Alta LR (2d) 17 (QB) at paras 35-39
4	*Anglo Pacific Group PLC v. Ernst & Young Inc.*	[2013] RJQ 1264 (CA) at para 77
5	*Re Sabine Oil & Gas Corp.* (2016)	547 BR 66 at pp 9, 10
6	*Re Sabine Oil & Gas Corp.* (2017)	567 BR 869 at p 6
7	*Re Androscoggin Energy LLC* (2005)	195 OAC 51 at para 15
8	*Re Calpine Canada Energy Limited*	2006 ABQB 153 at paras 17-18
9	*Bank of Montreal v. Dynex*	2003 ABQB 243 at paras 20, 40, 42, 56-58
10	*Re Walter Energy Canada Holdings, Inc.*	2016 BCSC 1746 at paras 53-59, 66, 67(b), 67(e), 67(g), 69
11	*St Lawrence Petroleum Limited v. Bailey Selburn Oil & Gas Ltd.*	[1963] SCR 482 at 488
12	*Mines and Minerals Act*	RSA 2000, c M-17, s 95(1).
13	*Cox v. Crystal Graphite Corp.*	2008 BCSC 38, [2008] BCWLD 1788 at paras 18-19
14	*Cormack v. Indergaard*	2018 ABCA 41

TAB 1

Most Negative Treatment: Distinguished
Most Recent Distinguished: Lane v. Trans Alberta Mortgage & Financial Services Ltd. | 1981 CarswellAlta 614, 21 R.P.R. 191, 15 Alta. L.R. (2d) 193, 8 A.C.W.S. (2d) 81 | (Alta. Q.B., Jan 29, 1981)

1977 CarswellAlta 192
Alberta Supreme Court

Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd.

1977 CarswellAlta 192, [1977] 1 A.C.W.S. 172, [1977] 2 W.W.R. 66, 4 A.R. 251, 72 D.L.R. (3d) 734

Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd., Westersund et al.

Moore J.

Judgment: January 24, 1977
Docket: Calgary

Counsel: *R. B. Low*, for plaintiff.
R. S. Dinkel, Q.C., for defendants.

Subject: Natural Resources; Civil Practice and Procedure; Property
Related Abridgment Classifications
Natural resources
III Oil and gas
III.6 Exploration and operating agreements
III.6.a Royalty agreement
III.6.a.iii Miscellaneous
Real property
II Registration of real property
II.2 Registration of land
II.2.b Land titles
II.2.b.vi Caveats
II.2.b.vi.B Requirements for validity
Headnote
Oil and Gas --- Exploration and operating agreements — Royalty agreement
Real Property --- Registration of land — Land titles — Caveats — Requirements for validlity
Real property — Royalty agreement as interest in land — When royalty agreement requires payment of royalty out of proceeds of sale of petroleum no interest in land created in favour of grantee — Land not subject to caveat — The Land Titles Act, R.S.A. 1970, c. 198, ss. 136, 144.
The court in each case where it is claimed that a royalty agreement creates an interest in land must examine the specific wording of the agreement. In the case of a royalty agreement in which the owner offers to pay the grantee a gross royalty of the proceeds of sale of the petroleum substances that may be produced, saved and marketed out of the land the obligation thus created does not confer on the grantee an interest in situ. Rather the obligation is to pay the grantee a sum of money out of the proceeds of sale of the petroleum substances after they have been removed from the land.
This obligation, furthermore, does not amount to a rent, for, should no petroleum ever be removed from the land, the grantee would get nothing, whereas rent is something that by its very nature accrues due to the lessor over a period of time and from time to time.
As the obligation in this case does not create an interest in land, it cannot be the subject of a caveat.

1977 CarswellAlta 192, [1977] 1 A.C.W.S. 172, [1977] 2 W.W.R. 66, 4 A.R. 251...

Table of Authorities

Cases considered:

St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd. (No. 2), 41 W.W.R. 210, 35 D.L.R. (2d) 574, affirmed 45 W.W.R. 26, [1963] S.C.R. 482, 41 D.L.R. (2d) 316 — *followed*

Bensette v. Reece, [1973] 2 W.W.R. 497, 34 D.L.R. (3d) 723 (Sask. C.A.)

Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd. (1969), 3 D.L.R. (3d) 630,*affirmed*, 15 D.L.R. (3d) 256 (Can.)

Sask. Minerals v. Keyes, [1972] 2 W.W.R. 108, [1972] S.C.R. 703, 23 D.L.R. (3d) 573 — *referred to*

***Moore J.*:**

1 The plaintiff, Vanguard Petroleums Ltd. (hereinafter referred to as "Vanguard"), seeks an order of this court confirming and continuing a caveat filed by Vanguard on 29th February 1956. The defendants counterclaim for a declaration that the caveat is of no force and effect.

2 The parties filed an agreed statement of facts as follows:

> 1. The plaintiff, Vanguard Petroleums Ltd. ('Vanguard') is a body corporate carrying on business in the Province of Alberta. The Defendant, Vermont Oil & Gas Ltd. ('Vermont') is a body corporate carrying on business in the Province of Alberta. The Defendants, Varno C. Westersund and Juanita Westersund ('the Westersunds') are man and wife and are residents of the Province of Alberta.
>
> 2. On or about March 15th, 1951 the Westersunds as Lessors and Vanguard as Lessee entered into a Petroleum and Natural Gas Lease ('the Lease'). A true copy of the Lease is attached as Exhibit '1' hereto.
>
> 3. On or about February 16th, 1956 the Westersunds and Vanguard entered into an Agreement ('the Gross Royalty Agreement'). A true copy of the said Gross Royalty Agreement is attached as Exhibit '2' hereto.
>
> 4. Concurrently Vanguard Petroleums Ltd. executed a letter agreement dated February 16th, 1956 ('the Surrender Agreement'). A true copy of the said Surrender Agreement is attached as Exhibit '3' hereto.
>
> 5. On or about February 29th, 1956 Vanguard filed at the Land Titles Office for the South Alberta Land Registration District a certain Caveat dated February 16th, 1956 which was registered as Instrument No. 7924 G.W. A true copy of the said Caveat is attached as Exhibit '4' hereto.
>
> 6. On or about June 12th, 1975 the Westersunds as Lessors and Vermont as Lessee entered into a Petroleum and Natural Gas Lease ('the Vermont lease'). A true copy of the said Vermont lease is attached as Exhibit '5' hereto.
>
> 7. Attached hereto and marked Exhibit '6' is a true copy of a certified copy of Certificate of Title 79 S 90A being the Certificate of Title in the South Alberta Land Registration District for the mines and minerals which are the subject matter of these proceedings.
>
> DATED at the City of Calgary, in the Province of Alberta, this 28th day of May, A.D. 1976.

3 The petroleum and natural gas lease between the defendants Westersund and Vanguard was entered into on 15th March 1951. The Westersunds are the registered owners, as joint tenants of what will hereinafter be referred to as the said "lands":

> The South Half (S. $^{1}/_{2}$) and Northeast Quarter (N.E. $^{1}/_{4}$) of Section Fifteen (15), Township Twenty (20), Range Twenty- five (25), West of the 4th Meridian, in the Province of Alberta, containing Four Hundred and Eighty (480) acres more or less, EXCEPTING out of the S.E. $^{1}/_{4}$ 6.15 acres more or less for Railway Right of Way, and 2.59 acres more or less, for extra lands, and out of the S.W. $^{1}/_{4}$ 6.38 acres more or less for Railway Right of Way, all as

shown on a plan of record in the Land Titles Office for the South Alberta Land Registration District as R.W. 321, the lands herein comprised containing 464.88 acres, more or less.

RESERVING unto the Canadian Pacific Railway Company all coal.

4 The lease was to be held by the lessee Vanguard as tenant for the term of 30 years from the date of the lease, and so long thereafter as the leased substances, or any of them, are produced from the said lands, or any operations are conducted thereon for the discovery and or recovery of the leased substances or any of them.

5 On 16th February 1956 the Westersunds (as "Owners") and Vanguard (as "Grantee") entered into an agreement wherein Vanguard surrendered the 1951 lease on certain terms and conditions, and paras. (1) and (3) are as follows:

Now THIS AGREEMENT WITNESSETH that in consideration of the premises and the sum of TEN ($10.00) DOLLARS now paid by the Grantee to the Owners (receipt whereof by the Owners is hereby acknowledged) the Owners covenant to and with the Grantee as follows: —

1. The Owners will pay to the Grantee a gross royalty of Seven (7%) percent of the proceeds of sale of the petroleum substances that may be produced, saved and marketed out of the said lands such gross royalty to be calculated and paid as follows: —

(a) Seven (7%) percent of the current market value at the well of all petroleum oil produced, saved and marketed from the said lands.

(b) Seven (7%) percent of the current market value of gas produced from the said lands and marketed or used off the said lands or in the manufacture of casing head gasoline.

(c) Seven (7%) percent of the amount actually received by the lessee on products obtained by absorption or other similar processes and on residue gas resulting therefrom provided that if the owners themselves conduct development operations upon the said lands or an operator other than a lessee is entitled to the receipts the subject of this sub-clause (c) this sub-clause shall apply in respect of the owners or such operator ...

3. Upon the surrender of the lease of the petroleum substances presently in effect between the Owners and the Grantee the Owners covenant that they will upon the grant of any subsequent lease or other disposition of the petroleum substances and similarly upon any successive surrender or termination and grant of lease or other disposition of the petroleum substances thereafter make provision for the due payment of the gross royalty hereby granted and the Grantee is hereby given and granted the continuing right to file and maintain a caveat against the said lands in respect of the said gross royalty hereby granted.

6 Vanguard then filed a caveat also on 16th February 1956 at the Land Titles Office against title to the lands, claiming an interest as grantee of a gross royalty of seven per cent of all petroleum and natural gas and related hydrocarbons other than coal within, upon or under the said lands pursuant to the provisions of the gross royalty agreement.

7 On 12th June 1975 the Westersunds entered into a new petroleum and natural gas lease with their co-defendant Vermont covering the said lands for $20,800 for a term of five years, quite obviously ignoring the royalty agreement. Soon thereafter notice was given to the plaintiff Vanguard to take proceedings to enforce the validity of its caveat.

8 The sole issue in these proceedings is whether the royalty agreement entered into in 1956 gives Vanguard an interest in land which would support the 1956 caveat.

9 It is interesting to observe the provisions of The Land Titles Act, R.S.A. 1970, c. 198, and in particular s. 136, which states in part:

> 136. Any person claiming to be interested under any will, settlement or trust deed, or any instrument of transfer or transmission or under an unregistered instrument, ... in any land, mortgage or encumbrance, may cause to be filed on his behalf with the Registrar a caveat ...

10 And s. 144 of the Act states in part:

> 144.(1) ... every caveat lodged against any land, mortgage or encumbrance shall be deemed to have lapsed after the expiration of 60 days after notice has been either served as process is usually served, or sent by registered mail, ...

11 Notice was given Vanguard to take proceedings to enforce the caveat, which resulted in the issuance of the statement of claim in this action.

12 Much has been written in both the United States and Canada about the meaning of the word "royalty".

13 In the Saskatchewan decision of *Bensette v. Reece*, [1973] 2 W.W.R. 497, 34 D.L.R. (3d) 723, the Saskatchewan Court of Appeal considered whether a royalty interest is an interest in land. In August 1927 Bensette and Graham acquired a six per cent royalty in the minerals in a certain parcel of land. In 1928 Bensette and Graham filed a caveat to protect the royalty interest. In the years that followed the land changed hands a number of times until 1957, when the caveat of Bensette and Graham was lapsed by the registrar, pursuant to notice at the request of Reece. The notice never reached the caveators, and the caveat lapsed. In 1965 Bensette and Campbell (administratrix de bonis non of the estate of Graham) filed another caveat under the royalty agreement. Bensette and Campbell brought action against Reece claiming, inter alia, a declaration that they are entitled to six per cent royalty on all oil, gas, petroleum and mines and minerals in Reece's title already produced from the land and which may be produced from the land and also an order that the caveat was validly registered. It was held that Reece was bound by the royalty agreement in 1927 and that the agreement gave them an interest in land necessary to support a caveat. Woods J.A. stated at p. 499:

> While definitions of 'royalty' are numerous, a perusal of the cases shows that it is not a term of art. Its meaning must be deduced from the circumstances surrounding its use.

14 And at p. 500:

> Had the words 'interest' or 'property' been used instead of 'royalty', it would be clear that an interest in the minerals themselves was to pass ...
>
> The words 'royalty in' connote an interest of some kind 'in' the minerals. If it were 'royalty on' the minerals, some kind of a commission would be readily inferable.

15 And further at p. 501:

> Here then is a transfer and sale of a six per cent royalty in minerals. Under the circumstances obtaining here, this connotes a conveyance of an interest in the minerals them selves in situ and hence an interest in the land which could properly be the subject of a caveat.

16 The granting provision in the Bensette case was "to give, grant, bargain, sell, assign and transfer and by these presents ... give, grant, bargain, sell, assign and transfer unto the parties of the second part [Bensette and Graham] a six per cent (6%) royalty in all the oil, gas, petroleum and mineral oils, mines and minerals acquired by the party of the first part ... which may be found in, under or upon the said lands". The granting provision was held to be a royalty on the petroleum substances then in place in the ground.

17 Allen J.A. of the Appellate Division of the Supreme Court of Alberta in *Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd.* (1969), 3 D.L.R. (3d) 630, affirmed 15 D.L.R. (3d) 256 (Can.), considered whether a gross overriding royalty was an interest in land. The granting provision is set forth at p. 633 as follows:

> High Crest covenants and agrees to grant and assign to Sterling a gross overriding royalty of Two per cent (2%) of High Crest's share of all petroleum, natural gas and related hydrocarbons produced, saved and sold from each property acquired by or for High Crest after the date hereof and during the term of this agreement ...

18 Allen J.A. stated at p. 640:

> The royalty clause in these agreements has been previously quoted in these reasons. Taking the High Crest agreement as typical it will be noted that there is to be assigned to Sterling 'a gross overriding royalty of Two per cent (2%) of High Crest's share of all petroleum, natural gas and related hydrocarbons produced, saved and sold from each property acquired by High Crest after the date hereof and during the term of this agreement'. This clearly indicates that the royalty is to be calculated and payable only upon the products mentioned after they have been taken from the ground and severed from the realty. It may follow from this that the royalty share of production which accrues to Sterling is personalty and not land or an interest therein.

19 Although the Court of Appeal referred the matter back to the trial judge on another point, it is clear that the court was of the clear opinion that, where the royalty relates to a share after the petroleum had been removed from the land, this is not an interest in land but is to be treated as personalty.

20 In *St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd.* (No. 2), 41 W.W.R. 210, 35 D.L.R. (2d) 574, affirmed 45 W.W.R. 26, [1963] S.C.R. 482, 41 D.L.R. (2d) 316, the Bailey company had agreed to drill a well and, the participant having agreed to participate in the drilling, entered into an agreement which provided that the participant, upon putting up a part of the cost of drilling the test well, would "be entitled to receive the percentage of net proceeds of production from the said well". Net proceeds of production were defined in the agreement to mean [p. 211]:

> 'Net proceeds of production' as used in this agreement and in any Schedule shall with respect to any well mean the proceeds from the sale of the Company's share of the production less a 10% carried interest.

21 Johnson J.A. stated at pp. 214-15:

> If this clause conveys any interest in the oil or gas, it was an interest which would only come into existence when these substances had been reduced to physical possession.

22 Clearly the court felt in the *Bailey* case that the wording of the clause only conveyed an interest in the petroleum substances after they had been removed and reduced to physical possession.

23 It is interesting to note the Supreme Court of Canada decision in *Sask. Minerals v. Keyes*, [1972] 2 W.W.R. 108, [1972] S.C.R. 703, 23 D.L.R. (3d) 573. The majority of the Supreme Court of Canada decided the case on a point not requiring a consideration of the nature of the royalty interest. The court was dealing with an agreement which provided in cl. 3, inter alia, a royalty [p. 110]:

> (b) a royalty of twenty-five cents (25 ¢) per ton on all anhydrous salt produced and sold from the said leasehold property

.

24 Martland J. in delivering the majority judgment found that it was not necessary to determine the question as to whether or not the use of the word "royalty" implied an intention to create an interest in land. Martland J. stated at pp. 110-11:

> The respondent contends that cl. 3(b) of the agreement created an interest in him in the land covered by lease No. A-4010, and that the appellant, when it took an assignment of the lease from Astral, took it subject to that property

interest. The appellant claims that the clause created only a contractual right enforceable against Astral, but not as against the appellant.

If the clause had used the word 'payment' instead of 'royalty' I would doubt whether the respondent's position would be arguable. Does the use of the word 'royalty' imply an intention by Astral to create an interest in land in the respondent?

I would doubt that it does. Astral's commitment under the clause is to make money payments in relation to salt which has been both produced and sold. It is similar to the provision contained in the agreement under consideration by this Court in *St. Lawrence Petroleum Ltd. v. Bailey Selburn Oil & Gas Ltd.* [supra], under which the appellant in that case was entitled to receive a percentage of net proceeds of production from an oil well. 'Net proceeds of production' were defined as proceeds of the sale of a share of production from a well after various deductions were made. The appellant's rights under this provision were considered to be 'as a matter of contract' (p. 488). The case was chiefly concerned with the effect of a further provision giving to the appellant a defined interest in the petroleum and natural gas within, upon, or under certain lands. There is no such provision in the present case.

However, in my opinion, it is not necessary to state a final opinion upon this point because, if it was intended by cl. 3 (b) to create any interest in the lands comprised in the lease, Astral was prohibited from creating it, by virtue of s. 11 of the Alkali Mining Regulations of Saskatchewan, previously cited, unless the written consent of the Minister of Mineral Resources had first been obtained.

25 In the *Saskatchewan Minerals* case, Laskin J., as he then was, wrote a dissenting judgment. He stated at p. 119:

There is no decision of this Court which either pronounces upon or examines royalties under so-called mining leases on the question whether they are or in what circumstances, if any, they can be interests in land. I speak here of royalties not in the sense of a vested interest in mineral deposits, or in oil or gas, as the case may be, in situ (which is a sense that has been sometimes attributed to them, particularly in a line of American cases, and see *Gowan v. Christie* (1873), L.R. 2 Sc. & Div. 273), but rather in the sense of a share in or a return on production for permission to exploit certain property or in respect of such exploitation: see *Re Dawson and Bell*, [1945] O.R. 825 at 838 , 842, [1946] 1 D.L.R. 327 (C.A.). This is the sense in which it is spelled out in the agreement of 3rd June 1948 between Keyes and Astral.

26 In this case the plaintiff contends that the reasoning of Laskin J. in the minority judgment is valid and that the parties' intention governs. It is argued that the royalty is being paid in return for the use of land and can be characterized as in the nature of "rent" and thus is an interest in land. It is suggested that cl. (3) of the royalty agreement overrides cl. (1) in that it clearly indicates that it was intended that the mineral interest should be subject to the plaintiffs' interest at all times and accordingly must be construed as intending to create an interest in land.

27 This much is clear from the authorities, and that is that a court must examine the wording of the documents in order to determine the question. In this case there was no parol evidence but only an agreed statement of facts. The court must therefore examine the documents in the light of the agreed statement.

28 Clause (1) of the royalty agreement, Ex. 2, states that the owners (Westersunds) will pay to the grantee (Vanguard) a gross royalty of seven per cent of the proceeds of sale of the petroleum substances that may be produced, saved and marketed out of the said lands. This is an obligation to pay Vanguard a sum of money out of the proceeds of sale of the petroleum substances *after* they have been removed from the land. The wording in the royalty agreement herein cannot be construed as an interest in situ. In my view, the royalty herein is on the proceeds of the sale of the petroleum substances after removal from the land. In other words, the owner and the grantee agreed to share in the proceeds of the sale of mineral substances after removal. This amounts to an obligation to pay by the owner to the grantee a sum of money based on a percentage of the sale proceeds.

29 I cannot agree that the payment can in any way amount to a rent. Rent is something that is due periodically for the use of property. Indeed "rent" is defined in Black's Law Dictionary, 4th ed., as "consideration paid for use or occupation of property". There are many definitions of "rent", but generally it is a payment made by one person to another for the use of property whether it be real or personal.

30 It is conceivable that no payment might ever become due to the grantee (Vanguard) if indeed petroleum substances are never removed from the land. In such case no payment would ever be due the grantee, Vanguard. Rent is something that by its very nature accrues due to the lessor over a period of time and from time to time.

31 Courts in the United States have debated the meaning of the word "royalty" for many years. The American courts have held that it is necessary to examine the language under particular sets of circumstances to determine the nature of a royalty.

32 Clause (3) of the royalty agreement herein cannot change the clear meaning of cl. (1). A caveat is merely a warning to everyone of an interest in land claimed by a party or parties. A caveat does not create an interest in land. Although cl. (3) of the royalty agreement purports to give the grantee, Vanguard, the right to file and maintain a caveat, the caveat, nevertheless, cannot be maintained if it is not based on something that is an interest in land.

33 The royalty granted to Vanguard does not create an interest in land, and accordingly the caveat filed by Vanguard cannot be maintained.

34 The argument of estoppel is not open to the plaintiff, not having been pleaded. In any event I do not believe estoppel applies in this case. The plaintiff is entitled to take proceedings against the defendant for an accounting of whatever funds are owing by the defendant to the plaintiff as a result of the agreement.

35 The action is dismissed. The defendants will be entitled to costs in the appropriate column with no limiting rule.

End of Document

TAB 2

Most Negative Treatment: Check subsequent history and related treatments.

2003 ABQB 1053
Alberta Court of Queen's Bench

James H. Meek Trust v. San Juan Resources Inc.

2003 CarswellAlta 1843, 2003 ABQB 1053, [2003] A.J. No. 1599, [2004] A.W.L.D. 192, 128 A.C.W.S. (3d) 589, 28 Alta. L.R. (4th) 181, 356 A.R. 72

James H. Meek Trust, by Its Interested Trustee, Gary D. Fender, the Estate of Marian Meek Fender, by Its Executor, Gary D. Fender, and Bessie M. Carrington (Applicants) and San Juan Resources Inc. and Imperial Oil Resources Limited (Respondents)

LoVecchio J.

Heard: August 27-29, 2003
Judgment: December 19, 2003
Docket: Calgary 0201-20724

Proceedings: additional reasons at *James H. Meek Trust v. San Juan Resources Inc.* (2005), 364 A.R. 309, 2005 ABQB 9, 2005 CarswellAlta 15, 37 Alta. L.R. (4th) 23 (Alta. Q.B.); reversed *James H. Meek Trust v. San Juan Resources Inc.* (2005), 2005 ABCA 448, 2005 CarswellAlta 1880 (Alta. C.A.)

Counsel: J.S. Shortt, Ms C. Ross for Applicants
M.W. Mudie for San Juan Resources Inc.
W.C. Hunter, J. Whitaker for Imperial Oil Ltd.
W.E. Brett Code, D. Sheehan for Hampstead Trust Corporation

Subject: Natural Resources; Contracts; Property
Related Abridgment Classifications
Civil practice and procedure
VII Limitation of actions
VII.4 Actions in contract or debt
VII.4.a Statutory limitation periods
VII.4.a.ii Which limitation period applies
Civil practice and procedure
XXII Judgments and orders
XXII.22 Interest on judgments
XXII.22.a Prejudgment interest
XXII.22.a.iii Date from which interest runs
Debtors and creditors
X Interest
X.1 When payable
X.1.g Compound interest
Natural resources
III Oil and gas
III.6 Exploration and operating agreements
III.6.a Royalty agreement
III.6.a.ii Gross overriding royalty

Natural resources
III Oil and gas
III.6 Exploration and operating agreements
III.6.k Miscellaneous
Natural resources
III Oil and gas
III.9 Practice and procedure
III.9.j Miscellaneous

Headnote

Natural resources --- Oil and gas — Exploration and operating agreements — Royalty agreement — Gross overriding royalty

Pursuant to agreement in 1952, D Ltd. granted M three per cent gross overriding royalty ("M royalty") on production that might arise from any interest that D Ltd. either had or might acquire in potential oil and gas prospects identified by M — HBOG Ltd. entered into joint operating agreement with D Ltd. covering particular parcel of land leased by HBOG Ltd. and assigned 50 per cent working interest in lease to D Ltd. — D Ltd.'s interest in particular parcel was subject to M royalty — In ensuing years, following multiple transactions, I Ltd. held convertible gross overriding royalty on production from 50 per cent working interest originally held by D Ltd., SJR Inc. owned 75 per cent working interest in parcel, and H Co. owned 25 per cent working interest in parcel — M royalty ultimately became part of subject matter of trust and applicants, who were trustee and beneficiaries of trust, applied for determination of number of issues relating to M royalty — M royalty not interest in land, M royalty attached to 100 per cent working interest in parcel in question, and M royalty not subject to deductions for processing and trucking costs — Words of M royalty agreement were not sufficiently precise to demonstrate intention that royalty was to be interest in land and agreement could be construed as only giving contractual right — M royalty was not limited to original 50 per cent working interest that D Ltd. was entitled to acquire from HBOG Ltd. as granting clause of agreement emphasized that royalty was calculated on D Ltd.'s working interest, whatever it might be at any given time — Limiting language in agreement was clear that only deductions allowed were those for production and severance tax.

Table of Authorities

Cases considered by *LoVecchio J.*:

Acanthus Resources Ltd. v. Cunningham (1998), 1998 CarswellAlta 11, 57 Alta. L.R. (3d) 9, [1998] 5 W.W.R. 646, 213 A.R. 375, 37 B.L.R. (2d) 89 (Alta. Q.B.) — distinguished

Amerada Minerals Corp. of Canada v. Mesa Petroleum (N.A.) Co. (1986), 47 Alta. L.R. (2d) 289, [1987] 1 W.W.R. 107, 73 A.R. 172, 1986 CarswellAlta 198, 47 Alta. L.R. 289 (Alta. C.A.) — distinguished

Bank of Montreal v. Dynex Petroleum Ltd. (1999), 182 D.L.R. (4th) 640, 1999 CarswellAlta 1271, 74 Alta. L.R. (3d) 219, [2000] 2 W.W.R. 693, 2 B.L.R. (3d) 58, 15 C.B.R. (4th) 5, 15 P.P.S.A.C. (2d) 179, (sub nom. *Bank of Montreal v. Enchant Resouces Ltd.*) 255 A.R. 116, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 220 W.A.C. 116, 1999 ABCA 363 (Alta. C.A.) — referred to

Bank of Montreal v. Dynex Petroleum Ltd. (2002), 2002 SCC 7, 2002 CarswellAlta 54, 2002 CarswellAlta 55, 19 B.L.R. (3d) 159, 208 D.L.R. (4th) 155, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 281 N.R. 113, 30 C.B.R. (4th) 168, 1 R.P.R. (4th) 1, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 299 A.R. 1, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 266 W.A.C. 1, [2002] 1 S.C.R. 146 (S.C.C.) — followed

Bank of Montreal v. Dynex Petroleum Ltd. (2003), 2003 ABQB 243, 2003 CarswellAlta 399 (Alta. Q.B.) — considered

Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd. (1969), 3 D.L.R. (3d) 630, 1969 CarswellAlta 107 (Alta. C.A.) — considered

Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd. (1970), 15 D.L.R. (3d) 256 (S.C.C.) — referred to

Guaranty Trust Co. of Canada v. Hetherington (1987), 50 Alta. L.R. (2d) 193, [1987] 3 W.W.R. 316, 44 R.P.R. 154, 77 A.R. 104, 1987 CarswellAlta 34 (Alta. Q.B.) — considered

Resman Holdings Ltd. v. Huntex Ltd. (1983), 28 Alta. L.R. (2d) 396, [1984] 1 W.W.R. 693, 54 A.R. 281, 1983 CarswellAlta 186 (Alta. Q.B.) — distinguished

Scurry-Rainbow Oil Ltd. v. Galloway Estate (1993), 8 Alta. L.R. (3d) 225, 138 A.R. 321, [1993] 4 W.W.R. 454, 1993 CarswellAlta 298 (Alta. Q.B.) — distinguished
Scurry-Rainbow Oil Ltd. v. Galloway Estate (1994), 23 Alta. L.R. (3d) 193, 157 A.R. 65, 77 W.A.C. 65, [1995] 1 W.W.R. 316, 1994 CarswellAlta 216 (Alta. C.A.) — referred to
Skyeland Oils Ltd. v. Great Northern Oil Ltd. (1976), [1976] 5 W.W.R. 370, 68 D.L.R. (3d) 318, 1976 CarswellAlta 114 (Alta. T.D.) — distinguished
St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd. (1962), 41 W.W.R. 210, 35 D.L.R. (2d) 574, 1962 CarswellAlta 70 (Alta. C.A.) — referred to
St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd. (1963), [1963] S.C.R. 482, 45 W.W.R. 26, 41 D.L.R. (2d) 316, 1963 CarswellAlta 78 (S.C.C.) — referred to
Vandergrift v. Coseka Resources Ltd. (1989), 67 Alta. L.R. (2d) 17, 95 A.R. 372, 1989 CarswellAlta 76 (Alta. Q.B.) — referred to
Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd. (1977), [1977] 2 W.W.R. 66, 4 A.R. 251, 72 D.L.R. (3d) 734, 1977 CarswellAlta 192 (Alta. T.D.) — referred to

Rules considered:

Alberta Rules of Court, Alta. Reg. 390/68
R. 410(c) — pursuant to

R. 410(e) — pursuant to

APPLICATION for determination of issues relating to gross overriding royalty agreement.

***LoVecchio J.*:**

Introduction

1 In the early 50's, the war was over and business in the oil and gas industry was heating up. James Meek had already identified a number of potential oil and gas prospects that might be of interest to Canadian Delhi Oil Ltd. and he would be seeking others. Pursuant to an agreement dated October 1, 1952, Delhi granted Mr. Meek a 3% gross overriding royalty on the production that might arise from any interest that Delhi either had, or might acquire in these prospects as partial consideration for the services he was providing.

2 The Applicants have applied under Rules 410 (c) and (e) of the Alberta Rules of Court for a determination of a number of issues relating to this GORR.

Background

3 In 1950, Howard Tracy Emery became the lessor of certain Crown petroleum and natural gas rights in a number of parcels of land, including the NE quarter of Section 35, Township 24, Range 13, west of the 4 th meridian pursuant to Crown lease no. 77998. NE Section 35 is comprised of legal subdivisions 9, 10, 15 and 16. The lease was held beneficially for Hudson's Bay Oil and Gas Company Limited and is currently described as Crown lease no. 24196A.

4 On August 10, 1950, HBOG entered into a Joint Operating Agreement with Delhi covering various lands, including NE Section 35. The agreement granted Delhi the opportunity to earn a 50% working interest. Following the drilling of certain wells by Delhi, HBOG assigned a 50% WI in the lease to Delhi under a Memorandum of Agreement dated March 14, 1951. HBOG retained a 50% WI in the lease.

5 Under the October 1, 1952 Meek Royalty Agreement referenced above, Delhi's interest in NE Section 35 was subject to the GORR as NE Section 35 included in the lands mentioned in Schedule "A". The JOA is also referenced in the Meek Royalty Agreement.

6 Clause 10 of the JOA governs the procedures for joint and independent drilling operations on the lands. It provides that should one of the parties decide to drill a well on any of the lands that are subject to the agreement, the other party may, but is not required to, participate in the drilling by paying its share of the cost of any wells. If the other party does not participate, the party that drilled the well is then entitled to have conveyed to it the non-participating party's full interest in the quarter section in which the well was drilled.

7 In 1981, Delhi became Sulpetro Limited through a series of corporate transactions. It is not disputed that Sulpetro assumed all of Delhi's rights and obligations under the JOA.

8 On May 28, 1987, Sulpetro entered into a farmout agreement with San Juan Resources Inc. Under that agreement, San Juan could acquire Sulpetro's interest in various lands, including NE Section 35, upon completion of a ten-well drilling program. The transfer was subject to a retained convertible gross overriding royalty in favour of Sulpetro. This farmout was the method chosen by Sulpetro to initiate independent drilling operations under clause 10 of the JOA.

9 Some time prior to 1987 and for reasons which were not detailed, the Sulpetro interest was encumbered by a 1.25% gross overriding royalty in favour of Petro Canada. The parties agree that the Meek Royalty is subject to the Petro Canada royalty.

10 On June 1, 1987, San Juan assigned the rights and obligations it acquired under the farmout agreement from Sulpetro to UniGlobe International Energy Corporation. San Juan retained a 4% gross overriding royalty.

11 On July 13, 1987, San Juan and UniGlobe entered into a letter agreement. They agreed that in the event HBOG elected not to participate in the drilling of a well in accordance with clause 10 of the JOA, San Juan would have the right, but not the obligation, to elect to participate in respect of any interest that might be forfeited by HBOG's non-participation.

12 On October 6, 1987, Sulpetro (on behalf of San Juan and UniGlobe) sent an independent operations notice to HBOG indicating its intentions to drill a number of wells on certain lands (including NE Section 35) and inviting HBOG to elect to participate. By the terms of the JOA, any wells that were subject to an independent operations notice were required to be commenced before February 3, 1988.

13 On November 9, 1987, HBOG advised Sulpetro that it would not participate in the proposed wells, but that it was reserving its rights under the terms of the JOA to participate after the fact upon payment of the appropriate penalty.

14 In the fall of 1987, Sulpetro went into receivership and on December 1, 1987, Imperial purchased from Sulpetro's receiver Sulpetro's interest in certain lands including NE Section 35. On that same day, Imperial, Sulpetro and the owners of the Meek Royalty entered into a novation agreement, under which Imperial assumed Sulpetro's obligations in regard to NE Section 35.

15 On December 27, 1987, a well was commenced at LSD 10 of NE Section 35. This was within the time period contemplated by the independent operations notice. Hydrocarbons were encountered, the well was completed and production from the well was reported on March 14, 1988.

16 On April 28, 1988, San Juan sent another notice to HBOG. This notice stated that a 30 day production test had been completed and, subject to a penalty, HBOG had ten days in which to once again elect to participate. The waiting period contemplated by the JOA expired without HBOG indicating that it wished to participate and HBOG's interest in all of NE Section 35 was forfeited. By exercising its rights of first refusal, San Juan acquired the forfeited interest.

17 On May 26, 1988, San Juan sold half of the 50% WI in NE Section 35 (which it had just acquired as a result of HBOG's forfeiture under the JOA) to Safeway Holdings Ltd. Safeway sold that interest to Hampstead Trust Corporation in 1996.

18 In June 1991, San Juan bought UniGlobe's 50% WI in NE Section 35 from UniGlobe's receiver.

19 In 1988, Imperial began to question whether San Juan, through the drilling conducted by UniGlobe, had actually earned the Sulpetro interest. In 1994, the parties settled their differences. They agreed that San Juan had actually earned the interest under the farmout agreement and, as a result, Imperial no longer had any interest in NE Section 35, other than the convertible gross overriding royalty retained by Sulpetro, notwithstanding that it still appeared as the lessee of the lands.

20 To remedy this anomaly, it was further agreed that Imperial would convey its interest in NE Section 35 to San Juan, and that San Juan would convey other interests to Imperial. To date, the assignment of the lease by Imperial to San Juan has not occurred.

21 The current undisputed interests are as follows:

Imperial is the lessee of the Crown petroleum and natural gas rights in all zones pursuant to Crown lease 24196A and holds a convertible gross overriding royalty on the production from the 50% WI originally held by Sulpetro, calculated according to a schedule;

San Juan owns a 75% WI and is the operator of record and the holder of the well licences;

Hampstead owns a 25% WI; and

Petro Canada holds a 1.25% gross overriding royalty on the production from the 50% WI originally held by Sulpetro.

22 The wells on NE Section 35 produce both oil and natural gas and form part of a unit which is operated by ConocoPhillips.

23 Since 1993, the Meek Royalty has been paid by Imperial into an escrow account held by ConocoPhillips pending the outcome of this matter.

24 The Meek Royalty ultimately formed part of the subject matter of the Meek Trust and the Applicants are the trustee and the beneficiaries of that trust. The relevant details of the Meek Royalty Agreement will be discussed as they arise.

Issues

25 Pursuant to an agreement among the parties, counsel asked me to address the following issues, leaving certain other issues to be addressed in subsequent applications:

1. Is the Meek Royalty an interest in land?

2. To what interests does the Meek Royalty attach?

3. Is the Meek Royalty subject to deductions for processing and trucking costs?

Decision

26 The Meek Royalty is not an interest in land. The Meek Royalty attaches to a 100% WI in NE Section 35 and it is not subject to deductions for processing and trucking costs.

Analysis

The Assertions of the Various Parties

27 The Applicants are seeking a declaration that the Meek Royalty is an interest in land, that it attaches to all of the working interests in NE Section 35, and that in calculating the amount payable to the holders of the Meek Royalty, no deductions should be made for the expense of processing and trucking the petroleum substances. Consequently, the Applicants are seeking payment of the Meek Royalty from San Juan, Hampstead and Imperial. In the alternative, the Applicants are seeking payment of the Meek Royalty from Imperial on the basis of the novation agreement.

28 San Juan takes the position that the Meek Royalty is not an interest in land, and that it has no liability as the Meek Royalty was merely a personal obligation between Delhi and Mr. Meek, to which San Juan is a stranger. In the alternative, San Juan argues that part of its interest arises directly from the former HBOG interest, and if the Meek Royalty is an interest in land, it attaches only to San Juan's 50 % WI that derives from the Delhi interest, but not to its 25% WI that derives from the interest forfeited by HBOG. San Juan suggests that in the further alternative, if the Meek Royalty is an interest in land that attaches to all of the interests, Hampstead, as the owner of a 25% WI, is liable for 25% of any amount owing.

29 Hampstead supports San Juan's position that the Meek Royalty is not an interest in land, and similarly argues in any event that since its interest arises directly from the HBOG forfeited interest, the Meek Royalty does not encumber it.

30 Imperial admits that the novation agreement imposes a contractual obligation upon it to pay the Meek Royalty to the Applicants, and it has paid the Meek Royalty into an escrow account. Imperial supports the position that the Meek Royalty is an interest in land, and therefore argues that the WI partners San Juan and Hampstead are liable for it in proportion to their respective working interests. Imperial will be seeking indemnity from San Juan for its contractual obligations to the Meek Trust in a future application.

31 In the event that they are held liable for payment of all or part of the Meek Royalty, San Juan and Hampstead take further issue with the method of calculation of the Meek Royalty. They argue that the Meek Royalty should be based on 3% of the proceeds of the sale of petroleum substances net of the costs of processing and trucking. The Applicants take the view that the royalty is to be calculated without any deductions for these costs. Imperial takes no position on this issue.

Issue 1 - Is the Meek Royalty an interest in land?

32 There is no doubt that a gross overriding royalty may be an interest in land: *Bank of Montreal v. Dynex Petroleum Ltd.* [1]. To determine whether the Meek Royalty is an interest in land, the Court must apply the test approved by the Supreme Court in *Dynex Petroleum Ltd.*.

33 Under this test the Meek Royalty will be an interest in land if:

> (1) The language used in describing the Meek Royalty is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the oil and gas substances recovered from the land; and
>
> (2) The interest, out of which the Meek Royalty is carved, is itself, an interest in land [2].

34 All of the parties in this application agree that the Delhi interest, being the interest from which the Meek Royalty is carved, is an interest in land. The only element of the test that remains to be considered is whether the language used in the Meek Royalty Agreement is sufficiently precise to show that the parties intended the Meek Royalty to similarly be an interest in land.

35 In so deciding, I must interpret the precise words used in the agreement having regard for the whole of the agreement as well as the circumstances surrounding it. In so doing, a balance must be struck between two competing forces. I must be wary of simply searching for some magic words while at the same time considering whether the precise words used had been carefully chosen so as to convey a particular meaning. My starting point will of course be the granting provision.

36 The granting provision of the Meek Royalty Agreement reads as follows:

> Delhi hereby sells, assigns, conveys, transfers and sets over unto Meek a gross overriding royalty in the amount of three percent (3%) of all oil, gas and other hydrocarbons which may be produced, saved and marketed from any and all lands described in Schedule "A" . . . under and by virtue of the agreements attached as Exhibits 1 to 10 inclusive of said Schedule "A" . . .

37 A series of cases have held that a royalty payable out of production is indicative of a mere contractual obligation to pay money and not an interest in land. [3] Hunt J. (as she then was) questioned the conclusion given the reality of oil and gas industry in *Scurry-Rainbow Oil Ltd. v. Galloway Estate* [4]. I agree with her observations. In the context of the oil and gas industry, the fact this royalty is stated to be payable out of production should not in and of itself be determinative that this royalty is merely a contractual payment obligation and not an interest in land. I must consider whether there are other provisions in the Meek Agreement which would indicate one interpretation over the other.

38 I find there are several clause which would suggest the Meek Royalty was to be a payment obligation. For example, Clause V(2)(a). It provides that the royalty shall be:

> . . . satisfied by payment by Delhi to Meek in Canadian funds . . . of Meek's proportionate share of the proceeds of sale of production of oil, gas and related hydrocarbons saved, recovered and marketed from the lands.

39 Further, the Meek Royalty Agreement does not allow the royalty owners to take their royalty in kind, a factor observed by Hawco J. in *Dynex* [5] as indicative of a personal right. This is also consistent with Virtue J.'s observation in *Vandergrift* that if the royalty owner's rights were passive, in that they could not seek to extract the hydrocarbons themselves or cause the extraction, a personal right was created. The Meek Royalty owners similarly have no right to drill, produce, market or operate the lands or have any input into the substances recovered, nor any power or discretion over the leases and lands to which the royalty applies.

40 The various respondents argued that the words "sells, assigns, conveys, transfers and sets over" represent conveyancing language that clearly manifests the intention to transfer an interest in land. With respect, such language in and of itself is not sufficiently precise to create an interest in land, particularly in view of the language granting the royalty on production, the references to payment and the passive rights of the royalty owners contained in the Meek Royalty Agreement.

41 I note that the words of conveyance in *Scurry-Rainbow* are distinguishable from those in the Meek Royalty Agreement in that the conveyancing words "all the estate, right, title, interest, claim and demand whatsoever, both at law and in equity of the owner", are not present in the Meek Royalty Agreement. In addition, there is no habendum ("to have and to hold") clause contained in the Meek Royalty Agreement unlike one of the agreements at issue in *Scurry-Rainbow*. In *Scurry-Rainbow*, Hunt J. found that *all of the conveyancing language, taken together*, described a property rather than a contractual right.

42 In *Scurry-Rainbow*, Hunt J. was dealing with a lessor's royalty converted into a royalty trust and cautioned against placing undue emphasis on cases construing different types of royalties. Finally, Hunt J. noted the critical role of commercial context evidence that was before her.

43 In this case, however, I have limited additional evidence aside from the words in the Meek Royalty Agreement to assist in its construction. There is evidence before me that no caveat was ever filed to protect the Meek Royalty. That is some evidence of the surrounding circumstances which, assuming its admissibility, is more consistent with an intention that the Meek Royalty is contractual in nature.

44 There is also the letter agreements between Delhi and Mr. Meek dated October 1, 1950, February 21, 1952 and April 30, 1952 referenced in the Meek Royalty Agreement. That agreement does not contain an "entire agreement" provision and in this case the Meek Royalty is compensation for services. The royalties in *Emerald* and *Dynex* (Hawco J.), which were granted for services, were found to be contractual in nature.

45 Based upon the precise words in the agreement having regard for the whole of the agreement as well as the available evidence of the surrounding circumstances, I conclude that the words of the Meek Royalty Agreement are not sufficiently precise to demonstrate the intention that the Meek Royalty was to be an interest in land. Rather, the Meek Royalty Agreement must be construed as giving only a contractual right. Imperial concedes that it is contractually responsible for the payment of the Meek Royalty pursuant to the novation agreement. Whether San Juan or others must indemnify Imperial for this obligation remains to be determined.

Issue 2 - To What Interests Does the Meek Royalty Attach?

46 Recital III of the Meek Royalty Agreement states:

> WHEREAS it is agreed that as at the date of this Agreement the lands which remain subject to Delhi's obligation to Meek under the said Letter Agreements are those set out and described in Schedule "A" annexed hereto and the interests in oil, gas and other hydrocarbon substances which may be produced, saved or marketed therefrom are the interest which Delhi *has acquired* ***or may be entitled to acquire under and subject to the terms and provisions of the Agreements*** annexed as Exhibits 1 to 10 inclusive to the said Schedule "A".
>
> (Emphasis added)

47 The Respondents argue that the words "may be entitled to acquire" should be interpreted as only referring to the 50% WI that Delhi was entitled to acquire from HBOG once Delhi completed a test well, pursuant to Clauses 5 and 6 of the JOA.

48 I see no reason why these words must be restricted as the Respondents suggest.

49 The full expression is "has acquired or may be entitled to acquire". The plain meaning of these words contemplate future growth. Similarly, the granting clause, reproduced in paragraph 36 above, also emphasizes that the Meek Royalty is calculated on Delhi's WI, whatever it may be at any given time. Further, it also references the JOA, the source of the increased WI to which the Meek Royalty owners seek their interest to attach.

50 More specifically, Delhi could acquire HBOG's interest by forfeiture under Clause 10 of the JOA. As HBOG did in fact decline to ultimately participate, Imperial became entitled to acquire the forfeited interest. The world was simply unfolding as the words had contemplated.

51 Counsel for Hampstead argued that the Meek Royalty should not attach to the portion of the WI that derived from HBOG's WI as it should be seen as having been acquired by San Juan directly from HBOG. This argument must fail as San Juan had no independent right to acquire the interest. The interest was only available through the operation of the forfeiture provisions of the JOA. Those rights run through the Delhi chain of title. The fact that San Juan's acquisition rights were obtained by way of a right of first refusal over the rights of UniGlobe only confirms this fact.

Issue 3 - Deductions

52 As noted above, the granting clause contained in the Meek Royalty Agreement bases the Meek Royalty upon all hydrocarbons "produced, saved and marketed" from the lands. Part V(2)(a) of the Meek Royalty Agreement states:

> Such overriding royalty shall be satisfied by payment . . . of Meek's proportionate share of the proceeds of sale of production of oil, gas and related hydrocarbons saved, recovered and marketed from the lands . . . less only production and severance tax applicable thereto, if any.

53 The Applicants take the position that the only deductions allowed by Part V(2)(a) are production and severance taxes, and they support their position with evidence that, historically, no other deductions were taken.

54 San Juan and Hampstead argue that the royalty is subject to processing and trucking costs as these were incurred after the point of measurement of the Meek Royalty, which they suggest is the point at which the substances are produced from the lands.

55 I do not question the validity of the several Alberta decisions relied on by the Respondents which describe that royalties must be calculated net of downstream costs: *Resman Holdings Ltd. v. Huntex Ltd.* [6], *Skyeland Oils Ltd. v. Great Northern Oil Ltd.* [7] and *Acanthus Resources Ltd. v. Cunningham* [8]. While I agree in principle with such deductions, none of these cases relied upon for deductions purposes appear to relate to agreements containing limiting language similar to that contained in the Meek Royalty Agreement. I further note there is no other evidence before me (as was the case in *Amerada Minerals Corp. of Canada v. Mesa Petroleum (N.A.) Co.* [9]) that might have assisted in construing the Meek Royalty Agreement so as to allow the deductions. The language is clear. The only deductions allowed are those for production and severance tax.

Conclusion

56 The Meek Royalty is not an interest in land. It attaches to a 100% WI in NE Section 35 and as a result of the novation agreement, Imperial remains liable for payment of the royalty on the production from the NE Section 35 lands. The Meek Royalty is not subject to deductions for processing and trucking costs.

Costs

57 The issue of costs should be deferred until such time as the remaining issues have been argued and determined.

Order accordingly.

Footnotes

1 [2002] 1 S.C.R. 146 (S.C.C.), affirming (1999), 74 Alta. L.R. (3d) 219 (Alta. C.A.).

2 In his written reasons for a unanimous Court, Justice Major quoted with approval the test enunciated by Virtue J. in *Vandergrift v. Coseka Resources Ltd.* (1989), 67 Alta. L.R. (2d) 17 (Alta. Q.B.) at p. 26.

3 See: *Vandergrift*, *Guaranty Trust Co. of Canada v. Hetherington* (1987), 50 Alta. L.R. (2d) 193 (Alta. Q.B.), *Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd.* (1977), 72 D.L.R. (3d) 734 (Alta. T.D.), *Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd.* (1969), 3 D.L.R. (3d) 630 (Alta. C.A.), aff'd (1970), 15 D.L.R. (3d) 256 (S.C.C.) and *St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd.* (1962), 35 D.L.R. (2d) 574 (Alta. C.A.), aff'd (1963), 41 D.L.R. (2d) 316 (S.C.C.).

4 (1993), 8 Alta. L.R. (3d) 225 (Alta. Q.B.) at para. 104, aff'd (1999), 23 Alta. L.R. (3d) 193 (Alta. C.A.)

5 *Bank of Montreal v. Dynex Petroleum Ltd.*, [2003] A.J. No. 349, 2003 ABQB 243 (Alta. Q.B.)]

6 (1983), [1984] 1 W.W.R. 693 (Alta. Q.B.)

7 [1976] 5 W.W.R. 370 (Alta. T.D.)

8 (1998), 213 A.R. 375 (Alta. Q.B.)

9 (1986), 47 Alta. L.R. (2d) 289 (Alta. C.A.)

End of Document

TAB 3

1989 CarswellAlta 76
Alberta Court of Queen's Bench,

Vandergrift v. Coseka Resources Ltd.

1989 CarswellAlta 76, [1989] A.W.L.D. 528, 15 A.C.W.S. (3d) 36, 67 Alta. L.R. (2d) 17, 95 A.R. 372

VANDERGRIFT et al v. COSEKA RESOURCES LIMITED et al.

Virtue J.

Judgment: March 30, 1989
Docket: Calgary No. 8201 33548

Counsel: *W.H. Kennedy*, for plaintiffs.
E.L. Bunnell, Q.C., for defendants except Telstar Resources Ltd.
B.K. O'Ferrall, for third party Dome Petroleum Ltd.
T.M. Hughes, for fourth party Wudel.
L.C. Fontaine, for fourth party Chevron Standard Ltd.

Subject: Natural Resources; Civil Practice and Procedure
Related Abridgment Classifications
Natural resources
III Oil and gas
III.8 Statutory regulation
III.8.e Pooling
Natural resources
III Oil and gas
III.8 Statutory regulation
III.8.f Production regulation
Headnote
Oil and Gas --- Exploration and operating agreements — Royalty agreement — General
Oil and Gas --- Statutory regulation — Provincial boards — General
Energy and natural resources — Oil and gas — Oil and gas interests — Nature of legal interest — Company having right under farmout agreement to earn interest in petroleum and natural gas lease in land upon drilling gas well on land — Company assigning itself and others gross overriding royalty in all petroleum substances recovered from land — Company completing earning well and receiving leasehold interest — Assignees of royalty interest claiming royalty on interest in land — Language of royalty agreement not showing intention of parties to create interest in land but conveying contractual right to share in petroleum substances after recovered from land — Interest out of which royalty carved not itself an interest in land as company not having earned lease at time royalty agreement executed — Court dismissing assignees action.
Energy and natural resources — Oil and gas — Government regulation — Production — Unitization — Company earning petroleum and natural gas lease under farmout agreement — Company having gross overriding royalty on actual production from land — Company transferring lease to owners of petroleum and natural gas lease on adjacent land — Owners obtaining gas block order for both lands to avoid off-target penalty — Assignees of royalty interest seeking

calculation of royalty based on pooled production from all wells in gas block — Gas block order not creating unitization of petroleum and natural gas area — Neither order nor legislation governing gas blocks requiring compulsory allocation of percentage of total amount of gas produced in unit to individual parcels of land or substituting previous contracts based on actual production with allocated percentage of production from entire unit — Court not amending existing arrangement between working interest owners and royalty holders in absence of clear contractual provisions or legislative authority — Court dismissing assignees' action.

Energy and natural resources — Oil and gas — Exploration and operations — Royalty agreements — Company having right under farmout agreement to earn interest in petroleum and natural gas lease in land upon drilling gas well on land — Company assigning itself and others gross overriding royalty in all petroleum substances recovered from land — Company completing earning well and receiving leasehold interest — Assignees of royalty interest claiming royalty on interest in land — Language of royalty agreement not showing intention of parties to create interest in land but conveying contractual right to share in petroleum substances after recovered from land — Interest out of which royalty carved not itself an interest in land as company not having earned lease at time royalty agreement executed — Court dismissing assignees' action.

Energy and natural resources — Oil and gas — Exploration and operations — Royalty agreements — Company earning petroleum and natural gas lease under farmout agreement — Company having gross overriding royalty on actual production from land — Company transferring lease to owners of petroleum and natural gas lease on adjacent land — Owners obtaining gas block order for both lands to avoid off-target penalty — Assignees of royalty interest seeking calculation of royalty based on pooled production from all wells in gas block — Gas block order not creating unitization of petroleum and natural gas area — Neither order nor legislation governing gas blocks requiring compulsory allocation of percentage of total amount of gas produced in unit to individual parcels of land or substituting previous contracts based on actual production with allocated percentage of production from entire unit — Court not amending existing arrangement between working interest owners and royalty holders in absence of clear contractual provisions or legislative authority — Court dismissing assignees' action.

Under a farmout agreement, S. Ltd. was entitled to acquire a 60 per cent working interest in 94.4 per cent of a petroleum and natural gas lease on seven sections of land known as the Suffolk lands by drilling a gas well on the lands. S. Ltd. granted itself and two others equal shares in the farmout agreement. S. Ltd. obtained a Crown Reserve and Natural Gas Licence for the lands and entered into a royalty agreement under which it assigned to itself and the other two grantees under the farmout agreement a 3 per cent gross overriding royalty in all petroleum substances recovered from the lands. The agreement provided that S. Ltd. was not required to conduct exploratory operations or to drill a well on the land. By a series of assignments, the 3 per cent royalty came to be held by the plaintiffs. Two years after execution of the royalty agreement, S. Ltd. completed the earning well under the farmout agreement and received a natural gas lease for the 60 per cent interest in the Suffolk lands. S. Ltd. sold the 60 per cent interest to the defendant working interest owners who also held the lease on the adjacent eight sections of land known as the TransAlta lands. The defendant C. Ltd. was retained as the field operator for both the Suffolk and TransAlta lands and five producing gas wells were drilled on the TransAlta lands. The defendants then entered into an agreement to pool their respective interests and a percentage of the pooled costs and revenues of the Suffolk and TransAlta lands were allocated to each working interest owner. Not being working owners, the plaintiffs were not parties to this agreement and continued to receive a 3 per cent royalty "applicable to production from the Suffolk lease". Two years after the earning well drilled by S. Ltd. on the Suffolk lands went into production, the Oil and Gas Conservation Board announced its intention to impose a retroactive off-target penalty for overproduction that would have resulted in the well being shut-in for two years. To avoid this penalty, C. Ltd. obtained from the board a gas block order for the Suffolk and TransAlta lands. Thereafter there was no change in the way C. Ltd. allocated production to the six wells in the gas block and the plaintiffs' royalty continued to be calculated solely upon 3 per cent of the actual production from the Suffolk well. Claiming that their royalty was an interest in land and that the gas block order had resulted in a statutory or defacto unitization of the lands in the gas block, the plaintiffs commenced this action for, inter alia, a declaration that their royalty should be calculated and paid as a percentage of the pooled production from all the wells in the gas block.

Held:

Action dismissed.

A royalty interest or an overriding royalty interest can be an interest in land if the parties use language sufficiently precise to show that intent rather than the intent to create a contractual right to a portion of the oil and gas recovered from the land, and if the interest out of which the royalty is carved is, itself, an interest in land. In each case where it is claimed a royalty agreement creates an interest in land, the court must examine the specific wording of the agreement to determine the intention of the parties. In this case the choice of language used was completely in the hands of the recipients of the royalty interest as for all practical purposes the recipients and the grantor were one and the same. The references in the agreement to a royalty in petroleum substances "found in" or "recovered from" the land as opposed petroleum substances "within, upon or under" the land conveyed a contractual right to the payment of a share of the petroleum after it had been removed, rather than an interest in land. Further, had the agreement been intended to create an interest in land one would expect it to include the right of the royalty holder to enter the land to explore and extract minerals. Since a mere entitlement to an overriding royalty without more does not carry with it a right to explore for oil and gas, the plaintiffs could neither extract the oil and gas themselves nor require S. Ltd. as grantor to drill for them. Also, as the plaintiffs sought to impose obligations on the defendants who were not party to the royalty agreement and did not participate in its drafting, it was reasonable to require that the language used show clearly the parties' intent for the royalty to be an interest in land.

When S. Ltd. granted the royalty, it had the right to earn an interest in land by drilling a well, but had not yet earned that interest and did not do so until two years after execution of the royalty agreement. The natural gas licence did not create an interest in land in S. Ltd. as a bare licence to drill and produce in the hands of one who neither owns nor leases the land or minerals is not an interest in land. Accordingly, when S. Ltd. granted the royalty, it did not own an interest in land and therefore could not convey an interest in the land to the plaintiffs.

The two most critical elements required for the unitization of a petroleum and natural gas area are the compulsory allocation of a percentage of the total amount of gas produced in the whole unit to individual parcels or tracts of land, and a provision that previous contracts are deemed to have been amended by substituting for actual production the allocated percentage of the production from the entire unit. The primary effect of the gas block order was to relieve against the necessity of imposing an off-target penalty in the Suffolk well and the order did not change the way in which the wells in the gas block could be produced but in fact conferred a substantial benefit on the plaintiffs by avoiding any payment of the penalty. Nothing in the order itself or the provisions of the Oil and Gas Conservation Act or the regulations required a percentage of the total production from the gas block to be allocated to each parcel of land in the block. Nor was there a formula setting out the basis on which such allocation could be made. In the absence of such provisions in the order or in the governing legislation, the conclusion to be drawn was that the issuance of the gas block order did not effect a compulsory unitization of the block. Further, without clear contractual provision or legislative authority, the court will not amend existing arrangements between working interest owners and royalty holders. The plaintiffs' rights were governed by the royalty agreement and their royalty remained payable on the production of the Suffolk lands alone.

Table of Authorities

Cases considered:

Alminex Ltd. v. Berkley Oil & Gas Ltd., [1972] 6 W.W.R. 412 (Alta. C.A.) [affirmed [1975] 1 S.C.R. 262, [1974] 1 W.W.R. 288] — *applied*

Bell v. Lever Bros. Ltd., [1932] A.C. 161 (H.L.) — *applied*

Bensette v. Reece, [1973] 2 W.W.R. 497, 34 D.L.R. (3d) 723 (Sask. C.A.) — *considered*

Guar. Trust Co. of Can. v. Hetherington, 50 Alta. L.R. (2d) 193, [1987] 3 W.W.R. 316, 44 R.P.R. 154, 77 A.R. 104 (Q.B.) — *applied*

Sask. Minerals v. Keyes, [1972] S.C.R. 703, [1972] 2 W.W.R. 108, 23 D.L.R. (3d) 573 — *considered*

Telestar Resources Ltd. v. Coseka Resources Ltd. (1980), 12 Alta. L.R. (2d) 187, 24 A.R. 562 (C.A.) — *applied*

Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd., [1977] 2 W.W.R. 66, 72 D.L.R. (3d) 734, 4 A.R. 251 (C.A.) — *applied*

Statutes considered:

Oil and Gas Conservation Act, R.S.A. 1980, c. 0-5

s. 1(1)(b.1)

s. 72

s. 76.3 [en. R.S.A. 1980, c. 16 (Supp.), s. 4 (not yet proclaimed)]

Regulations considered:

Mines and Minerals Act, S.A. 1962, c. 49 — Natural Gas Licence Regulations, 1962, Alta. Reg. 297/62

s. 14

Authorities considered:

Kuntz "Classifying Non-operating Interests in Oil and Gas", Canadian Institute of Resources Law, 7th April 1988.

Action for declaration that gross overriding royalty be calculated and paid as a percentage of the pooled production of all wells in a gas block.

***Virtue J.*:**

Introduction, issues, and relief sought

1 The plaintiffs are entitled to an overriding royalty in the gas and oil substances recovered from seven sections of leasehold land in the Coleman field (the "Suffolk lands") on which there is one producing gas well. The lease on the Suffolk lands is held by the defendants (the working interest owners) who also hold the lease on the adjacent eight sections of land (the "TransAlta lands") on which there are five producing gas wells. Coseka Resources Ltd. operates the wells on all the lands in the gas block for the leaseholders. The Energy Resources Conservation Board of Alberta issued an order establishing the Suffolk lands and the TransAlta lands as a gas block. The gas block order was in effect from 29th June 1978 until November 1987, when it was rescinded.

2 There are two main issues to be dealt with:

3 1. Have the defendants wrongfully taken gas, underlying the Suffolk lands, without payment to the plaintiffs for their royalty?

4 2. Did the issuance of the gas block order entitle the plaintiffs to be paid their royalty based upon the pooled production from all the wells in the gas block, rather than on the one well on the Suffolk lands?

5 The plaintiffs seek a declaration that their royalty should be calculated on the basis of the total production from the gas block during the time the gas block order was in effect, and, in addition, specific performance of the royalty agreement on the basis of such a declaration; and an accounting for all royalties said to be due to the plaintiffs, with interest.

6 The trial, by agreement of the parties, was split into two parts: the first, to determine the issues arising between the plaintiffs and the defendants, and the second, if required, to deal with the issues arising between the defendants and the third and fourth parties.

The facts

7 Imperial Oil Enterprises and others ("Imperial") held the petroleum and natural gas lease from the Crown on the Suffolk lands. On 1st April 1971 Imperial entered into a farmout agreement with Suffolk Oil and Gas Ltd. ("Suffolk") under which Suffolk was to acquire a 60 per cent working interest in 94.4 per cent of the lease held by Imperial in exchange for drilling a gas well on the lands.

8 On 2nd April 1971 Suffolk as grantor, and Suffolk, Kenneth Kary, and Vandergrift Oil and Gas Limited as grantees, agreed in writing that the obligations, benefits and liabilities under the farmout agreement were held by grantees in equal shares.

9 On 12th May 1971 Suffolk obtained Crown Reserve and Natural Gas Licence No. 236 for the Suffolk lands.

10 Suffolk intended to sell off portions of the leasehold interests it would earn under the farmout agreement to working interest owners in order to finance the costs of drilling the well provided for in the farmout agreement. Before doing so, Suffolk, on 13th May 1971 (the day after it acquired Natural Gas Licence No. 236) entered into a royalty agreement under which it assigned to itself, Suffolk Oil & Gas Ltd., and to Kenneth Kary and Vandergrift Gas and Oil Enterprises Ltd., a three (3%) per cent gross overriding royalty on all petroleum substances recovered from the lands.

11 By a series of assignments, the 3 per cent overriding royalty came to be held by the plaintiffs, Millard R. Vandergrift (1/3), Howard J. Fogarty (1/9), Oilmen's Wellsite Services Limited (1/9), The Carbon Brick and Coal Company Limited (1/9) and 240689 Alberta Limited (1/3). (The plaintiff 240689 has subsequently discontinued its action so that the remaining plaintiffs represent two thirds of the royalty holders.)

12 On 13th August 1973, after Suffolk completed the well it was to drill under the farmout agreement (the 4-23 well), the Alberta Department of Mines & Minerals granted to Suffolk a natural gas lease covering the 60 per cent interest in the Suffolk lands which it had earned under the farmout agreement.

13 Suffolk had planned to retain a portion of the lease on the Suffolk lands itself, but because drilling costs on the farmout well exceeded estimates Suffolk ended up selling its entire interest in the lease to finance the well, and on 5th July 1974 Suffolk transferred the lease to nine working interest owners who are now represented by the defendants. The only interest retained by the original developers was the 3 per cent overriding royalty, which is now held by the plaintiffs.

14 The defendants, as the leaseholders, had the sole responsibility for the operation of the field. They retained Coseka Resources Ltd. as the field operator for both the Suffolk and the TransAlta lands.

15 The gas well drilled by Suffolk under the farmout agreement on the Suffolk lands is known as the 4-23 well. After the 4-23 well was drilled, the defendants drilled five wells on the TransAlta lands. All the wells were successful natural gas producers.

16 In September 1973 the defendants entered into an agreement under which they pooled their respective interests, and agreed to allocate the pooled costs and revenues of the Suffolk and TransAlta lands (including well 4-23) to each working interest owner in accordance with a schedule of percentages of production. The plaintiffs, not being working owners, were not party to this agreement, nor were they, as holders of a non-operating royalty interest, responsible for the payment of any of the expenses of operating the field. The agreement, however, identified the interests of the various royalty holders, and provided a method for payment to the plaintiffs of their 3 per cent royalty "applicable to production from the (Suffolk) lease".

17 On 6th April 1978 the field operator, Coseka, applied to the Oil & Gas Conservation Board for a gas block order. The board registered the application, advertised the suspension of Pt. 4 of the Oil & Gas Conservation Regulations, and, when no objections were received, conducted a hearing, following which it issued Gas Block Order 7806 on 29th June 1978. This order established a rectangular block of fifteen sections of land, made up of the seven sections comprising the Suffolk lands and the eight sections comprising the TransAlta lands, as the North Coleman Gas Block No. 1. Several years later, on 1st October 1987, a decision of the Court of Appeal of Alberta directed the board to reconsider its gas block order. The board did so, and on 18th November 1987 the board rescinded the order. The order was in effect from 29th June 1978 to 1st October 1987.

18 It is the position of the plaintiffs that the gas block order (while it was in force) constituted a form of "statutory or *defacto* unitization" of the North Coleman gas field. The result of this, the plaintiffs say, is that rather than being entitled to a 3 per cent overriding royalty on the gas produced from the 4-23 well, they should be entitled to their royalty based upon a proportionate share of the pooled production from all the wells in the North Coleman Gas Block No. 1.

The plaintiffs say further that, as the Suffolk lands comprise seven of the fifteen sections included in the gas block order, their 3 per cent royalty should be based on 94.4 of 7/15ths of the total production from all the wells in the block.

19 The defendants maintain that the plaintiffs' royalty has been properly calculated and paid to them based upon the actual production from the Suffolk lands, and that the gas block order did not change the basis for the payment of royalties to the plaintiffs as set out in the royalty agreement.

20 The way in which the royalty is calculated is of considerable significance. The well on the Suffolk lands (well 4-23), came into production in November 1975. It was successful in producing gas from both the Devonian level and the Mississippian level which lies above the Devonian. Originally, the well was produced from the Devonian level which was quite productive and easier to get at and handle than the Mississippian zone. In May 1978, as a result of a drilling accident, a tool (known as a mandril) lodged in the hole. It could not be retrieved, and as a result it blocked off the production of gas from the Devonian level. Since that time 4-23 has produced only from the Mississippian level. No claim is advanced based on this drilling accident, but the 4-23 well does not have the same production capacity as it did before the accident, and, as the plaintiffs' royalty under the royalty agreement is based on actual production, their potential royalty income is affected.

1. Have the defendants acted unfairly in producing the gas from the Coleman field?

21 The plaintiffs allege that the defendants' operator, Coseka, has acted unfairly with respect to producing gas from the 4-23 well in comparison to the wells on the TransAlta lands, and further that it is operating the field so as to drain off natural gas from the pool beneath the 4-23 well to a well on the TransAlta lands. The plaintiffs seek an accounting for additional royalty which they allege is due because of these production practices.

22 There are six producing gas wells in the Coleman Gas Block; one on the Suffolk lands, and five wells on the TransAlta lands. All produce only from the Mississippian zone, except well 6-14 on the TransAlta lands which produces from both the Devonian and Mississippian levels, but primarily from the Devonian. All the gas wells are operated by the defendant Coseka on behalf of the defendant leaseholders. The wells in the gas block are shut in from time to time for technical reasons and also when the demand for natural gas is reduced. The operator, Coseka, makes the decision as to which well or wells will be shut in.

23 The evidence does not substantiate the plaintiffs' allegation that Coseka, in assigning production to individual wells, has discriminated against the 4-23 well to the detriment of the plaintiffs. In fact, Coseka prefers to produce the 4-23 well because the royalty factor is 3 per cent while it is 5 per cent on the wells on the TransAlta lands. In its application for the block order Coseka stated with respect to the 4-23 well: "the full productive capabilities of the well are required to meet and maintain the total gas contract commitments for the North Coleman field". The evidence of Mr. Jones as to production practices was credible, and I accept it. I conclude from all the evidence that in operating the field Coseka has acted fairly when it has been necessary to shut in a well, or wells, for market-based or other reasons.

24 Nor does the evidence satisfy me that the Devonian gas reservoir under 4-23 is being drained by the production at that level from the 6-14 well. Again, I accept the evidence of Mr. Jones which was to the effect that drainage is limited to one-half mile of the well site, and, with respect to the 6-14 well, would not occur beyond the boundaries of section 14.

25 I also conclude on the evidence that there has been no discrimination against drilling new wells on the Suffolk lands (on which the plaintiffs would receive a royalty) in favour of other lands in the block. The evidence of Mr. Jones is that the updip part of the reservoir is the most desirable place to drill in the North Coleman field, and that portion of the reservoir is not within the Suffolk lands. His further evidence is that it is economically more advantageous to produce from the Mississippian zone because of the greater sulphur recovery from gas produced from that level.

26 The plaintiffs' allegations of unfair production practices are not substantiated by the evidence, and no claim is made out based on these allegations.

2. The board order

27 I am satisfied that it was not the defendants' intent to effect a compulsory unitization of the Suffolk and TransAlta lands, by the board order. The dominant motivation for the application by Coseka was to avoid the imposition by the Oil and Gas Conservation Board of a substantial off-target penalty that would otherwise have seriously restricted production from the 4-23 well. When the well was drilled the board agreed not to impose a penalty at that time, but in October 1977 the board announced its intention to impose an off-target penalty, on a retroactive basis, back to the first day of production in November 1975. This would have put well 4-23 into an overproduced status with the result that it would have been shut in for a period of about two years, to the great disadvantage of the plaintiffs. None of the other wells in the North Coleman field were subject to board-imposed limits on production. The board suggested to Coseka that the imposition of the penalty could be avoided if Coseka were to obtain a gas block order for the North Coleman field. Coseka acted on the board's suggestion, the Coleman Gas Block No. 1 order was granted, and the imposition of the off-target penalty on well 4-23 was avoided.

28 The application for the gas block order was advertised by the board in The Albertan, 19th May 1978, The Calgary Herald, 19th May 1978, and the The Edmonton Journal, 20th May 1978. Coseka did not consider it necessary to give any further notice to the plaintiff royalty holders as it was very much to the advantage of the royalty holders to avoid the imposition of the off-target penalty on the well on which they were drawing their royalties.

29 After the block order was granted there was no change in the way in which Coseka allocated production to the various wells in the field, nor in the calculation and payment of the plaintiffs' 3 per cent royalty. The royalty continued to be based solely upon 3 per cent of the actual production from the 4-23 well. Although the block order was issued on 29th June 1978, the plaintiffs did not complain about the method of calculating and paying their 3 per cent overriding royalty until roughly four years later. In February 1982 Carbon Brick claimed, for the first time, that the plaintiffs' 3 per cent gross overriding royalty should be calculated and paid on the basis of the pooled production from all the wells in the gas block. Its position was that the plaintiffs' royalty was an interest in land, and that the gas block order had resulted in a statutory or defacto unitization of the lands in the gas block. In 1979 and early 1980 the working interest owners had endeavoured to negotiate a unitization agreement which would have included both the working owners and the overriding royalty holders, but negotiations broke down when the Suffolk 3 per cent royalty group (the plaintiffs) insisted on receiving a participation factor of 37 per cent, and the TransAlta 5 per cent royalty group insisted on receiving a participation factor of 66 per cent which would leave only 34 per cent for the Suffolk group. The impasse was not resolved, and the unitization agreement was never achieved.

Is the plaintiffs' royalty an interest in land as claimed by the plaintiffs?

30 An informative publication of the Canadian Institute of Resources Law, entitled "Classifying Non-operating Interests in Oil and Gas", by Eugene Kuntz, dated 7th April 1988, discusses the legal nature of non-operating oil and gas interests and in particular whether royalties are an interest in land or a contractual right. The author reviews both the Canadian and United States authorities on the subject.

31 From this and other authorities to which I was referred it appears reasonably clear that under Canadian law a "royalty interest" or an "overriding royalty interest" can be an interest in land if:

32 1) the language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the oil and gas substances recovered from the land; and

33 2) the interest, out of which the royalty is carved, is itself an interest in land.

34 The court, in each case where it is claimed that a royalty agreement creates an interest in land, must examine the specific wording of the agreement to determine the intention of the parties. *Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd.*, [1977] 2 W.W.R. 66, 72 D.L.R. (3d) 734, 4 A.R. 251 (C.A., Moore J., now C.J.C.).

35 In *Guar. Trust Co. of Can. v. Hetherington*, 50 Alta. L.R. (2d) 193 at 216, [1987] 3 W.W.R. 316, 44 R.P.R. 154, 77 A.R. 104 (Q..B.), Mr. Justice O'Leary, after a careful review of the authorities, reached a similar conclusion which, with respect, I adopt:

> It seems clear from the authorities that the characterization of the royalty interest granted or assigned in a given case depends upon the intention of the parties as expressed in the wording of the instrument.

36 In *Sask. Minerals v. Keyes*, [1972] S.C.R. 703, [1972] 2 W.W.R. 108, 23 D.L.R. (3d) 573, Martland J. doubts that the use of the word "royalty" implies an intention to create an interest in land.

37 In *Bensette v. Reece*, [1973] 2 W.W.R. 497, 34 D.L.R. (3d) 723 (Sask. C.A.), Woods J.A., at p. 499, holds that "royalty" is not a term of art, and its meaning must be deduced from the circumstances surrounding its use.

Interpretation of the royalty agreement

1. Is the language of the royalty agreement sufficiently precise to convey an interest in land?

38 In the circumstance of this case, the choice of language used in the royalty agreement was completely in the hands of the recipients of the royalty interest. The grantor, Suffolk Oil and Gas Ltd., held the farmout agreement to the benefit of the grantees, Suffolk Oil and Gas Ltd., Vandergrift Oil and Gas Ltd. and Kenneth Kary. When it came to drafting the royalty agreement, the grantor of the royalty and the recipient of the royalty were, for all practical purposes, one and the same. The choice of the language used was completely theirs. If they intended to grant an interest in land, it was open to them to do so without negotiation or consideration of outside parties. Their language could readily have been as precise as was required to create an interest in land, if that is what was intended.

39 In those circumstances, what language did the parties use to describe the grant of royalty:

> AND WHEREAS the Grantor has agreed to ... grant to the Royalty Owners a Three (3%) percent *gross overriding royalty on all petroleum substances recovered from the lands* ...
>
> **2. Gross Overriding Royalty**
>
> The Grantor does hereby grant and assign to the Royalty Owners a Three (3%) percent gross overriding royalty out of the 94.4% interest of the Grantor *in all petroleum substances found within, upon or under the lands* ...
>
> **3. Royalty Provisions**
>
> (a) The Royalty Owners' *share of production* shall be paid for ...
>
> (c) Notwithstanding anything to the contrary herein contained or implied Suffolk shall be entitled to use free *from the payment of the overriding royalty herein reserved such part of the production of petroleum substances* ...
>
> (d) Suffolk shall keep and maintain, at all times and from time to time, true and correct books, records and accounts *showing the quantity of the petroleum substances sold from each and every well drilled by it* upon the lands ... for the purpose of *ascertaining the quantity and nature of the petroleum substances sold from any well*.
>
> **4. Books And Accounts**

> Suffolk shall deliver and furnish to The Royalty Owners on or before the last day of each calendar month a complete statement or statements with respect to the *quantity and kind of the petroleum substances produced and saved* during the preceding calendar month *from the lands* ...
>
> **6. Performance Of License By Suffolk**
>
> Suffolk shall pay all rentals, royalties, taxes and charges payable under the License and as to *production from the lands*, and shall keep the License in good standing until surrender thereof as herein provided, but *nothing herein shall be construed as requiring Suffolk to conduct exploratory operations or to drill a well or wells on the lands* ...
>
> **15. Miscellaneous Provisions**
>
> (a) All terms and conditions of this Agreement shall run with and be binding upon the lands. [emphasis added]

40 In reading the agreement one is struck by the fact that the first reference to the nature of the interest to be conveyed used the expression "royalty on all petroleum substances recovered from the lands", not petroleum within, upon and under the lands, but, those substances "recovered" from the lands. The next reference, in para. 2, is to a royalty on "petroleum substances found". Again, the reference is not to petroleum substances within, upon or under the lands, but to substances "found" within, upon or under the lands. The other references in agreement are to royalty in terms of "a share of production", "petroleum substances sold", "petroleum substances produced". Taken as a whole, I am of the view that the agreement conveys a contractual right to the payment of a royalty on petroleum substances produced from the lands, that is, a share of the petroleum after it has been removed, rather than on interest in land.

41 In *Vanguard Petroleums v. Vermont*, Moore J., after reviewing the decision of Allen J.A. in *Emerald Resources Ltd. v. Sterling Oil Properties Mgmt. Ltd.* (1969), 3 D.L.R. (3d) 630 (Alta. C.A.), affirmed 15 D.L.R. (3d) 256 (S.C.C.), stated that the Court of Appeal in that case (p. 71):

> ... was of the clear opinion that, where the royalty relates to a share after the petroleum had been removed from the land, this is not an interest in land but is to be treated as personalty.

With respect, I share the same view.

42 One of the incidents of an interest in land one would expect to find in a royalty agreement intended to create an interest in land would be the right to the royalty holder to enter upon the lands to explore for and extract the minerals. A mere entitlement to an overriding royalty, without more, does not, in my view, carry with it the right to explore for oil and gas. In this case the royalty agreement specifically provides that "nothing herein shall be construed as requiring Suffolk to conduct exploratory operations or to drill a well on the lands". Thus the royalty holders could not themselves extract the oil and gas, nor could they require the grantor to drill a well for that purpose. In addition, I regard it as significant that the parties who drafted the royalty agreement now seek to use the agreement to impose obligations on the defendants who were not parties to the agreement and had no part in the drafting of it. Where that is the case, it is not unreasonable, in my view, to require that the language used show clearly that the parties intended the royalty to be an interest in land.

43 On reviewing the whole of the agreement and the circumstances in which it was made, I am persuaded that the royalty agreement in this case did not create an interest in land, but gave a contractual right to a payment calculated on production.

2. Was the grantors interest, out of which the royalty was carved, an interest in land?

44 In *Telstar Resources Ltd. v. Coseka Resources Ltd.* (1980), 12 Alta. L.R. (2d) 187 at 191, 24 A.R. 562 (C.A.), Morrow J.A. describes an overriding royalty as " 'a percentage carved out of the lessee's working interest' " or a " 'charge

on that working interest' ". If the interest, out of which the royalty is carved, is not itself an interest in land, then the royalty cannot be an interest in land.

45 When the royalty agreement was entered into, the grantor, Suffolk, had an interest in the farmout agreement from Imperial, and it had a natural gas licence from the Crown. At that time, Suffolk, which granted the royalty, did not have a lease, and it would not acquire a lease until it earned it by drilling a well. The farmout agreement stated that "if Suffolk drills the well to the contract depth", as required by the agreement, *then* Imperial would "convey to the Farmee an undivided sixty (60%) per cent of the Farmors' interest in the lands and the leases ... effective as of and from the release date of the rig used to drill the well to contract depth". The agreement went on to provide in para. 7(c):

> It is specifically understood by Farmee that if Farmee fails to complete ... the well ... Farmee has no interest whatsoever in the lands.

46 The effect of this was that Suffolk, at the time it granted the royalty, had the right to earn an interest in land by drilling a well, but it had not yet earned it. Suffolk did not acquire the lease until 13th August 1973, that is, more than two years after the royalty agreement was executed.

47 Insofar as the natural gas licence is concerned it did not create an interest in land in the grantor, Suffolk. The Natural Gas Licence Regula tions, 1962, Alta. Reg. 297/62, describe the rights which accompany a natural gas licence:

> 14. A licence conveys the right to drill a well or wells for natural gas that is the property of the Crown ... and the right to produce the same ...

48 In my view, a bare licence to drill and produce, in the hands of one who neither owns nor leases the lands or minerals, is not an interest in land.

49 The result is that when Suffolk granted the royalty it did not own an interest in land and could not, therefore, "carve out" or convey an interest in land to the plaintiffs.

50 Neither of the two conditions for the creation of an interest in land has been met: The language of the royalty agreement is not sufficiently precise to show an intention to create such an intent, and the grantor did not itself have an interest in land.

Did the gas block order alter or change the terms of the plaintiffs' royalty agreement?

51 Counsel for the plaintiffs submits that the issuance of the block order "pooled" the production from the Suffolk and TransAlta lands, and thereafter, natural gas should be treated as having come from the pool rather than from an individual well. The result, he says, is that the plaintiffs' royalties must be calculated not on the actual production from the Suffolk lands, as provided in the royalty agreement, but on a percentage of the pooled production from the entire block. In effect, he says that the block order constituted a compulsory unitization of the lands in the block.

52 The two most critical elements required for the unitization of a petroleum and natural gas area are:

53 1) The compulsory allocation of a percentage of the total amount of gas produced in the whole unit to individual parcels, or "tracts", of lands; and

54 2) A provision that previous contracts are deemed to have been amended by substituting for actual production the allocated percentage of the production from the entire unit. The issuance of the gas block order, in this case, did not achieve either of those requirements.

55 The operative part of the gas block order reads as follows:

1. The area outlined on the attachment to this order marked Appendix A to this order is a gas block, and shall be known as North Coleman Gas Block No. 1.

2. The application of Part 4 of the Oil and Gas Conservation Regulations for wells drilled or to be drilled for the production of gas from the North Coleman Rundle A Pool and the North Coleman Palliser A Pool in the North Coleman Gas Block No. 1 is suspended for the duration of the said block.

3. A well through which production is taken or will be taken from the said block shall be at least 800 metres from each other well producing from the same formation except the following wells which will produce at the interwell distance of 731 metres from each other:

4. A well through which production is taken or will be taken from the North Coleman Rundle A Pool and the North Coleman Palliser A Pool within the said block shall be at least 400 metres from the boundaries of the gas block.

5. The minimum distance provided in clause 3 shall be the minimum horizontal distance between the uppermost points of intersection of the well bores with the gas productive part of the pool, and the minimum distance provided in clause 4 shall be the minimum horizontal distance between the uppermost point of intersection of the well bore and the boundary of North Coleman Gas Block No. 1.

56 The Oil and Gas Conservation Act, s. 1(1)(*b*.1) defines "block" as follows:

(*b*.1) "block" means an area or part of a pool consisting of production spacing units grouped for the purpose of obtaining a common, aggregate production allowable.

57 The primary effect of this gas block order was to relieve against the necessity of imposing an off-target penalty on well 4-23.

58 Generally, a gas block order permits the board to determine the production of gas which will be allowed, on the basis of total production from the entire block, rather than for each individual well or production spacing unit. However, there is nothing in the board order itself, or in the Act or the regulations, which requires a percentage of the total production from the block to be allocated to each parcel of land in the block. Nor is there a formula setting out the basis on which such allocation could be made.

59 This absence of any provision for the compulsory allocation of production is especially significant when the gas block legislation is contrasted with the compulsory pooling powers of the board under s. 72 of the Oil and Gas Conservation Act. That section provides "for the alloca tion to each tract of its share of production ..." Section 76.3, which also deals with compulsory pooling, provides that the allocation is binding upon each owner "or anyone entitled to a contractual benefit through an owner". The absence of such provisions in the gas block order or in the legislation governing such orders leads me to the conclusion that the issuance of the gas block order did not affect a compulsory unitization of the block.

60 I am of the view that, in the absence of clear provisions in the block order or in the legislation, pooling production from the block, allocating a percentage of total production to individual parcels of lands, and providing that such allocation binds the owner, and those contracting with them, the plaintiffs' royalty continues to be payable on production from the Suffolk lands, as provided in the royalty agreement.

61 In the absence of clear contractual provisions or legislative authority, the courts will not amend existing arrangements between working interest owners and royalty holders. As stated by Chief Justice Smith in *Alminex Ltd. v. Berkley Oil & Gas Ltd.*, [1972] 6 W.W.R. 412 at 413:

> It appears clear to me that, in the absence of specific provisions to the contrary in the contractual arrangements [unit agreements], unitization of oil-producing lands does not modify the terms of an initial or basic document such as an oil lease or a farm-out agreement.

62 In my view the plaintiffs' rights are governed by the terms of the royalty agreement and their royalty remains payable on production from the Suffolk lands alone.

63 One of the fundamental difficulties which the plaintiffs face is that they are unable to show that they have any right, contractual or otherwise, to control the manner in which the owners of the lease arrange the production of natural gas from their lands. The royalty agreement makes no provision for such production controls, and states specifically that the royalty holders do not have the right to require Suffolk to explore or to drill wells on the land, nor is there any provision for shut in royalties, delay rentals or a minimum guaranteed royalty. It is not the function of the court to modify a bargain which has been reached, or to impose one which has not been achieved. As stated by Lord Atkin in *Bell v. Lever Bros. Ltd.*, [1932] A.C. 161 at 226 (H.L.):

> Nothing is more dangerous than to allow oneself liberty to construct for the parties contracts which they have not in terms made by importing implications which would appear to make the contract more businesslike or more just.

64 Further, the issuance of the gas block order did not change the way in which the wells in the gas block could be produced, except to avoid the threatened off-target production penalty on well 4-23. Prior to the block order the defendants could produce each of the wells at whatever rate they chose. After the gas block order was issued the defendants could still produce all the wells (including 4-23) at the rate they deemed appropriate. The only change was that the 4-23 well could be produced without being subject to a production penalty. This was, of course, a substantial benefit to the plaintiff royalty holders.

Misrepresentation as to common ownership

65 As I have concluded that the plaintiffs' royalty is not an interest in land, it is not necessary for me to deal with the plaintiffs' allegation that Coseka misrepresented the facts to the board when it stated in its application for the block order that the lands to be included have common working interest ownership. Having found that the royalty, in this case, is not an interest in land, the statement was an accurate representation of the facts.

66 In the result, I conclude that the plaintiffs are entitled to be paid their royalty on the actual production from the Suffolk lands as provided in the royalty agreement. The plaintiffs' action is dismissed. The defendants and the third and fourth parties will have their costs, to be taxed on col. VI of Sched. "C", including all proper disbursements, no limiting rule to apply, provided that the parties are at liberty to apply for further directions as to costs, if required.

Action dismissed.

TAB 4

2013 QCCA 1323
Cour d'appel du Québec

Anglo Pacific Group PLC c. Ernst & Young Inc.

2013 CarswellQue 11251, 2013 CarswellQue 7724, 2013 QCCA 1323, [2013] R.J.Q. 1264, 237 A.C.W.S. (3d) 28, J.E. 2013-1467, EYB 2013-225348

Anglo Pacific Group PLC, Appelante-intimée, c. Ernst & Young inc., Intimée-séquestre requérant, et 9261-0690 Québec inc., Mise en cause-intervenante, et Northern Star Mining corp. et Jake Resources inc., Mises en cause-débitrices

Thibault J.C.A., Morin J.C.A., Bouchard J.C.A.

Heard: 28 mai 2013
Judgment: 6 août 2013
Docket: C.A. Qué. Québec 200-09-007899-120

Counsel: *Me Sébastien Guy*, pour l'appelante
Me Alain Gaul, Me Hugo Babos-Marchand, pour l'intimée
Me Christian Roy, Me Caroline Légaré, pour la mise en cause 9261-0690 Québec inc.

Subject: Insolvency; Corporate and Commercial; Natural Resources; Property

***Thibault J.C.A., Morin J.C.A., Bouchard J.C.A.*:**

[UNOFFICIAL ENGLISH TRANSLATION]

1 The appellant is appealing from a judgment of the Superior Court, District of Abitibi, rendered on November 21, 2012 by the Honourable Ivan St-Julien J., who allowed the respondent's motion entitled *Motion Seeking the Authorization to Sell Property of the Debtors and the Issuance of a Vesting Order*. Accordingly, St-Julien J. authorized the respondent to sell the property of the debtors, Northern Star Mining Corp. and Jake Resources Inc., and issued a vesting order under which the property acquired by the impleaded party 9261-0690 Québec inc. was free of the charges listed in the conclusions of his judgment, more particularly those resulting from a debenture, a royalty agreement and two universal hypothecs entered into between the appellant and the debtors on August 28, 2009.

2 For the reasons of Thibault J.A., to which Morin and Bouchard JJ.A. subscribe, *THE COURT*:

3 *DISMISSES* the appeal and the motion for leave to appeal *de bene esse*, with costs.

3 (s)

***Thibault J.C.A.*:**

4 The appellant is appealing from a judgment of the Superior Court, District of Abitibi, rendered on November 21, 2012 by the Honourable Ivan St-Julien J.,[1] who allowed the respondent's motion entitled *Motion Seeking the Authorization to Sell Property of the Debtors and the Issuance of a Vesting Order*. Accordingly, St-Julien J. authorized the respondent

to sell the property of the debtors, Northern Star Mining Corp. (NSM) and Jake Resources Inc. (JRI), and issued a vesting order under which the property acquired by the impleaded party 9261-0690 Québec inc. was free of the charges listed in the conclusions of his judgment, more particularly those resulting from a debenture, a royalty agreement and two universal hypothecs entered into between the appellant and the debtors on August 28, 2009.

5 The appeal addresses the issue of the nature of a debenture and a royalty agreement entered into in the context of Québec mining law, and their survival when the holder of a mining right declares bankruptcy. It is a matter of determining whether those acts constitute a real right, whether their registration in the public register of real and immovable mining rights (hereinafter referred to as the "mining register") means they are enforceable against third parties, and whether they survive a vesting order issued pursuant to the *Bankruptcy and Insolvency Act*[2] (hereinafter referred to as the "BIA"). Another aspect of the appeal concerns whether the two universal hypothecs granted the appellant survive the vesting order.

1- The facts

6 On August 28, 2009, the appellant, a royalty company, and the debtors,[3] companies operating in the gold exploration sector in Val-d'Or, signed a debenture (*Senior Secured Convertible Debenture*) by which the appellant granted the debtor NSM a loan of $8 000 000. Since the debtors' property was already charged by way of securities in favour of first ranking secure creditors, the appellant required, as a condition of the loan, that the debtors grant it a perpetual royalty, which is described in a royalty agreement attached to Appendix 1 of the debenture. Furthermore, the debenture was guaranteed by two universal second hypothecs, in favour of the appellant, on all the movable and immovable property of the debtors.

7 On August 31, 2009, the appellant published the second hypothecs in the land register, the mining register and the register of personal and movable real rights (hereinafter referred to as the "RDPRM"). On August 27 and September 14, 2010, it published the debenture, including the royalty agreement, in the mining register under registration numbers 53572 and 53585.

8 On August 18 and 19, 2010, the debtors filed a notice of intent to make a proposal to their creditors pursuant to the BIA. The deadline for filing a proposal was extended several times until January 24, 2011. On that date, the debtors did not file a proposal and they did not seek an additional period of time to do so, with the result that they were deemed to have assigned their property that day. Samson Bélair/Deloitte & Touche was appointed trustee for the debtors' assets.

9 On February 4, 2011, Computershare Trust Company of Canada, trustee of the first ranking secure creditors, filed a motion to appoint the respondent as receiver for the debtors' assets. The motion was allowed on February 21, 2011 in a judgment that was rectified on February 24, 2011.

10 On June 22, 2011, the respondent filed a motion for authorization to acquire the mining claims in the name of the debtor NSM. On June 27, 2011, the authorization was granted. The respondent acquired new claims through a loan of $635 951.25 from the first ranking secure creditors. On January 16, 2012, the ministère des Ressources naturelles et de la Faune confirmed the transfer of the new claims.

11 On February 2, 2012, the respondent filed a motion to authorize a procedure for the sale of the debtors' assets. The motion was allowed on February 13, 2012. The trial judge authorized the sale of the debtors' assets according to the *Procedure for the sale process*. That document provided for a detailed procedure. Announcements were published in five newspapers and offer letters were sent to more than 650 business corporations.

12 The February 13, 2012 judgment authorizing the sale procedure preserved the creditors' rights:

> CONSIDERING that this Order shall in no way prejudice or limit the right of any stakeholder to make representations as to the scope or the effect of a prospective vesting order to be sought by the Receiver; . . .

13 On February 22, 2012, the attorneys for the appellant wrote to the respondent. According to them, the royalty agreement constituted real rights that survived the sale of the debtors' assets. The documents related to the royalty agreement were in fact part of the information disclosed to the potential buyers for their due diligence.

14 On June 19, 2012, the respondent filed a motion entitled *Motion seeking the authorization to sell property of the debtors and the issuance of a Vesting Order*. It sought authorization to sell the assets of the debtors to the impleaded party according to the conditions provided for in a document entitled *Amended Offer*. It also sought the striking of the claims and charges affecting the debtors' assets (except those listed in the conclusions).

15 The sale procedure authorized by the trial judge in his judgment of February 13, 2012 allowed 55 business corporations to show their interest in acquiring the debtors' assets. Among them, five filed a purchase offer, four of which were deemed compliant. The offer of the impleaded party proved to be well above the others. The main conditions of the sale are described in the motion:

> 37. The material terms of the transaction, as set out in the Offer, as such Offer was later amended (the "Transaction") are as follows:
>
> (i) The Purchaser will assume and pay, perform and discharge, the Assumed liabilities (as such term is defined in the Offer). The Assumed Liabilities consist mainly of 1) the charge created in favour of the trustee to the notices of intention of the Debtors pursuant to a rectified judgment rendered on October 28, 2010 in the present matters, 2) the charges set out in sections 14.06(7), 81.4 (4) and 81.6 (2) *BIA*, 3) the "Receiver's Charge" created pursuant to a judgment rendered on February 21, 2011 in the present matters, 4) the Legal Hypothecs without any admission on each case of their validity and opposability and limited to the immoveable concerned, 5) the "Receiver's Borrowing Charge" created pursuant to a judgment rendered on February 21, 2011 as modified by a judgment rendered June 28, 2011 in the present matters, 6) the municipal and school taxes owed by either one of the Debtors (the "Property Taxes"), subject and limited to the Property Taxes that are secured by a charge with a prior ranking over the Secured Notes and 7) the unpaid source deductions on the salaries paid to the Debtors' employees (the "Unpaid Deductions"), subject and limited however to the Unpaid Deductions that are secured by a charge with a prior ranking over the Secured Notes and only to the extend that the proceeds of the Accounts Receivable (as such term is defined in the Offer) would not be sufficient to enable the Receiver to pay its fees and disbursements and the Unpaid Deductions;
>
> (ii) The Purchaser will pay to the Receiver by way of a Credit Bid (as such term is defined in the Sale Procedures) an amount of US$41,356,783.35 of the Secured Notes and an amount of CA$538,896.09 (with interest thereon, representing an aggregate amount of CA$643,216.65 in principal and interest accrued to May 8 th , 2012) of the Receiver's Borrowing Charge, plus any applicable sale taxes;
>
> (iii) The Purchased Assets shall not include the goods subject to a third-party ownership and all accounts receivable, including cash, deposits and prepaid expenses;
>
> (iv) The Purchased Assets are being sold on an "as is, where is" basis.
>
> [*sic*]

16 The appellant did not contest the conclusions related to the sale of the debtors' assets or the striking of certain claims listed in the motion. It also consented to the sale having the same effects as a sale by judicial authority within the meaning of the *Civil Code of Québec*. It opposed, however, the conclusions related to the striking of its claims, as published in the land register, the mining register and the RDPRM.

17 On July 16, 2012, with the consent of the appellant and the respondent, the trial judge rendered judgment. In a first stage, he pronounced the uncontested conclusions of the respondent's motion. He authorized the sale of the debtors'

property to the impleaded party according to the conditions of the *Amended Offer*. He declared that the sale had the effects of a sale by judicial authority within the meaning of the *Civil Code of Québec*. Lastly, he reserved the rights of the appellant:

> [17] **DECLARES** that notwithstanding paragraphs 12 (d) and 16 herein, nothing in the present order shall affect:
>
> a) The Anglo-NSR Obligations;
>
> b) The net smelter return royalty granted in favour of Anglo by the Debtor Northern Star Mining Corp. and registered at the Public Register of Real and Immovable Mining Rights under 53572, as amended under number 53585 (the "**Anglo NST Royalty**"); and
>
> c) The Encumbrances granted by the Debtors to secure the Anglo NSR Obligations, namely:
>
> • The deed of hypothec registered by Anglo at the Land Registry for the Registration Division of Abitibi under numbers 16 505 699 and 16 505 700;
>
> • The deed of hypothec registered by Anglo at the Public Register of Real and Immovable Mining Rights under numbers 53154 and 53155; and
>
> • The deed of hypothec registered by Anglo at the Register of Personal and Movable Real Rights under numbers 09-0536464-0001 and 09-0536464-0004;
>
> (hereinafter collectively defined as the "**Anglo Security**");
>
> For greater clarity, save for the Anglo-NSR Obligations and the related Anglo Security, no other obligations between any of the Debtors and Anglo arising from any agreement will benefit from the exception provided in this paragraph;

18 On November 21, 2012, the trial judge dismissed the appellant's contestation. In that second stage, he issued a vesting order in favour of the impleaded party 9261-0690 Québec inc. as acquirer of the debtors' property, an order in which the appellants' rights were discharged. He also ordered the provisional execution of his judgment.

19 On November 27, 2012, the appellant filed a notice of appeal in accordance with subsections 193(*a*) and (*c*) of the BIA, and a motion to suspend the provisional execution ordered by the trial judge. On November 30, 2012, it filed a motion for leave to appeal *de bene esse* from the judgment in first instance in order to avoid contestation of the validity of its notice of appeal. On December 6, 2012, the motion for suspension of provisional execution was allowed and the motion for leave to appeal *de bene esse* was postponed *sine die*. [4]

2- Judgment in first instance

20 The judge analyzed the debenture and the royalty agreement in order to decide whether the debtors charged their property with a real right in favour of the appellant. First, he concluded that the contracts entered into did not give the appellant a direct right of enjoyment in the "Products" or "Properties" of the debtors. Second, he affirmed that the non-existence of such a right in the property prevented the creation of a real right, as the Court stated in *Épiciers Unis Métro-Richelieu Inc. v. The Standard Life Assurance Co.* [5] According to the judge, the debtors could also not charge the underground mineral substances with a conventional hypothec since they belonged to the domain of the State. [6]

21 The judge stated that, regardless of the nature of the rights granted the appellant in the debenture and the royalty agreement, their registration in the mining register did not make them enforceable against third parties. Rather, according to him, section 14 of the *Mining Act* [7] created a means whereby the registration was enforceable against the State only.

For these rights to be enforceable against third parties, they would have to have been published in the land register and in the RDPRM.

22 Lastly, the judge studied the effects of the vesting order pronounced under section 243 of the BIA. He indicated that the order had the same effect as a sale by judicial authority, i.e. it discharged the real rights to the extent provided for in the *Code of Civil Procedure*. According to article 696 of the *Code of Civil Procedure*, the sheriff's sale discharged the real rights not included in the sale conditions, with the exception of those listed in that provision. Since the debenture and the royalty agreement evidenced the existence of a personal obligation between the appellant and the debtors, not the granting of a real right, they were not contemplated by the exceptions provided for in article 696 of the *Code of Civil Procedure* and, therefore, did not survive the vesting order.

3- Questions in dispute

23 Three questions emerge from the examination of the arguments submitted by the parties:

1. Do the debenture and the royalty agreement entered into between the debtors and the appellant on August 28, 2009 constitute an innominate real right in favour of the appellant?

2. Does the registration of the debenture and the royalty agreement in the mining register make those acts enforceable against third parties?

3. Do the rights resulting from the debenture and the royalty agreement survive the vesting order?

4- Analysis

24 Before studying the questions in dispute, I would like to point out that, according to clause 9.12 of the debenture, [8] the parties explicitly agreed that the debenture must be interpreted according to, and governed by, the laws of Québec.

4.1 Existence of an innominate real right

25 The appellant argued that the trial judge erred in refusing to acknowledge that it held an innominate real right on the "Products" and "Properties" defined in the debenture. [9] Its argument was based on five elements, which I summarize as follows.

26 *First*, it contended that the constitution of an innominate real right depends on the parties' intention. It referred to the Court's ruling in that regard in *Club Appalaches inc. v. Québec (Attorney General)* [10] in order to affirm that the determination depends on the analysis of the parties' intention, their conduct, the circumstances in which the act was concluded and custom. To determine whether the parties intended to create an innominate real right, it must be determined whether the parties sought to: (1) create a permanent right, (2) bind their heirs, assigns and successors (right of pursuit) and (3) attribute a value to the right involved.

27 According to the appellant, clauses 4.3, 9.15, 9.16 and 9.18 of the debenture and clause 2.1 of the royalty agreement allows one to determine that the three conditions were met. [11] It pointed out that the constitution of the perpetual royalty and its nature as a real right were the essential conditions for the financing granted the debtors. It also insisted on the fact that custom in the mining industry created, for the parties involved, a legitimate expectation that such agreements would be respected despite a change of owner. In support of its contentions, the appellant cited the following excerpt from the work entitled *Canadian Law of Mining*:

> Oil and gas cases will be considered by the courts in any analysis of hardrock mineral royalties, nothwithstanding the differences between the industries. . . .

> Indeed, it makes a certain amount of sense to ask that a royalty, in order to qualify as an interest in land, be adequately associated with the land from which it is carved just as a rentcharge is connected with the land by virtue of the remedy of distress. A royalty should be tied directly to the minerals that exist in and are produced from a specific parcel of land. The tie or connection should be made with mineral operations on the land no matter who carries them out. It should not depend upon the identity or character of the person conducting the operations. Thus, a net smelter royalty may be much more of an interest in land than a net profits interest, for the latter depends very much on the profit-making and cost-containment abilities of the operator.
>
> It would be no bad thing if the development of judicial policy on royalties should give conscious attention to the needs of business efficacy and fairness as well as those of stability in property law. The circumstances in which people accept royalties would be relevant. They often accept them as partial consideration in a property transaction and know that it may be some time and several operators before a property comes into production. Industry expectations also would be relevant; although they are not the source of legal obligation, they can hardly be disregarded in deciding which is the better direction to develop legal principles. In many circumstances, there may be a clear expectation that a person who acquires a mineral property knowing it is subject to a royalty should pay the royalty; and that royalty-holders should be entitled to a payment if and when the property comes into production, no matter who owns it. Over time, a perception may grow that justice is not well served by rules that excuse the owner from paying the royalty. [12]
>
> [*sic*]

28 *Second*, the appellant proposed that the fact that the royalty is calculated in cash is not an obstacle to the creation of an innominate real right. In its opinion, the trial judge confused the nature of the royalty and the manner in which it is calculated. That misconception was said to be based on an erroneous interpretation of clause 9.15 of the debenture and of the definition of the term "Properties" in clause 1.1.53 of that act:

> 1.1.53 **Properties**" means the rights, present and future, to conduct Exploration, Development and Mining within the geographic locations identified in Schedule 3, including for greater certainty as of the date hereof the Existing Claims, and any rights substituted for such rights or issued as a consequence of such rights, whether extending over a greater or lesser area and including all related rights with respect thereto;
>
> . . .
>
> 9.15 Nature of Interest. All covenants, conditions, and terms of this Debenture (including the Net Smelter Return Royalty) shall: (a) be of benefit to and run as a covenant with the Properties; (b) create a direct real property interest in the Products and the Properties in favour of the Holder, sufficient to secure the payments herein provided for, and shall attach to (i) any amendments, relocations, adjustments, resurvey, additional locations or conversions of any mining claims comprising the Properties; and (ii) to any renewal, amendment or other modification or extensions of any leases of any real property interests comprising the Properties, and shall inure to the benefit of and be binding upon the parties hereto, and their respective successors and assigns, including, without limitation, partners, joint venture partners, lessees and mortgagees. Nothing herein shall be construed to create, expressly or by implication, a joint venture, mining partnership, commercial partnership, or other partnership relationship between the Corporation or the Pledgor on one hand and the Holder on the other hand.

29 Also in regard to the second argument, the appellant pleaded that a mining claim is an immovable real right and, as such, constitutes separate property. The claim gives its holder the right to obtain a mining lease if certain conditions are met, and the obtaining of a mining lease gives its holder the rights of an owner.

30 The calculation formula provided for in the royalty agreement does not change the direct relationship between the appellant and the "Properties". Rather, it imposes on the holder of the mining claim the obligation to perform [TRANSLATION] "a service" for the benefit of the creditor.

31 *Third*, the appellant affirmed that the parties can grant an innominate real right over incorporeal property. Here, it is the "Properties", i.e. the existing claims (more than 290), as well as the mining rights substituted for them, resulting from them or otherwise related to them, for the four different projects: Midway, Callahan, McKenzie Break and Fournière. The appellant pointed out that the notion of property refers to both corporeal and incorporeal property (art. 899 C.C.Q.). For example, it refers to a movable hypothec on claims (arts. 2710-2713 C.C.Q.) and a movable hypothec on securities (arts. 2714.1-2714.7 C.C.Q.).

32 *Fourth*, the appellant firmly opposed the idea that the absence of a right of enjoyment in a thing prevents the creation of an innominate real right. That theory, developed by Professor Madeleine Cantin Cumyn, [13] is based on article 405 of the *Civil Code of Lower Canada*:

> **Art. 405.** A person may have on property either right of ownership, or a simple right of enjoyment, or a servitude to exercise. [Emphasis added.]

33 But article 911 of the *Civil Code of Québec* does not make that distinction, with the result that it is no longer necessary to grant a right of enjoyment in property in order to create a real innominate right:

> **911**. A person, alone or with others, may hold a right of ownership or other real right in a property, or have possession of the property.
>
> A person also may hold or administer the property of others or be trustee of property appropriated to a particular purpose.

34 *Fifth*, the royalty agreement grants the appellant a real right in the "Products", i.e. in the substances extracted, which must be considered movables by anticipation. A mining claim grants its holder the right to obtain a mining lease, which gives the holder the rights of an owner.

35 To answer the question posed in this section, I propose to (1) define the characteristics proper to a real right constituted by innominate dismemberment, (2) ascertain the capacity of the debtors to constitute a real right in favour of the appellant, and (3) study the debenture, the royalty agreement and the circumstances surrounding their drafting in order to define the nature of the rights granted the appellant and decide whether the debtors granted it an innominate real right.

4.1.1 Characteristics proper to a real right

36 Civil law is a complete system, and care must be taken not to adopt principles from foreign legal systems without questioning their compatibility with our law. [14] That word of caution is required because the appellant seeks to indirectly import certain common law notions applicable to mining royalties. [15]

37 The appellant argued that it holds an innominate real right both in the mining rights (mining lease claim), which are incorporeal property, and in the substances to be extracted, which are corporeal property, and that such a right does not require it to hold a [TRANSLATION] "right of enjoyment" on the property. According to the appellant, that requirement, which stems from article 405 of the *Civil Code of Lower Canada*, was not included in the *Civil Code of Québec*. An innominate real right is constituted, it wrote, when the parties to the act intend to (1) create a permanent right, (2) bind their heirs, assigns and successors (right of pursuit) and (3) attribute a value to the right involved.

38 In my opinion, the appellant committed an error of principle at the stage of identifying the conditions required to constitute an innominate real right, and that distorts its argument. Let me explain.

39 The main distinctions between a personal right and a real right can be summarized as follows. A personal right (an *in personam* right) is the right of a person to require a prestation by another person. [16] Although that right may involve property, it is exercised against a person: it is not a right on a thing, but a right to a thing, [17] in contrast to a real right, which is enforceable against third parties, subject to the rules of publication. [18] A personal right is called [TRANSLATION] "relative" because it binds only the creditor and the debtor. [19] The creditor of a personal right holds no right of pursuit or right of preference in the thing. [20]

40 Conversely, a real right gives its holder a power that can be exercised directly on property. [21] There is no intermediary between the holder of the right and the property. A real right gives its holder a right to pursue the property (right of pursuit) and to enforce the right against any person in whose hands the property may be found. [22] It also gives its holder the capacity to abandon the right and, in the case of accessory real rights, a right of preference. [23]

41 The right of ownership is the most complete real right. [24] Article 947 of the *Civil Code of Québec* defines ownership in the following manner:

> **947.** Ownership is the right to use, enjoy and dispose of property fully and freely, subject to the limits and conditions for doing so determined by law.
>
> Ownership may be in various modes and dismemberments.

42 The right of accession (*accessio*) is added to those prerogatives:

> **948.** Ownership of property gives a right to what it produces and to what is united to it, naturally or artificially, from the time of union. This right is called a right of accession.

43 According to authors Lafond, Lamontagne and Normand, *usus* is the right to use property and the right to enjoy it; *fructus* is the right to benefit from property, to receive its fruits (that which is produced by growing) and products (for example, trees and ore); *abusus* is the right to dispose freely and completely of the property, both physically and legally; *accessio* is the ability to make one's own that which the property generates and that which is attached to it (for example, deposits and islands).

44 Article 911 of the *Civil Code of Québec* states that a person can hold a right of ownership in a property. As article 947 of the *Civil Code of Québec* indicates, the right of ownership concerns property (not only a thing, as provided for in article 406 of the *Civil Code of Lower Canada*). [25] Property can be corporeal or incorporeal, and is divided into movables and immovables (art. 899 C.C.Q.). [26]

45 For some authors, the classic and materialistic conception of ownership is outdated. [27]

46 The question as to whether ownership can refer to incorporeal property under the *Civil Code of Québec* has been the subject of numerous commentaries in legal theory. [28] The Québec legislator is said to have opened the door to a shift in paradigm by substituting the word "property" for the word "thing" in the definition of ownership (art. 947 C.C.Q.), by stating what the specific dismemberments of ownership are (art. 1119 C.C.Q.) and, more generally, by more broadly recognizing that real rights can concern rights (a movable hypothec on debts is one example).

47 Some authors believe that the word "property" in article 899 of the *Civil Code of Québec* refers only to corporeal or tangible things. [29] Others believe that the use of the word "property" in article 947 of the *Civil Code of Québec* could be more the result of a terminological choice than of a determination to accept that the object of ownership can be made intangible. [30] Authors Normand, Lamontagne and Emerich come down in favour of recognition of the ownership of incorporeal property, [31] while author Brierley does not appear to have closed the door on that possibility. [32]

48 Regarding Québec mining rights, sections 8 and 9 of the *Mining Act* provide for the following:

8. The mining rights conferred by the following titles are immovable real rights:

- claims;
- mining exploration licences;
- mining leases;
- mining concessions;
- seabed exploration licences;
- seabed mining leases;
- exploration licences for surface mineral substances;
- leases to mine surface mineral substances;
- licences to explore for petroleum, natural gas and underground reservoirs;
- leases to produce petroleum and natural gas;
- authorizations to produce brine;
- leases to operate an underground reservoir.

9. Every real and immovable mining right constitutes a separate property.

49 The rights listed in section 8 of the *Mining Act* are evidently incorporeal rights. Section 9 sets out, however that all mining rights, real and immoveable constitute "separate property". The English version of this article states as follows: "Every real and immovable mining right constitutes a separate property".

50 The English version of the French expression "propriété distincte" is "separate property", envisions a distinct property and not strictly a separate right of ownership. Bear in mind here that, in article 899 of the *Civil Code of Québec*, the English version of the French word "bien" is "property". However, in article 947 of the *Civil Code of Québec*, the English version of the French word "propriété" is "ownership".

51 According to authors Lamontagne and Brisset des Nos, who are no doubt aware of that distinction, "separate property" must be understood in the following manner:

> [TRANSLATION]
>
> . . . according to section 9, mining rights constitute "separate property" in that they affect the subsurface independently of the surface, as the disposition of surface rights does not include mining rights — except, by accessory means, those related to the lower mineral substances — and vice versa. [33]

52 The Québec legislator thus provided for a specific mining rights regime by giving those rights the quality of "separate property" within the above meaning.

53 In my opinion, given the provisions of the *Civil Code of Québec* and the *Mining Act*, ownership refers both to corporeal and incorporeal property inasmuch as the holder has all the attributes of ownership (*usus*, *abusus* and *fructus*):

> [TRANSLATION]
>
> The right of ownership necessarily concerns property that may be corporeal or incorporeal (intellectual rights, negotiable instruments and debts) (art. 899 C.C.Q.). Hence, the object does not include only tangible property, but property made intangible as well. That observation stems from substitution of the word "property" for the word "thing" — a notion traditionally reserved for what has a tangible existence only — in the definition of ownership as it appeared previously in the *Civil Code of Lower Canada*.
>
> The conclusion must not be drawn from that change that any property — and, above all, any right — has the required qualities to become the object of a right of ownership. The object must be sufficiently individualized to have its own identity. Furthermore, its holder must have — or at least be able to claim to have — all the attributes of ownership (*usus, fructus, abusus* and *accessio*) on the property. [34]

54 Ownership can be dismembered. Dismemberment occurs when two or more people each have one or more attributes of the right of ownership — the right of use (*usus*), of enjoyment (*fructus*) and of free disposition (*abusus*) — of the same property, but do not possess all of them. [35] According to Professor Sylvio Normand, dismemberment of ownership [TRANSLATION] "causes a division of the body of ownership attributes, with the result that one or more of the attributes inherent in the right of ownership shifts to the hands of another person, the holder of the dismemberment". [36]

55 Article 1119 of the *Civil Code of Québec* explicitly provides that usufruct, use, servitude and emphyteusis are dismemberments of the right of ownership and are real rights. In each of these cases, the holder of the dismemberment of the right of ownership enjoys certain attributes of ownership. The usufrutuary has "the right of use and enjoyment, for a certain time, of property owned by another . . ." (art. 1120 C.C.Q.). The user has "the right to enjoy the property of another for a time and to take the fruits . . . thereof" (art. 1172 C.C.Q.). Emphyteusis is "the right which, for a certain time, grants a person the full benefit and enjoyment of an immovable owned by another . . ." (art. 1195 C.C.Q.). A servitude is a charge imposed on an immovable — the servient land — that requires the owner of the land to tolerate "certain acts of use by the owner of the dominant land or himself abstain from exercising certain rights inherent in ownership" (art. 1177 C.C.Q.). In each of these situations, the owner of the property and the holder of the dismemberment share the attributes of ownership as long as the dismemberment lasts:

> [TRANSLATION]
>
> *Usufruct* is the right to temporarily use and enjoy property belonging to another. It transmits to its holder the *usus* and the *fructus*, while the owner retains the *abusus* and the *accessio* (art. 1120 C.C.Q.). *Use*, which is reduced usufruct, allows its holder to use the property of another, for a certain time. It limits the right to the fruits and revenues to the extent of the needs of the user and the persons living with the user or the user's dependants. The user has only limited *usus* and *fructus* (art. 1172 C.C.Q.). A *servitude* is a charge imposed on an immovable in favour of another immovable; it grants limited *usus* (art. 1177 C.C.Q.). Lastly, emphyteusis allows the holder to fully use an immovable belonging to another and to derive all its benefits provided the holder makes improvements to it. That dismemberment shifts virtually all the attributes of ownership to the holder of the emphyteusis, and the owner retains only a facet of *accessio* (art. 1195 C.C.Q.). [37]

56 The courts and doctrine also recognize that ownership can be the object of conventional innominate dismemberments. [38] For example, the right to fish, the right to hunt and the right to log have been qualified as such because their holders have an unnamed [TRANSLATION] "right of enjoyment" on property:

> [TRANSLATION]
>
> The right to innominate enjoyment on property allows a person — not an immovable — to derive the benefit from property belonging to another person. Its holder derives a direct benefit from the recognized right. That right can take various forms. The examples provided by the jurisprudence and doctrine are frequently akin to nominate dismemberments. However, for various reasons, that qualification has proven impossible.
>
> Thus, the right to fish and the right to hunt cannot be considered a usufruct, since wild animals are not fruits of the forest or the sea. The usufruct qualification is hardly more suitable for the right to log or the right to extract certain substances from the ground, since wood and minerals are products, not fruits. Furthermore, although this is rare, a right of way can be granted in favour of a person, not in favour of an immovable, thereby making the qualification as a servitude impossible. The qualification as an innominate dismemberment could be suitable for a contract of emphyteusis, but a crucial element for its constitution would be missing.
>
> Innominate dismemberment that grants a right of enjoyment was wrongly presented as a change in servitude [TRANSLATION] "midway between a real servitude and a personal obligation". Doctrine authors are in fact used to qualifying innominate dismemberments as personal servitudes and dealing with the subject in a chapter they devote to servitudes. However, personal servitudes are associated with real rights, not personal rights. Moreover, that category is in opposition to the category of [TRANSLATION] "real" servitudes. To eliminate any confusion, it would be preferable to avoid using the expression [TRANSLATION] "personal servitudes" — although it is wholly justifiable — and substitute for it one of the following expressions: innominate dismemberments of ownership, innominate rights of enjoyment or innominate real rights. [39]

57 The appellant argued that the interpretation of author Cantin Cumyn that the holder of an innominate real right must justify a [TRANSLATION] "right of enjoyment" on the thing was not retained in Québec jurisprudence. [40] According to the appellant, for a real right to be created, it is sufficient to grant a permanent right on an immovable, to bind a person's heirs and to attribute a value to the right involved. As I wrote earlier, when the author wrote her paper, article 405 of the *Civil Code of Lower Canada* prescribed the following:

> **Art. 405.** A person may have on property either a right of ownership, or a simple right of enjoyment, or a servitude to exercise. [Emphasis added.]

58 The appellant is wrong. Article 911 of the *Civil Code of Québec*, despite formulating the above article differently, did not change the state of the law regarding the attributes of ownership and its dismemberments. That is what the comments of the Minister show:

> [TRANSLATION]
>
> That article retains the substance of article 405 of the *Civil Code of Lower Canada*, from the standpoint of the relations that may exist between a person and property. It provides that a person can be the holder of a real right other than that of ownership, such as a right of usufruct or a real security, and can be the holder of the rights listed, alone or with others, to cover the cases of co-ownership. [41]

59 And that is also shown by the text of article 947 of the *Civil Code of Québec*, cited earlier.

60 A real right requires the existence of a direct right on property. The expression [TRANSLATION] "simple right of enjoyment" in article 405 of the *Civil Code of Lower Canada* referred to one or more of the three attributes related to

ownership — the right to use, enjoy and freely dispose of — transferred by the owner to a third party that then becomes the holder of a real right, i.e. a dismemberment, in the thing of another person. Those attributes subsist under the *Civil Code of Québec* and, for dismemberment of a real right to occur, one or more of them must be assigned by the owner.

61 To underpin the idea that a real right requires a legal relationship between a person and property, I refer to *Sacchetti v. Lockheimer*, in which the Supreme Court wrote the following:

> A real right is a legal relationship between a person and a thing: it gives its holder a direct and immediate legal power over the thing, a power which he exercises without intermediary. If principal (the right of ownership and its components), it relates to the physical aspect of the thing; if accessory (such as a hypothec, pledge or privilege), it concerns the monetary value of the thing as a guarantee of the performance of a principal obligation. The attributes of the real right are the right of pursuit and the right of preference, as well as possession and the right of abandonment. [42]

62 In *Haddad v. Groupe Jean Coutu (PJC) inc.*, Kasirer J.A. wrote the following:

> [TRANSLATION]
>
> [76] The charge also cannot be considered a personal servitude in the circumstances since it gives no right of enjoyment to PJC or its franchisees on the Haddad immovable. As Rochette J.A. explained in *Épiciers Unis*, such a charge is not exercised directly on a thing and therefore cannot constitute a real right, even as a personal servitude. Despite the terms used in the act, the clause imposes only a personal obligation on Mr. Haddad to comply with the non-competition commitments contracted to the benefit of his PJC. [43]

63 I conclude that the holder of a real right constituted by the dismemberment of an innominate ownership right, such as a mining claim or lease, must necessarily and obligatorily justify a direct right in the property (both corporeal and incorporeal) — the right to use, enjoy or dispose of the property — in addition to the right of pursuit and the capacity to abandon the property.

64 At this stage in the analysis, the rights of the debtors should be examined and their capacity to constitute an innominate real right in favour of the appellant should be ascertained.

4.1.2 Capacity of the debtors to constitute an innominate real right

65 The *Mining Act* provides the legal framework in which the Québec mining industry operates. The object of that legislation is to promote Québec mineral prospecting, exploration and mining. [44] Section 3 provides, subject to sections 4 and 5, that the rights to mineral substances and underground reservoirs form part of the domain of the State. [45]

66 The regime provides that, to mine the mineral substances (with the exception of some of them), the operator must obtain a mining lease from the State. [46] A claim is generally obtained beforehand. [47] A claim is a title, limited in time (two years, unless renewed) that gives its holder an exclusive right to engage in the limited exploration for certain mineral substances, a limited right to extract the mineral substances and a right to a mining title, i.e. a mining lease. [48] A mining lease gives the operator the rights and obligations of an owner, particularly the right to mine and extract mineral substances, [49] under certain restrictions. A mining lease is granted to the claim holder if the holder establishes the existence of indicators of the presence of a workable deposit, and if the holder meets the requirements and pays the annual rental prescribed by regulation. [50] The term of a mining lease is 20 years. It can be renewed for ten years, under certain terms and conditions, three times, under the conditions determined by the Minister. [51] Without a mining lease, a claim holder may not mine the mineral substances.

67 Section 8 of the *Mining Act* provides that a mining claim and lease are immovable real rights. A mining lease creates a dismemberment of the right of ownership of the subsoil that is part of the domain of the State. The dismemberment necessarily ends upon expiry of the lease or its revocation. [52] That *sui generis* immovable real right is akin to emphyteusis, according to authors Lamontagne and Brisset des Nos, [53] since, for the duration of the lease, the leasee has the rights and obligations of an owner, subject to the restrictions of Division V of the *Mining Act*. [54] Except as regards the minerals extracted and the mining tailings, the lessee does not in fact acquire a right of ownership to the soil or subsoil. [55]

68 The appellant contended that the real rights granted it by the debtors are the result of the claims that the debtors held. More specifically, it argued that the debtors instituted, in its favour, a conventional innominate dismemberment of their claims and the rights resulting from them, particularly mining leases. As I explained earlier, the *Civil Code of Québec* and the *Mining Act* authorize the dismemberment of property, which can be corporeal or incorporeal. The claim and the immovable lease, which are separate incorporeal property, can therefore be dismembered. That means that the holder of the claim or the mining lease can grant to a third party one or more of the attributes of ownership associated with the right held.

69 The dismemberment of the right of ownership stems from the exercise of *abusus*, which is linked, as explained earlier, to the right to dispose of one's property. [56] Hence, one must, in principle, hold part of the *abusus* in order to grant a third party a real right on property. For example, emphyteusis has the power to create a servitude on the property that is its object. [57] The holder of a mining lease, who has the rights and obligations of an owner, can dismember the right in favour of a third party for the duration of the lease (since more rights than one has acquired cannot be assigned) and grant the third party a real right in the mineral substances that its lease allows it to mine.

70 What about a claim? In the context of the *Mining Act*, the State is the owner of the right to the mineral substances. It is the State that dismembers its ownership right in favour of a person by attributing a claim to that person. Can the holder of the claim, which is a separate immovable real right, in turn dismember its ownership? The holder of a mining claim can, of course, exercise its right jointly with another person if they can organize the exercise of their right by means of an agreement that can be published. [58] A mining claim grants its holder the right to use the property and to explore for deposits. Those rights can be dismembered. However, the holder of a mining claim does not, at that stage, have a right on the mineral substances as the holder of a mining lease does. In that context, did the debtors have the capacity to grant the appellant a real right on the mineral substances likely to be extracted, should a deposit be discovered and a mining lease granted?

71 Yes, in my opinion. Although the law says nothing on that specific subject, I believe that the principles applicable to a hypothec granted by a non-owner must be adapted to the situation of a claim holder who grants a real right on extracted mineral substances of which it will become the owner after the granting of a mining lease. Bear in mind that, under the *Civil Code of Lower Canada*, the law declared null a hypothec on the property of another, subject to improvement of an insufficient title (art. 2043 C.C.L.C.). The *Civil Code of Québec* allows a hypothec on the property of another or on future property, but it specifies that the hypothec begins to affect the property only when the grantor acquires title to the hypothecated property (art. 2670 C.C.Q.).

72 Here is author Payette's explanation of the rules surrounding a hypothec granted by a non-owner:

> [TRANSLATION]
>
> *(a) Hypothec granted by a non-owner*
>
> **467.** As long as the grantor does not become the holder of the right on which the grantor created a hypothec, the hypothec does not affect the right (art. 2670 C.C.Q.). A hypothec created on the property of another does not affect it from the time of its creation, but is likely to affect it one day. It is incorrect to say that it is null; if it were, it would

> be difficult to explain how it began to affect the property from the day that the grantor acquired it or how it acquires rank on the movable property affected, upon its registration, although it was registered prior to the acquisition (art. 2954 C.C.Q.).
>
> Furthermore, the grantor must have the capacity to alienate the property hypothecated (art. 2681 C.C.Q.). However, even though a person does not yet have ownership of property, the person has the capacity to alienate it if the future property is likely to be the object of an obligation (art. 1374 C.C.Q.); in that case, there is a sale of property that is still non-existent or a sale of the thing of another; although the sale of the thing of another can be declared null, it becomes unassailable if the seller subsequently acquires ownership of the property (art. 1713 C.C.Q.). It is therefore more precise to say, paraphrasing the terms used by the legislator for the sale, that a hypothec on the property of another becomes unassailable on the day when the grantor becomes its owner.
>
> Under the *Civil Code of Lower Canada*, doctrine and jurisprudence attributed to the subsequent acquisition of an immovable the effect of improving the hypothec previously granted by the new owner; Québec law is said to be distinguished, on this point, from French law, certain texts of which differ from those found in the Code and led to the conclusion that a hypothec granted by a non-owner is absolutely null.
>
> Mention must also be made of certain circumstances in which the law allows the holder of a hypothec acquired in good faith on the property of another to enforce it against the true owner. [59]
>
> [References omitted.]

73 I note from the principles that prevailed under the *Civil Code of Lower Canada* and those applicable under the *Civil Code of Québec* that the validity of a real right granted by a non-owner is not challenged when the grantor becomes the owner of the hypothecated property.

74 At a time when mining law promises to be a driving force of the Québec economy, civil law must adapt to the economic and legislative reality associated with mining law, without undermining the foundations of property law and without overshadowing the conditions for constituting a real right. Civil law is sufficiently flexible to allow the holder of a mining claim — a potential owner of extracted mineral substances — to grant a real right, not only on the claim, but also on the extracted mineral substances over which the holder will obtain an ownership right after a mining lease has been granted.

75 Like the situation that prevails when a non-owner grants a hypothec on property before becoming its owner — a hypothec that will affect the property when the non-owner's ownership is confirmed — a claim holder can grant an immovable real right on extracted mineral substances of which the claim holder will become the owner after the granting of a mining lease. The immovable real right will then take effect when the right of ownership of the extracted mineral substances is confirmed. The subsequent coming into effect of the real right constituted by the claim holder carries with it the obligation for the parties to provide for a right of pursuit in the act instituting it and to publish the act.

76 Now let us see whether the terms of the debenture and the royalty agreement make it possible to conclude that the debtors instituted on the "Properties" and the "Products" a real right in favour of the appellant.

4.1.3 Do the debenture and the royalty agreement constitute a real right?

77 The creation of an innominate real right is not solely the result of the use of these terms in a contract. In addition, the contract must contain the essential characteristics of a real right. The characteristics are, as I wrote earlier, the attribution to the innominate real right beneficiary of one or more of the attributes of ownership — the right to use, enjoy and freely dispose of the property — as well as a right of pursuit on the property and the capacity to abandon it.

78 The only mention in clauses 9.15 and 9.17 of the debenture are alone insufficient to qualify the right to royalties as a real right, since the appellant was not granted a direct right in the property ("Properties" and "Products"), whether it be the right to use, enjoy or dispose of the property:

> 9.15 Nature of Interest. All covenants, conditions, and terms of this Debenture (including the Net Smelter Return Royalty) shall: (a) be of benefit to and run as a covenant with the Properties; (b) create a direct real property interest in the Products and the Properties in favour the Holder, sufficient to secure the payments herein provided for, and shall attach to (i) any amendments, relocations, adjustments, resurvey, additional locations or conversions of any mining claims comprising the Properties; and (ii) to any renewal, amendment or other modification or extensions of any leases of any real property interests comprising the Properties, and shall inure to the benefit of and be binding upon the parties hereto, and their respective successors and assigns, including, without limitation, partners, joint venture partners, lessees and mortgagees. Nothing herein shall be construed to create, expressly or by implication, a joint venture, mining partnership, commercial partnership, or other partnership relationship between the Corporation or the Pledgor on one hand and the Holder on the other hand.
>
> . . .
>
> 9.17 Mining Methods - No Implied Covenants. Each of the Pledgor and the Corporation and its Affiliates shall act reasonably in accordance with sound mining and engineering practices. Each of the Pledgor and or the Corporation shall do all things and make all payments necessary or appropriate to maintain the right, title and interest of the Pledgor and/or the Corporation in the Properties and the NSM Plant and to maintain the Properties and the NSM Plant in good standing, provided that each of the Pledgor and the Corporation shall have the sole and exclusive right to determine the timing and the manner of any production from the Properties and all related exploration, development, operational and mining activities, provided such determination is made in accordance with sound mining and engineering practices. Nothing in this Debenture shall require the Pledgor and or the Corporation to explore, develop or mine or continue operations on the Properties or to process ores from the Properties.
>
> [Emphasis added.]

79 According to the terms of the royalty agreement, the royalty payable was dependent on the sale of the mineral substances extracted or processed by the debtors (clauses 1.8 and 1.10 of the royalty agreement). [60]

80 The analysis of all the clauses of the acts in question, namely, the debenture and the royalty agreement, does not make it possible to conclude that real rights were created in favour of the appellant. The right resulting from the royalty agreement was a personal right to receive the payment of a royalty calculated according to the terms and conditions provided for in clauses 2.1 *et seq.*, [61] when the mineral substance was sold. Of course, the appellant had the right to inspect the premises (clause 5.3) concerned by the royalty agreement, [62] and to be informed of the work (clause 7.1.2) involved in the debenture, [63] but it had no attribute of ownership (*usus, fructus* or *abusus*) in the mining claim or lease or in the mineral substances extracted or to be extracted. For example, in the event of the debtor's failure to extract the ore or sell it, the acts in question gave the appellant no right to extract the ore itself or have it extracted by another commercial corporation, or, if it was extracted, to sell the ore itself. In the same way, the acts in question did not grant the appellant the right to be paid, as it chose, in cash or in kind, in order to link the royalty to the mineral substances, not to the profits derived from their sale. The debtors' right was not dismembered. In accordance with clause 9.17 of the debenture, the debtors retained the full and exclusive right to conduct all their business: "each of the Pledgor and the Corporation shall have the sole and exclusive right to determine the timing and the manner of any production from the Properties and all related exploration, development, operational and mining activities, provided such determination is made in accordance with sound mining and engineering practices. Nothing in this Debenture shall require the Pledgor

and or the Corporation to explore, develop or mine or continue operations on the Properties or to process ores from the Properties".

81 As I explained earlier, the appellant's theory is based on the erroneous idea that a real right is constituted when the parties' intention is to: (1) create a permanent right; (2) bind their heirs, assigns and successors (right of pursuit); and (3) attribute a value to the right involved. The constitution of a dismemberment of the property requires a division of the attributes of ownership, i.e. *usus, fructus* or *abusus*, a division absent from the debenture and the royalty agreement.

82 I would like to point out in passing that the Supreme Court discussed the consequences of a royalty agreement in a common law context in *Bank of Montreal v. Dynex Petroleum Ltd.* [64] The right to royalties can constitute a personal right or, according to the parties' intention, an "interest in land". The concept of an interest in land gives the holder of the right an interest in land against the subsurface or the ore, [65] which enables it to enforce its right to the royalty against the new owner. [66] The Supreme Court confirmed that an interest in land can be created from a direct participation or a *profit à prendre*, if that reflects the parties' intention:

> 21 In this appeal, to clarify the status of overriding royalties, the prohibition of the creation of an interest in land from an incorporeal hereditament is inapplicable. A royalty which is an interest in land may be created from an incorporeal hereditament such as a working interest or a *profit à prendre*, if that is the intention of the parties. [67]

83 The elements that make it possible to determine the existence of an intention to create an interest in land were described in *St-Andrew Goldfield Ltd. v. Newmont Canada Limited*. I want to stress that, even in a common law context, it is not certain that the debenture or the royalty agreement entered into between the debtors and the appellant would have created an interest in land:

> [98] Royalty interests can be interests in land if the language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the substances recovered from the land, and the interest, out of which the royalty is carved, is itself an interest in land. The intentions of the parties, judged by the language creating the royalty, determine whether the parties intended to create an interest in land or to create contractual rights only. (*Bank of Montreal v. Dynex Petroleum Ltd.*, 2002 SCC 7 (CanLII), [2002] 1 S.C.R. 146, at paras. 12, 14 and 22.)
>
> [99] Turning then to the language of the Barrick royalty agreement, Newmont "***covenants and agrees . . . to pay***. . . a net smelter return royalty . . . with respect to all valuable minerals ***produced*** from mining rights and surface leases known as the Holt-McDermott mining claims and leases".
>
> [100] While I agree with Newmont that there is no magical "incantation" that must be used to create an interest in land, it is trite to say that language used in an agreement is intended to have and does have a certain meaning. As all the witnesses at this hearing acknowledged, each royalty agreement is different. It is therefore necessary to examine the specific wording used by the parties to determine the meaning that they ascribed to the royalty in this case and the rights that they intended to create.
>
> [101] The use of the words "covenants and agrees to pay" and "produced" in the description of the Barrick royalty is the first indication that the parties intended to create only contractual rights to the payment of a royalty and not an interest in land.
>
> [102] The case law that the parties have submitted makes a valid distinction between the "granting" of royalties attached to or "in" the land or the minerals themselves, thus creating an interest in the land, and the payment of royalties attached to the minerals or revenues "produced" or "removed" from the land, resulting in the creation of contractual rights to the payment of a share of the revenue from the minerals after they have been extracted: see, for example, *Bensette and Campbell v. Reece* [1973] 2 W.W.R. 497 (Sask.C.A.), at p. 500; *Vandergrift v. Coseka Resources Limited* 1989 CanLII 3163 (AB QB), (1989), 67 Alta. L.R. (2d) 17 (Alta.Q.B.), at pp. 26 to

> 28; *Guar. Trust Co. v. Hetherington* 1987 CanLII 3332 (AB QB), (1987), 50 Alta. L.R. (2d) 193 (Alta.Q.B.), at pp. 216 to 222 and 224; *St. Lawrence Petroleum Limited v. Bailey Selburn Oil & Gas Ltd. (No. 2)* (1963), 45 W.W.R. 26 (S.C.C.), at pp. 31 to 33; and *Blue Note Mining Inc. v. Fern Trust (Trustee of)*, [2008] N.B.J. No. 360 (N.B.Q.B.), at paras. 34 and 40.
>
> [103] Other relevant factors to determine the parties' intention to create contractual rights or an interest in land are: whether the royalty holder retains a right to enter upon the lands to explore for and extract the minerals: *Vandergrift v. Coseka Resources Limited*, *supra*, at pp. 28 to 29; and whether the owner of the lands is in complete control of its interest in the lands acquired with the only right in the royalty holder being to share in the revenues produced from the minerals extracted from the lands: *St. Lawrence Petroleum Limited v. Bailey Selburn Oil & Gas Ltd.* (No. 2), *supra*, at pp. 32 to 33.
>
> [104] Under the Barrick royalty agreement, the royalty holder retains no interest in or control over the kind of operations or activities that the owner of the property may carry out and, as an express condition or limitation of the royalty, the royalty holder has no right to claim a reversionary interest in any of the property should the owner seek to relinquish all or any portion of the property. The royalty holder's rights to re-enter upon the property are only for accounting and auditing purposes with respect to the protection of the royalty holder's contractual rights to payment of the royalty.
>
> [105] In light of the other noted terms of the Barrick royalty agreement, the provision in section 14 for registration of a notice of the agreement is not sufficient by itself to demonstrate that the parties intended to create an interest in land. As noted in the cases submitted by the parties, a contractual provision for registration of a royalty is not determinative of the issue. The notice of the agreement was not registered on the title to the transferred property at the time of the closing of the purchase by St. Andrew.
>
> [106] From my reading of the provisions of the Barrick royalty agreement, I cannot see that the parties intended by the royalty to create an interest in land. The provisions are consistent with the creation only of a contractual right to payment of the royalty. It would have been a very simple thing for the parties to have used specific language to create an interest in land. The effect of the Barrick royalty agreement is to create only a contractual right to the payment of the royalty. [68]

[Emphasis added.]

84 To grant a person an innominate real right, a right of enjoyment (*usus*, *fructus* or *abusus*) in the property must be assigned to the person. The debtors had the capacity to grant such a right in their claims, the mining leases and the substances to be extracted. Reading the debenture and the royalty agreement confirmed that the debtors did not grant the appellant any of the attributes of ownership whatsoever in regard to their claims or the mineral substances to be extracted in the event that a mining lease was granted. The debtors retained all the attributes related to ownership and, although they expressed the wish to grant a real and perpetual right in the "Properties" and "Products", they instead granted the appellant the right to receive a percentage of the profits derived from the sale of the mineral substances extracted.

4.2 Enforceability of the debenture and the royalty agreement against third parties

85 As I mentioned earlier, the debenture and the royalty agreement were not published in the land register, but they were published in the mining register. The respondent and the impleaded party contended that the failure to publish those acts in the land register means that they are not enforceable against them. The appellant argued that the *Mining* Act establishes a publication mechanism that differs from the general regime, exempting it from publication in the land register and making the acts enforceable against third parties upon publication in the mining register.

86 The *Mining Act* provides for the following:

> **10. The following are exempt from registration at the registry office:**

• claims;

• mining exploration licences;

• seabed exploration licences;

• exploration licences for surface mineral substances;

• non-exclusive leases to mine surface mineral substances;

• licences to explore for petroleum, natural gas and underground reservoirs;

• authorizations to produce brine.

11. A public register of real and immovable mining rights granted under this Act shall be kept at the Ministère des Ressources naturelles et de la Faune.

13. The registrar appointed by the Minister of Natural Resources and Wildlife shall

(1) keep the public register of real and immovable mining rights;

(2) make in the register a summary entry of such rights and their renewal, transfer, surrender, abandonment, revocation or expiry, and keep in the register the titles evidencing those rights;

(3) register therein any other instrument relating to those rights.

14. Every transfer of a real and immovable mining right, and every other act to which paragraph 3 of section 13 applies, shall be registered in the public register of real and immovable mining rights on presentation of a copy of the instrument evidencing the transfer or act and on payment of the fees fixed by regulation.

No such transfer or act, whether or not it is exempt from registration at the registry office of the registration division, may have effect against the State unless it has been registered in the public register of real and immovable mining rights. [69]

[Emphasis added.]

87 Two observations arise from these provisions. The first concerns the creation of an exemption from publishing certain mining rights in the land register (s. 10 of the *Mining Act*). Author Daniel Morin pointed out that the objective of the exemption is to [TRANSLATION] "make the land register more flexible and avoid the State's having to register certain real rights that are considered 'temporary' because of their relatively short existence". [70] The second concerns the registrar's obligation to keep the mining register and enter in it the mining title, along with its renewal, transfer, surrender, abandonment, revocation or expiry, as well as any act related to those rights (s. 13 of the *Mining Act*).

88 Section 14 of the *Mining Act* provides explicitly that, to be enforceable against the State, the transfer of a mining right or the instrument to which paragraph 3 of section 13 applies, whether it is exempt or not from registration at the registry office, must be published in the mining register.

89 The *Mining Act* has nothing to say about the enforceability against third parties of the transfer of a mining right, its renewal, etc. or an instrument to which paragraph 3 of section 13 of the Act applies. Hence, the rules of the general regime in the *Civil Code of Québec* for the publication of rights apply. Here are the relevant articles:

2938. The acquisition, creation, recognition, modification, transmission or extinction of an immovable real right requires publication.

Renunciation of a succession, legacy, community of property, partition of the value of acquests or of the family patrimony, and the judgment annulling renunciation, also require publication.

Other personal rights and movable real rights require publication to the extent prescribed or expressly authorized by law. Modification or extinction of a published right shall also be published.

2941. Publication of rights allows them to be set up against third persons, establishes their rank and, where the law so provides, gives them effect.

Rights produce their effects between the parties even before publication, unless the law expressly provides otherwise.

2972. The land register contains one land book for each registration division in Québec.

Each land book contains an index of immovables, a register of real rights of State resource development, a register of public service networks and immovables situated in territory without a cadastral survey and an index of names. The index of names comprises all the entries that cannot be made in the index of immovables or the other registers kept by the Land Registrar.

. . .

2972.2. The register of real rights of State resource development contains one land file, identified by a serial number, for each such real right in the registration division the *situs* of which is not immatriculated.

3040. The *situs* of a real right of State resource development which is not immatriculated is described by the mention of the nature of the right and a description of the place where it is exercised, unless a land file has been opened for the *situs* of the right in question.

The number of the land files of the immovables on which the right is exercised shall be included in the application for the opening of the land file of that right, so that the relevant correspondences may be entered in the land register, either in the index of immovables or in the register of public service networks and immovables situated in territory without a cadastral survey; the right is enforceable against third persons only from the time the relevant correspondences are entered in the register.

[Emphasis added.]

90 Articles 2938, 2941 and 3040 of the *Civil Code of Québec* provide that immovable real rights are subject to publication and that publication makes those rights enforceable against third parties. [71] In principle, to the extent that they grant a real right, the debenture and the royalty agreement must be published in the land register in order to be enforceable against third parties. In that regard, I cite the comments of author Morin:

[TRANSLATION]

According to the legislator, the register of real and immovable mining rights is an administrative register that allows the State to control mining rights and be informed of any transfer or assignment, or other rights that may affect them. To that end, any right or transfer that is not published in the register is not enforceable against the State, regardless of whether it is exempt or not from registration at the registry office. However, the rights not published in the register are effective between the parties pursuant to the relative effect of the contracts. Besides that stipulation, the *Mining Act* has nothing to say about the enforceability granted by the register of real and immovable mining rights.

Lastly, and in accordance with article 2938 of the *Civil Code of Québec*, real rights of State resource development, with the exception of those with the exemption under section 10 of the *Mining Act*, must absolutely be published

in the register of real rights of State resource development (hereinafter referred to as the "**R.R.R.S.R.D.**"), which is an integral part of the land register.

But, as I mentioned previously, the objective of the publication of rights is to make them enforceable against third parties. To achieve that objective, they must have been published in the appropriate register. [72]

[References omitted.]

91 And here are the comments of authors Denys-Claude Lamontagne and Jean Brisset des Nos:

[TRANSLATION]

109. The real immovable mining rights that must be registered at the registry office are the following:

- mining leases;
- mining concessions;
- seabed mining leases;
- exclusive leases for the mining of surface mineral substances;
- leases to produce petroleum and natural gas;
- leases to produce brine;
- leases to operate an underground reservoir.

110. First, for purely administrative purposes, the real and immovable mining rights that must be published are entered in the register of real rights of State resource development, centralized at the ministère des Ressources naturelles, de la Faune et des Parcs.

111. Next, these mining rights and the associated acts (sale, transfer, etc.) are entered in the public register of real and immovable mining rights, kept at the same department. We explained earlier the rules of publication in this area: an unpublished right is not enforceable against the State.

112. Last, these mining rights and the related acts are published at the registry office according to the *Civil Code of Québec*, which provides for special rules of publication.

. . .

• The legislator maintained the mining register and the personal file of holders of mining rights, described in articles 2129 (*d*) *et seq.* of the *Civil Code of Lower Canada* (*supra*, Nos. 115 and 116), and continued, since January 1, 1994, under the names register of real rights of State resource development and directory of holders of real rights. Let us explore this further.

The register of real rights of State resource development is the centrepiece of the publication of real and immovable mining rights, and possibly other rights that will be determined by future laws and regulations. Just as the registration of a right in the index of immovables makes it enforceable against third parties, a real right of State resource development is validly published as of its registration in the corresponding register. Article 3040 of the *Civil Code of Québec* clearly establishes that the registration of a right in the register means that "the right is enforceable against third persons" only from the time the relevant correspondence (a two-way process) is established with the land register. Thus, with that sole reservation, a real right of State resource development is enforceable against third parties once it is entered in the register of State rights of resource development, not

> the supplementary directory of holders of real rights. That register is part of the real publication, even in the absence of registration of the basis for the right concerned, since, although the registrations are not grouped by corporeal immovable (as registered immovables are), they are at least grouped by incorporeal immovable (as mining leases are), i.e. by the real rights of State resource development to which the records in numerical order correspond. That is why the registrar cannot accept an application in respect of a right when it contains no designation of the record in question or is not accompanied by a notice referring to the record, unless it includes or is accompanied by an application to establish a record. Exceptionally however, before a record is opened, an application that does not evidence a real right established by an agreement or an agreement related to a real right gives rise to registration in the index of names. [73]

[Emphasis added.]

92 The appellant contended that the publication of the debenture and the royalty agreement in the land register was not necessary, since the *Mining Act* explicitly provides for another mode of publication, which exempts it from the obligation to publish in the land register, as article 2934 of the *Civil Code of Québec* stipulates:

> **2934.** The publication of rights is effected by their registration in the register of personal and movable real rights or in the land register, unless some other mode is expressly permitted by law.
>
> Registration benefits the persons whose rights are thereby published.
>
> [Emphasis added.]

93 The appellant is wrong. Here are the comments of the Minister of Justice concerning the adoption of that article:

> [TRANSLATION]
>
> That article is new law. It indicates, at the beginning of Book Nine, the manner in which a right is to be published; it identifies, also at the beginning, the registers in which the rights are entered.
>
> The first paragraph of article 2934 refers indirectly to a hypothec with delivery, which does not give rise to an entry in a register, since holding the property or title is a method of publication that is still valid and useful (art. 2703).
>
> The second paragraph indicates the people who benefit from the registration. [74]
>
> [Emphasis added.]

94 In this case, the words "unless some other mode is expressly permitted by law" must be understood to mean a mode that enables third parties to be informed of the existence of a real right. The mining register is not such a mode. The entries therein serve to make the rights enforceable against the Minister, not third parties, which must be [TRANSLATION] "informed" through the land register, as article 3040 of the *Civil Code of Québec* requires.

4.3 Effect of the vesting order

95 The appellant argued that the trial judge had a misconception of the nature of the sale ordered under the authority of section 243 of the BIA. According to it, such a sale must comply with the principles of the *Civil Code of Québec*. More specifically, it contended that the sale of the debtors' property constitutes, in reality, a taking in payment (not a sale by judicial authority). Therefore, the judge should not have discharged the real rights held by the appellant (the debenture, the royalty agreement and the universal hypothecs).

96 Subsidiarily, the appellant contended that the judge erred by refusing to consider its contestation as an opposition to secure charges. [75] It referred the Court to *Frères Maristes (Iberville) v. Gestion N. Cammisano inc.*, [76] in which the

Superior Court recognized that a real right survives the adjudication of ownership in the context of a sale by judicial authority for taxes and it is not discharged by the sheriff's sale.

97 In accordance with subsection 243 (1) of the BIA, a court may, on application by a secured creditor, appoint a receiver and grant the receiver the following powers:

> **243.** (1) Subject to subsection (1.1), on application by a secured creditor, a court may appoint a receiver to do any or all of the following if it considers it to be just or convenient to do so:
>
> (a) take possession of all or substantially all of the inventory, accounts receivable or other property of an insolvent person or bankrupt that was acquired for or used in relation to a business carried on by the insolvent person or bankrupt;
>
> (b) exercise any control that the court considers advisable over that property and over the insolvent person's or bankrupt's business; or
>
> (c) take any other action that the court considers advisable.
>
> [Emphasis added.]

98 It is pursuant to paragraph 243(1)(*c*) of the BIA that the receiver can ask the court to sell the property of a bankrupt debtor, free of any charge. [77]

99 The appellant contended that the sale authorized by the trial judge in fact constituted a disguised taking in payment, not allowed under the *Civil Code of Québec*. I fail to see on what factual or legal foundation the appellant bases its contention. Concretely, the sale authorized by the trial judge did not constitute a disguised taking in payment. First, let me point out that it was preceded by a transparent and public procedure aimed at obtaining purchase offers. Second, let me say that the sale was granted to the impleaded party because it submitted the best offer. Accordingly, although the impleaded party was the mandatary of the first ranking secure creditors and acquired the debtors' assets by means of a credit bid, the judicial operation carried out constituted a sale, not a taking in payment. The impleaded party did not pay itself out of the debtors' assets, as is the case in taking in payment; rather, it made the acquisition by means of a sale.

100 The effects of the vesting order are those of a sale by judicial authority. [78] They discharged all the real rights not included in the terms of sale, as in the exceptions under article 696 of the *Code of Civil Procedure*:

> **696.** A sheriff's sale discharges the immovable from all real rights not mentioned in the conditions of sale except:
>
> (1) servitudes;
>
> (2) *(paragraph repealed)*;
>
> (3) rights of emphyteusis, the rights necessary for the exercise of superficies and rights of substitution not yet open, except when it appears in the record of the case that there exists a prior or preferable claim;
>
> (4) *(paragraph replaced)*;
>
> (5) the administrative encumbrance affecting a low-rental housing immovable.
>
> A sheriff's sale does not affect the legal hypothec securing the rights of municipalities, school boards or the Comité de gestion de la taxe scolaire de l'île de Montréal in respect of instalments not yet due of special taxes, the payment of which is spread over a certain number of years; such instalments do not become due by reason of the sale of the immovable and are not collocated, but remain payable according to the terms of their imposition.

101 In actuality, the appellant's rights (even if they had been real rights) were not mentioned in the rights that survived the sale. Rather, they were included in the rights to be discharged. Furthermore, those rights are not listed in the exceptions in article 696 of the *Code of Civil Procedure*.

102 I want to point out that the appellant did not contest Conclusion 11 of the respondent's motion, which asked precisely that the sale have the same effects as a sale by judicial authority according to the *Civil Code of Québec* (art. 2794 C.C.Q. and art. 696 C.C.P.). Furthermore, it acknowledged before the Court that the acquisition procedure by means of a credit bid was legal.

103 *Frères Maristes (Iberville) v. Gestion N. Cammisano Inc.*, [79] cited by the appellant, does not support its position. That judgment deals with the effect of a sale for taxes, governed by sections 528 and 529 of the *Cities and Towns Act*. [80] Those sections specify that the sale discharges the immovable "of any privilege or hypothec with which it may be charged." In that specific legislative context, it goes without saying that real rights other than hypothecs and privileges are not struck.

104 In conclusion, the operation authorized by the trial judge constitutes a sale and it has the same effects as a sale by judicial authority, i.e. it discharges the real rights to the extent provided for in the *Code of Civil Procedure* (art. 2794 C.C.Q. and art. 696 C.C.P.). The trial judge was correct to strike the debenture, the royalty agreement and the universal second hypothecs entered into between the debtors and the appellant on August 28, 2009.

105 Before I conclude, a procedural issue related to the institution of the appeal should be decided. As I pointed out earlier, the appellant submitted a notice of appeal on the basis of subsections 193 (*a*) and (*c*) of the BIA. Furthermore, it filed a motion for leave to appeal *de bene esse*, should its notice of appeal be contested.

106 There was in fact no such contestation at the hearing. Indeed, the appeal is within the framework of subsections 193 (*a*) and (*c*) of the BIA. First, it concerns the appellant's right to eventually receive royalties. Second, the royalties are the result of the granting of a loan of $8 000 000 and would no doubt exceed $10 000 if the conditions required for their payment were met.

107 In the circumstances, I am of the opinion that the motion for leave to appeal *de bene esse* should be dismissed.

108 Therefore, I propose to dismiss the appeal and the motion for leave to appeal *de bene esse*, with costs.

108 (s)

Footnotes

1 *Ernst & Young inc. v. Anglo Pacific Group PLC*, S.C. Abitibi, Nos. 615-11-001228-107 and 615-11-001229-105, November 21, 2012, St-Julien J. (hereinafter referred to as the "judgment appealed from").

2 *Bankruptcy and Insolvency Act*, R.S.C. (1985), c. B-3.

3 JRI is a subsidiary of NSM. It was constituted to operate an ore processing plant. The property of the debtors consisted essentially in mining claims or interests in the mining claims, an ore processing plant and specialized equipment for the mining sector.

4 *Anglo Pacific Group PLC v. Ernst & Young inc.*, 2012 QCCA 2149.

5 [2001] R.J.Q. 587 (C.A.).

6 *A. Brousseau & Fils ltée. v. Turcotte*, J.E. 2003-535 (C.A.).

7 *Mining Act*, R.S.Q., c. M-13.1.

8 See appendix.

9 See paragraph 28 *infra*, as well as the appendix.

10 [1999] R.J.Q. 2260 (C.A.). See also *Fortier v. Grenier*, 2006 QCCS 1929; *Duchesne v. Duchesne*, B.E. 2001BE-12 (S.C.); *Les Frères Maristes (Iberville) v. Gestion N. Cammisano inc.*, [1993] R.D.I. 187 (S.C.), discontinuance of appeal (C.A., 1993-05-21), 500-09-002077-923.

11 See paras. 28 and 78 *infra*, as well as the appendix.

12 Barry J. Barton, *Canadian Law of Mining* (Calgary: Canadian Institute of Resources Law, 1993) at 465 and 470-471. See also *Bank of Montreal v. Dynex Petroleum Ltd.*, [2002] 1 S.C.R. 146, 2002 SCC 7.

13 Madeleine Cantin Cumyn, "De l'existence et du régime juridique des droits réels de jouissance innommés : essai sur l'énumération limitative des droits réels", (1986) 46 *R. du B.* 3, 25, 36 and 39-40.

14 *Farber v. Royal Trust Co.*, [1997] 1 S.C.R. 846 at para. 31.

15 *Bank of Montreal v. Dynex Petroleum Ltd.*, *supra* note 12.

16 Arts. 1371 and 1373 C.C.Q.; Sylvio Normand, *Introduction aux droits des biens*, 1st ed. (Montréal: Wilson & Lafleur, 2000) at 39 [Normand 1]; Pierre-Claude Lafond, *Précis de droit des biens*, 2nd ed. (Montréal: Thémis, 2007) No. 412 at 162-163; Denys-Claude Lamontagne, *Biens et propriété*, 6th ed. (Cowansville, Qc.: Yvon Blais, 2009) No. 96 at 59; Jean-Louis Baudouin and Pierre-Gabriel Jobin, *Les obligations*, 7th ed., by Pierre-Gabriel Jobin and Nathalie Vézina (Cowansville, Qc.: Yvon Blais, 2013) No. 6 at 6.

17 Normand 1, *ibid.* at 39; Jean-Louis Baudouin and Pierre-Gabriel Jobin, *ibid.*, No. 6 at 6.

18 Normand 1, *ibid.* at 36; D.-C. Lamontagne, *supra* note 16, No. 103 at 61; P.-C. Lafond, *supra* note 16, Nos. 444-445 at 173.

19 J.-L. Baudouin and P.-G. Jobin, note 16 at 6-7; Pierre-Claude Lafond, *ibid.*, No. 414 at 163; Normand 1, *ibid.* at 41; Denys-Claude Lamontagne, *ibid.*, No. 99 at 60.

20 Pierre-Claude Lafond, *ibid.*, No. 416 at 164; Normand 1, *ibid.* at 41; Jean-Louis Baudouin and Pierre-Gabriel Jobin, *ibid.*, No. 6 at 7.

21 Normand 1, *ibid.* at 29-30; D.-C. Lamontagne, *supra* note 16, Nos. 102-104 at 60-61; Pierre Basile Mignault, *Le droit civil canadien*, Vol. 2 (Montréal: Théoret, 1896) at 390; Pierre-Claude Lafond, *ibid.*, No. 422 at 166. See also para. 425 of Pierre-Claude Lafond, where it is mentioned that the idea of a direct right on property may appear contestable.

22 Pierre-Claude Lafond, *ibid.*, No. 443 at 173; Normand 1, *ibid.* at 36; Denys-Claude Lamontagne, *ibid.* No. 117 at 69.

23 Pierre-Claude Lafond, *ibid.*, Nos. 449-453 at 174-175; Normand 1, *ibid.* at 36-39; Denys-Claude Lamontagne, *ibid.*, Nos. 116-118 at 69.

24 Pierre-Claude Lafond, *ibid.*, Nos. 657-684 at 259-270; Normand 1, *ibid.* at 91-94; Denys-Claude Lamontagne, *ibid.*, No. 207 at 158-159.

25 However, bear in mind that, as we have seen, article 405 C.C.L.C. already dealt with property ownership.

26 Article 899 C.C.Q. reproduces article 374 C.C.L.C. almost textually.

27 Normand 1, *supra* note 16 at 96; Sylvio Normand, "Les nouveaux biens", (2004) 106 *R. du N.* 177, 183-185 [Normand 2]; Denys-Claude Lamontagne, *ibid.*, No. 205 at 157; Yaël Emerich, *La propriété des créances : approche comparative* (Cowansville, Qc.:

Yvon Blais, 2006) at 18-67 [Emerich 1]; Yaëll Emerich, "Faut-il condamner la propriété des biens incorporels ? Réflexions autour de la propriété des créances" (2005) 46 *C. de D.* 905 at 909-912 and 916-920 [Emerich 2]; Yaëll Emerich, "Regard civiliste sur le droit des biens de la common law pour une conception transsystémique de la propriété" (2008) 38 *R.G.D.* 339 at 370-376 [Emerich 3].

28 See Denys-Claude Lamontagne, *ibid.*, No. 205 at 157; Normand 1, *ibid.* at 96; Normand 2, *ibid.* at 183-185; Emerich 1, *ibid.* at 18-67; Emerich 2, *ibid.* at 909-912 and 916-920; Emerich 3, *ibid.* at 370-376; P.-C. Lafond, *supra* note 16, No. 419 at 165; John E.C. Brierley, "Regards sur le droit des biens dans le nouveau Code civil du Québec" (1995) 47 *R.I.D.C.* 33 at 36-49; Roderick A. Macdonald, "Reconceiving the Symbols of Property: Universalities, Interests and Other Heresies" (1994) 39 *McGill Law Journal* 761 at 785-812; Madeleine Cantin Cumyn and Michelle Cumyn, "La notion de biens" in *Mélanges offerts au professeur François Frenette - Études portant sur le droit patrimonial* (Québec: Les Presses de l'Université Laval, 2006) at 140-150.

29 M. Cantin Cumyn and M. Cumyn, *ibid.* at 140-150.

30 R. A. Macdonald, *supra* note 28 at 798 and 804; John E.C. Brierley, "Regards sur le droit des biens dans le nouveau Code civil du Québec" (1995) 47 *R.I.D.C.* 33 at 35-36.

31 Normand 1, *supra* note 16 at 96; Normand 2, *supra* note 27 at 184-185; Denys-Claude Lamontagne, *supra* note 16, No. 205 at 157; Emerich 2, *supra* note 27 at 909-912 and 916-920; Emerich 1, supra note 27 at 52-56.

32 J.E.C. Brierley, *supra* note 30 at 36 and 48-49.

33 Denys-Claude Lamontagne and Jean Brisset des Nos, *Le droit minier*, 2nd ed. (Montréal: Thémis, 2005) No. 73 at 47.

34 Normand 1, *supra* note 16 at 96.

35 Ministère de la Justice, *Commentaires du ministre de la Justice : le Code civil du Québec*, Vol. 1, (Québec: Les Publications du Québec) at 556.

36 Normand 1, *supra* note 16 at 31.

37 *Ibid.* at 31-32.

38 *Ibid.* at 32 and 267-269; M. Cantin Cumyn, *supra* note 13; P.-C. Lafond, *supra* note 16, Nos. 679-680 at 758-759; *Club Appalaches inc. v. Québec (Procureur général)*, *supra* note 10. Author Denys-Claude Lamontagne is of the opinion that that is not possible. See D.-C. Lamontagne, *supra* note 16, No. 114 at 67-68.

39 Normand 1, *ibid.* at 269-270.

40 M. Cantin Cumyn, *supra* note 13.

41 Ministère de la Justice, *supra* note 35 at 535.

42 *Sacchetti v. Lockheimer*, [1988] 1 S.C.R. 1049 at 1056. (The Court used the word "thing", given that, according to article 406 C.C.L.C., ownership concerned a thing.)

43 *Haddad v. Groupe Jean Coutu (PJC) inc.*, 2010 QCCA 2215at para. 76.

44 *Mining Act*, *supra* note 7, s. 17.

45 *Ibid.*, s. 3; D.-C. Lamontagne and J. Brisset des Nos, *supra* note 33 at 14.

46 *Mining Act*, *ibid.*, at s. 100.

47 *Ibid.* at s. 101.

48 *Ibid.*, ss. 61, 64, 65, 69 and 101; D.-C. Lamontagne and J. Brisset des Nos, *supra* note 33, Nos. 78-79 at 50-54; Jean-Paul Lacasse, *Le claim en droit québécois* (Ottawa: Les Éditions de l'Université d'Ottawa, 1976) at 105-117.

49 *Mining Act*, *ibid.*, ss. 100 and 105; Denys-Claude Lamontagne and Jean Brisset des Nos, *ibid.*, Nos. 89-92 at 59-60.

50 *Mining Act*, *ibid.*, s. 101; J.-P. Lacasse, *supra* note 48, 1976, at 115-117.

51 *Mining Act*, *ibid.*, s. 104.

52 D.-C. Lamontagne and J. Brisset des Nos, *supra* note 33 at 67.

53 *Ibid.* at 68-69.

54 *Mining Act*, *supra* note 7, at s. 105.

55 D.-C. Lamontagne and J. Brisset des Nos, *supra* note 33, No. 102 at 68.

56 P.-C. Lafond, *supra* note 16, No. 665 at 263.

57 D.-C. Lamontagne, *supra* note 16, No. 467 at 321-322.

58 Art. 1014 C.C.Q. See Henri Lanctôt, "La convention de coparticipation" (Insight Information Co., Deuxième forum minier, Québec) September 30, 2004 at 23.

59 Louis Payette, *Les sûretés réelles dans le Code civil du Québec*, 4th ed. (Cowansville, Qc.: Yvon Blais, 2010) No. 467 at 213.

60 See the appendix.

61 *Ibid.*

62 *Ibid.*

63 *Ibid.*

64 *Supra* note 12.

65 Valérie Mac-Seing, "Prête-nom dans le cadre de transactions immobilières au Québec : défis et enjeux", in Service de la formation continue, Barreau du Québec, *Développements récents en droit immobilier et commercial* (Cowansville, Qc.: Yvon Blais, 2006) at 88-89; Barbara Pierre, "Classification of Property and Conceptions of Ownership in Civil and Common Law", (1997) 28 *R.G.D.* 235 at 251-252.

66 B.J. Barton, *supra* note 12 at 463-464.

67 *Banque de Montréal v. Dynex Petroleum Ltd.*, *supra* note 12 at para. 21.

68 *St. Andrew Goldfields Ltd. v. Newmont Canada Limited*, 2009 CanLII 40549at paras. 98-103 (Ont. Sup. Ct. J.), upheld by 2011 ONCA 377.

69 *Mining Act*, *supra* note 7, ss. 10-14.

70 Daniel Morin, "Chronique - De la publicité de certains droits miniers réels immobiliers", in *Repères*, February 2013, *Droit civil en ligne*, EYB2013REP1311 at 4.

71 On this subject, see D.-C. Lamontagne and J. Brisset des Nos, *supra* note 33, Nos. 103-124 at 69-85; Denys-Claude Lamontagne and Pierre Duchaine, *La publicité des droits*, 5th ed. (Cowansville, Qc.: Yvon Blais, 2012) Nos. 69-70 at 63-64.

72 D. Morin, *supra* note 70 at 7.

73 D.-C. Lamontagne and J. Brisset des Nos, *supra* note 33 at 71-72 and 82-83.

74 Ministère de la Justice, *Commentaires du ministre de la Justice : le Code civil du Québec*, Vol. 2, (Québec: Les Publications du Québec) at 1843.

75 Art. 676 C.C.P.

76 *Supra* note 10.

77 Jacques Deslauriers, *La faillite et l'insolvabilité au Québec*, 2nd ed. (Montréal: Wilson & Lafleur, 2011) at 257; Kevin P. McElcheran, *Commercial Insolvency in Canada*, 2nd ed. (Markham: LexisNexis Canada Inc., 2012) at 217.

78 *Supra* note 2, s. 72. See also Alain Heyne and Éric Lavallée, "Séquestre intérimaire et séquestre de la partie XI de la *Loi sur la faillite et l'insolvabilité*", in JurisClasseur Québec, coll. "Droit des affaires", *Faillite, insolvabilité et restructuration*, Vol. 9 (Montréal: LexisNexis Canada, 2013), loose-leaf, at 9/94.

79 *Supra* note 10.

80 R.S.Q., c. C-19.

End of Document

TAB 5

In re: SABINE OIL & GAS CORPORATION, et al.,[1] Debtors.

1 The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, include: Sabine Oil & Gas Corporation (4900); Giant Gas Gathering LLC (3438); Sabine Bear Paw Basin LLC (2656); Sabine East Texas Basin LLC (8931); Sabine Mid-Continent Gathering LLC (6085); Sabine Mid-Continent LLC (6939); Sabine Oil & Gas Finance Corp. (2567); Sabine South Texas Gathering LLC (1749); Sabine South Texas LLC (5616); and Sabine Williston Basin LLC (4440). The location of Debtor Sabine Oil & Gas Corporation's corporate headquarters and the Debtors' service address is: 1415 Louisiana St., Suite 1600, Houston, Texas 77002.

Chapter 11, Case No. 15-11835 (SCC) (Jointly Administered)

UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

547 B.R. 66; 2016 Bankr. LEXIS 720; 62 Bankr. Ct. Dec. 78

March 8, 2016, Decided

SUBSEQUENT HISTORY: Affirmed by HPIP Gonzales Holdings, LLC v. Sabine Oil & Gas Corp. (In re Sabine Oil & Gas Corp.), 2017 U.S. Dist. LEXIS 38204 (S.D.N.Y., Mar. 9, 2017)

CASE SUMMARY:

OVERVIEW: HOLDINGS: [1]-The court authorized rejection by debtors, engaged in the acquisition, production, exploration, and development of onshore oil and natural gas properties, of certain gas gathering contracts pursuant to 11 U.S.C.S. § 365(a) because rejection was a reasonable exercise of debtors' business judgment, as they claimed that it was not financially viable for them to deliver the minimum amounts of gas and condensate set forth in the agreements; [2]-The court could not decide substantive legal issues, including whether the covenants at issue ran with the land, in the context of a motion to reject, unless such motion was scheduled simultaneously with an adversary proceeding or contested matter to determine the merits of the substantive legal disputes related to the motion.

OUTCOME: Motino to reject granted.

CORE TERMS: covenant, gathering, dedication, conveyance, equitable servitude, lease, touch, executory contract, oil, business judgment, decision to reject, pipeline, property interests, covenant running, privity of estate, horizontal, deliver, property law, oil gas, transport, promisor's, mineral, real property, triggered, assign, debtors in possession, legal issues, midstream, gatherer, caselaw

LexisNexis(R) Headnotes

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers

[HN1] Under 11 U.S.C.S. § 365(a), a debtor in possession, subject to the court's approval, may assume or reject any executory contract of the debtor. Subject to the requirement of notice and a hearing, and the bankruptcy court's approval, § 365(a) allows the debtor in possession to evaluate its executory contracts (and unexpired leases) and decide which ones would be beneficial to adhere to and which ones it would be beneficial to reject. The purpose behind allowing the assumption or rejection of executory contracts is to permit the trustee or debtor-in-possession to use valuable property of the estate and to renounce title to and abandon burdensome property.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Procedures

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Powers

[HN2] The process of deciding a motion to assume or reject is one of the bankruptcy court placing itself in the position of the debtor in possession and determining whether assuming or rejecting the contract would be a good business decision or a bad one. This analysis is generally referred to as a "business judgment" test, although it varies somewhat from the traditional business judgment rule employed in state corporate law, and requires the court to look at whether the debtor's decision to assume or reject is beneficial to the estate. The bankruptcy court generally defers to a debtor's determination as to whether rejection of an executory contract is advantageous, unless the decision to reject is the product of bad faith, whim, or caprice. Unless a separate provision of the Bankruptcy Code provides a non-debtor party with specific protection, the interests of the debtor and its estate are paramount; adverse effects on the non-debtor contract party arising from the decision to assume or reject are irrelevant. At root, the question for the court on a motion to reject is whether a reasonable business person would make a similar decision under similar circumstances.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > Procedures

[HN3] Although Fed. R. Bankr. P. 6006 and 9014 provide that a proceeding to reject an executory contract is a contested matter, the U.S. Court of Appeals for the Second Circuit's decision in Orion Pictures Corp. v. Showtime Networks makes clear that such a proceeding should be considered a summary proceeding, intended to efficiently review the trustee's or debtor's decision to adhere to or reject a particular contract in the course of the swift administration of the bankruptcy estate. It is not the time or place for prolonged discovery or a lengthy trial with disputed issues.

COUNSEL: [1]** For the Debtors: Paul M. Basta, P.C., Jonathan S. Henes, P.C., Christopher Marcus, P.C., KIRKLAND & ELLIS LLP, KIRKLAND & ELLIS INTERNATIONAL LLP, New York, NY; James H.M. Sprayregen, P.C., Ryan Blaine Bennett, Esq. (argued), Brad Weiland, Esq., Chicago, IL.

For Nordheim Eagle Ford Gathering, LLC: Robert G. Burns, Esq. (argued), BRACEWELL & GIULIANI LLP, New York, NY; William A. (Trey) Wood III, Esq., Jason G. Cohen, Esq., Houston, TX.

For HPIP Gonzales Holdings, LLC: Keith Simon, Esq. (argued), Annemarie V. Reilly, Esq., LATHAM & WATKINS LLP, New York, New York.

For the Official Committee of Unsecured Creditors: Mark R. Somerstein, Esq. (argued), Keith H. Wofford, Esq., D. Ross Martin, Esq., C. Thomas Brown, Esq., ROPES & GRAY LLP, New York, New York.

For Wells Fargo, National Associate, as Administrative Agent under First Lien Credit Agreement: Margot B. Schonholtz, Esq. (argued), Robert H. Trust, Esq., LINKLATERS LLP, New York, New York.

JUDGES: HONORABLE SHELLEY C. CHAPMAN, UNITED STATES BANKRUPTCY JUDGE.

OPINION BY: SHELLEY C. CHAPMAN

OPINION

[*69] BENCH DECISION ON DEBTORS' OMNIBUS MOTION TO AUTHORIZE REJECTION OF CERTAIN EXECUTORY CONTRACTS[2]

2 This decision was dictated on the record of the hearing held on March 8, 2016. **[**2]** It has been modified to include full citations and defined terms, and reflects minor additional non-substantive modifications.

HONORABLE SHELLEY C. CHAPMAN
UNITED STATES BANKRUPTCY JUDGE:

Before the Court is the Debtors' Motion (the "Motion") for an Order Authorizing Rejection of Certain Executory Contracts [ECF No. 371]. By the Motion, the Debtors seek to reject certain contracts between Sabine Oil & Gas Corporation

("Sabine") and Nordheim Eagle Ford Gathering, LLC ("Nordheim"), and between Sabine and HPIP Gonzales Holdings, LLC ("HPIP") pursuant to section 365(a) of the Bankruptcy Code.

On October 8, 2015, Nordheim and HPIP[3] each filed an objection to the Motion [ECF Nos. 386 and 387]. On October 14, 2015, the Debtors filed their omnibus reply to the objections [ECF No. 410]. On January 8, 2016, Nordheim filed a surreply to the Motion [ECF No. 676], and on January 22, 2016, the Debtors filed a response to that surreply [ECF No. 742]. The Court heard oral argument on the Motion on February 2, 2016.

3 Nordheim and HPIP are so-called "midstream gatherers." Situated operationally between upstream companies such as Sabine and downstream refining companies, midstream gatherers gather, treat, transport, and/or process mineral products **[**3]** produced from a well before such products enter the commercial market. *See, generally*, Kurt L. Krieger, *Gathering and Transporting Marcellus and Utica Shale Natural Gas to the Market and the Regulation of Midstream Pipeline Companies*, 19 Tex. Wesleyan L. Rev. 49 (2012).

Background

The Debtors -- an independent energy company engaged in the acquisition, production, exploration, and development of onshore oil and natural gas properties in the United States -- filed petitions for relief under chapter 11 of the Bankruptcy Code with this Court on July 15, 2015. The Debtors are operating their businesses and managing their properties as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. The Court entered an order authorizing the joint administration and procedural consolidation of the Debtors' chapter 11 cases pursuant to Bankruptcy Rule 1015(b) on July 16, 2015. There has not been a request for the appointment of a trustee or examiner in these chapter 11 cases. On July 28, 2015, the Office of the U.S. Trustee for the Southern District of New York formed the official committee of unsecured creditors pursuant to section 1102 of the Bankruptcy Code. Familiarity with the background of the Debtors' businesses and chapter 11 cases, and with the December 16, 2014 combination of Sabine Oil & Gas LLC **[**4]** and Forest Oil Corporation (the "Combination"), is assumed.[4]

4 *See, generally, Declaration of Michael Magilton (A) in Support of First Day Motions and (B) Pursuant to Local Bankruptcy Rule 1007-2* [ECF No. 3].

[*70] A. The Nordheim Agreements

As a result of the Combination, Sabine became party to two contracts with Nordheim, each dated January 23, 2014: the first, a Gas Gathering Agreement, and the second, a Condensate Gathering Agreement (together, the "Nordheim Agreements"). By the Gas Gathering Agreement, Sabine agreed to "dedicate" to the "performance" of that agreement all of the gas produced by Sabine from a designated area and deliver such gas to Nordheim, and Nordheim agreed to gather, treat, dehydrate, and re-deliver that gas to Sabine. Nordheim further agreed to construct, at its sole cost and expense, a gathering system of pipelines and treatment facilities to provide certain agreed-upon services. The Gas Gathering Agreement contemplates a separate and subsequent conveyance from Sabine to Nordheim of a mutually agreed tract of land in connection with Nordheim's construction and operation of the gathering system. Sabine also agreed to deliver a certain minimum amount of gas to Nordheim on an annual **[**5]** basis. To the extent it does not deliver such minimum amounts, Sabine is required to make a deficiency payment to Nordheim; Sabine also is obligated to pay monthly gathering fees to Nordheim. The Gas Gathering Agreement has a 10-year term, with automatic yearly renewal subject to termination, and is governed by Texas law.

The Condensate Gathering Agreement between Sabine and Nordheim contains substantially the same terms as the Gas Gathering Agreement, but it relates to liquid hydrocarbons and other liquids rather than gas. The Court will refer to the liquid hydrocarbons, gas, and other products that are the subject of the dedications in the Nordheim Agreements as the "Nordheim Products."

Each Nordheim Agreement specifically provides that the agreement itself is a "covenant running with the [land]" within the designated area, and is enforceable by Nordheim against Sabine, its affiliates, and their successors and assigns.[5]

5 Nordheim Gas Gathering Agreement ¶ 1.6; Nordheim Condensate Gathering Agreement ¶ 1.6.

B. The HPIP Agreements

Sabine also became party to two contracts with HPIP as a result of the Combination: one, a Production Gathering, Treating and Processing Agreement, dated May 3, **[**6]** 2013, and the other a Water and Acid Gas Handling Agreement, dated May 2014, with no specific date (together, the "HPIP Agreements"). The former, the HPIP Gathering Agreement, obligates Sabine to "dedicate" to the "performance" of the agreement certain leases owned by Sabine and the oil, gas, and water produced from the wells located on the land subject to those leases, and to deliver that oil, gas, and water to HPIP. Pursuant to the agreement, HPIP agreed to construct, operate, and maintain gathering facilities to provide certain services with respect to the products delivered by Sabine. The HPIP Gathering Agreement is also governed by Texas law.

The latter, the HPIP Handling Agreement, contains substantially similar terms to those set forth in the HPIP Gathering Agreement, but provides for HPIP to construct, operate, and maintain disposal facilities for and perform disposal services with respect to all of the water and acid gas produced by Sabine from the same land subject to the leases. The Court will refer to the oil, gas, acid, and water that are the subject of the dedications in the HPIP Agreements as the "HPIP Products."

[*71] Each HPIP Agreement provides that Sabine's undertaking to **[**7]** deliver the HPIP Products to HPIP is a covenant "running with the lands and leasehold interests" identified in the agreement,[6] and further provides that the agreement "shall be binding upon and inure to the benefit of the Parties hereto, their successors, assigns, heirs, administrators and/or executors."[7]

6 HPIP Gathering Agreement ¶ 1.2; HPIP Handling Agreement ¶ 1.2.

7 HPIP Gathering Agreement ¶ 9.2.1; HPIP Handling Agreement ¶ 8.2.1.

Discussion

A. The Debtors Have Satisfied the Standard for Rejection of the Agreements

The Debtors seek to reject the Nordheim Agreements and the HPIP Agreements (referred to collectively as the "Agreements") pursuant to section 365(a) of the Bankruptcy Code. [HN1] Under that provision, a debtor in possession, "subject to the court's approval, may assume or reject any executory contract...of the debtor."[8] Subject to the requirement of notice and a hearing, and the bankruptcy court's approval, section 365(a) allows the debtor in possession to evaluate its executory contracts (and unexpired leases) and "decide which ones would be beneficial to adhere to and which ones it would be beneficial to reject."[9] "The purpose behind allowing the assumption or rejection of executory contracts is to permit the trustee or debtor-in-possession **[**8]** to use valuable property of the estate and to renounce title to and abandon burdensome property."[10]

8 11 U.S.C. § 365(a).

9 *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F. 3d 1095, 1098 (2d Cir. 1993).

10 *Id.*

As the Second Circuit held in *Orion Pictures Corp. v. Showtime Networks*, [HN2] the "process of deciding a motion to assume [or reject] is one of the bankruptcy court placing itself in the position of...the debtor in possession and determining whether assuming [or rejecting] the contract would be a good business decision or a bad one."[11] This analysis is generally referred to as a "business judgment" test, although it varies somewhat from the traditional business judgment rule employed in state corporate law,[12] and requires the court to look at whether the debtor's decision to assume or reject is beneficial to the estate.[13] The bankruptcy court generally defers to a debtor's determination as to whether rejection of an executory contract is advantageous,[14] unless the decision to reject is the product of bad faith, whim, or caprice.[15] Unless a separate provision of the Bankruptcy Code provides a non-debtor party with specific protection, the interests of the debtor and its estate are paramount; adverse effects on the non-debtor contract party arising from the decision to

assume or reject are irrelevant. **[**9]** [16] At root, **[*72]** the question for the court on a motion to reject is "whether a reasonable business person would make a similar decision under similar circumstances."[17]

11 *Id.* at 1099; *see also In re Penn Traffic Co.*, 524 F.3d 373, 383 (2d Cir. 2008); *In re The Great Atlantic & Pacific Tea Co.*, 544 B.R. 43 (Bankr. S.D.N.Y. 2016) (RDD).

12 *In re The Great Atlantic & Pacific Tea Co.*, 544 B.R. at 48.

13 *In re Enron Corp.*, No. 01-16034 (AJG), 2006 WL 898033, at *4 (Bankr. S.D.N.Y. Mar. 24, 2006).

14 *In re Balco Equities Ltd., Inc.*, 323 B.R. 85, 98 (Bankr. S.D.N.Y. 2005).

15 *Westbury Real Estate Ventures v. Bradlees, Inc. (In re Bradlees Stores, Inc.)*, 194 B.R. 555, 558 n.1 (Bankr. S.D.N.Y. 1996).

16 *In re Penn Traffic Co.*, 524 F.3d at 383; *In re The Great Atlantic & Pacific Tea Co.*, 472 B.R. at 672-73; *In re Old Carco LLC*, 406 B.R. 180, 192-93 (Bankr. S.D.N.Y. 2009).

17 *In re Helm*, 335 B.R. 528, 538-39 (Bankr. S.D.N.Y. 2006).

The Debtors argue that rejection of the Nordheim Agreements and the HPIP Agreements is a reasonable exercise of their business judgment and is in the best interests of their estates because those Agreements are unnecessarily burdensome. Specifically, the Debtors submit that it is not financially viable for them to deliver the minimum amounts of gas and condensate set forth in the Agreements, and, absent rejection, they would therefore be required to make the contractual deficiency payments, which would impose a considerable and unnecessary drain on the estates' resources. If rejection is authorized, the Debtors state that they plan to enter into new gathering agreements with other gatherers on terms more favorable to the Debtors.

Both Nordheim and HPIP object to the Debtors' proposed rejection, but for slightly different reasons. In its papers, Nordheim argues that the Debtors' decision to reject the Nordheim Agreements does not satisfy the business judgment standard because Sabine's covenants to dedicate **[**10]** the Nordheim Products and to pay a "transportation fee" are covenants that run with the land and therefore would survive rejection.[18] As argued by Nordheim, if the Debtors reject the Nordheim Agreements, Sabine would remain bound by those covenants, and rejection of the remainder of the agreements would provide little or no benefit to the Debtors' estates.

18 Nordheim Objection, ¶ 16 (citing *In re Banning Lewis Ranch Co., LLC*, 532 B.R. 335, 346 (Bankr. D. Colo. 2015) for proposition that debtor's rejection of an agreement does not affect covenants to non-debtor parties that run with the land).

At oral argument, however, Nordheim put forward an additional and distinct argument for the first time: that while the Court can authorize the Debtors' rejection of the Nordheim Agreements, it cannot in doing so make a determination as to the legal status under Texas property law of those covenants in the Nordheim Agreements that Nordheim argues "run with the land." In support of its argument, Nordheim relies on the Second Circuit's decision in *Orion* as a legal limitation on the Court's authority in the context of the Motion. In that case, the Second Circuit found that a bankruptcy court had committed reversible error by deciding a disputed factual issue in the context of a **[**11]** motion to assume an executory contract.

Like Nordheim, HPIP argues that Sabine's dedication of certain of its leases and the HPIP Products are covenants that run with the land and are not subject to rejection.[19] Unlike Nordheim, however, HPIP does not object to the rejection of the HPIP Agreements, but opposes only the Debtors' attempt to reject those certain covenants contained in the HPIP Agreements that HPIP argues "run with the land."[20] Contrary to Nordheim's *Orion* argument, HPIP submits that the Court should make an affirmative determination in the context of this Motion that the covenants do in fact run with the land and therefore cannot be rejected.

19 HPIP Objection, ¶ 9 (citing *Gouveia v. Tazbir*, 37 F.3d 295, 298 (7th Cir. 1994) holding that covenants running with the land are property interests and cannot be extinguished through bankruptcy).

20 HPIP Objection, p. 2.

[*73] Significantly, neither Nordheim nor HPIP has put forward any arguments or evidence that the Debtors' decision to reject their Agreements is the product of "bad faith, whim or caprice." As discussed more fully below, after review of Nordheim's *Orion* argument and Judge Drain's recent decision in *In re The Great Atlantic & Pacific Tea Company, Inc.* interpreting *Orion*, the Court **[**12]** concludes that it cannot decide substantive legal issues, including whether the covenants at issue run with the land, in the context of a motion to reject, unless such motion is scheduled simultaneously with an adversary proceeding or contested matter to determine the merits of the substantive legal disputes related to the motion.[21] [HN3] Although Federal Rules of Bankruptcy Procedure 6006 and 9014 provide that a proceeding to reject an executory contract is a contested matter, the Second Circuit's decision in *Orion* makes clear that such a proceeding "should be considered a summary proceeding, intended to efficiently review the trustee's or debtor's decision to adhere to or reject a particular contract in the course of the swift administration of the bankruptcy estate. It is not the time or place for prolonged discovery or a lengthy trial with disputed issues."[22] In the instant case, because there is not procedural clarity or consensus as to whether issue was properly joined on the substantive legal issues presented by the Motion -- *i.e.*, whether certain of the contractual terms are covenants that "run with the land" under Texas law -- the Court must proceed in accordance with *Orion* and rule on the Motion without deciding in a binding way **[**13]** the underlying legal dispute with respect to whether the covenants at issue run with the land. The Court does so reluctantly inasmuch as there is no doubt that bifurcating the motion to reject and further proceedings to finally resolve the underlying property law dispute is an inefficient use of judicial and private resources; it would have been far preferable for the Court to hear the two together.

21 *Orion*, 4 F.3d. at 1099.

22 *Id.* at 1098-99.

At oral argument, counsel for HPIP acknowledged that HPIP does not object to the Debtors' rejection of the HPIP Agreements, stating that "there's no question they should reject"[23] and that "assumption wouldn't make any sense."[24] Accordingly, there is no dispute with respect to the reasonableness of the Debtors' decision to reject the HPIP Agreements. Nordheim, however, challenges the reasonableness of the Debtors' decision to reject the Nordheim Agreements, but has put forward no evidence or argument that the Debtors' decision was the product of bad faith, whim, or caprice, or was otherwise an unreasonable exercise of the Debtors' business judgment.

23 Tr. of 2/2/16 Hearing 94:16-17 [ECF No. 816].

24 Tr. of 2/2/16 Hearing 97:20-23.

If it is ultimately determined that the covenants at issue in the Agreements **[**14]** do not run with the land, as the Debtors argue and the Court believes to be the case, the Debtors will be free to negotiate new gas gathering agreements with any party, likely obtaining better terms than the existing agreements provide. If, however, the covenants are ultimately determined to run with the land, the Debtors will likely need to pursue alternative arrangements with Nordheim and HPIP consistent with the covenants by which the Debtors would remain bound. In either scenario, the Debtors' conclusion that they are better off rejecting the Nordheim and **[*74]** HPIP Agreements is a reasonable exercise of their business judgment. Therefore, even though, as explained below, the Court's conclusion that the covenants at issue do not run with the land is non-binding, the Court finds the Debtors' decision to reject each of the Nordheim Agreements and the HPIP Agreements to be a reasonable exercise of business judgment.

In the absence of any allegation challenging the Debtors' decision-making process, the Court finds that the Debtors have properly and adequately considered the business and legal risks associated with rejection of the Nordheim Agreements and the HPIP Agreements. Taking into account **[**15]** HPIP's consent to the rejection of the HPIP Agreements, and having identified no basis to find otherwise with respect to either the Nordheim Agreements or the HPIP Agreements, the Court defers to the business judgment of the Debtors to reject the Agreements. Rejection of the Agreements relieves the Debtors of those terms that are subject to rejection (whether that be all or some of the terms of the Agreements as

will be decided in a subsequent proceeding or agreed to by the parties), and will likely allow for the more efficient use of the Debtors' assets.

The Court's non-binding analysis as to whether the covenants at issue "run with the land" under Texas law follows.[25]

25 It is clear that under *Orion* the Court may consider disputed legal issues in a non-binding way in the context of a motion to reject. *In re The Great Atl. & Pac. Tea Co., Inc.*, 544 B.R. at 52.

B. The Covenants At Issue Do Not "Run with the Land" under Texas Law

The covenants at issue are (i) the Debtors' dedication to HPIP of the HPIP Products and certain leases to the performance of the HPIP Agreements; (ii) the Debtors' dedication to Nordheim of the Nordheim Products to the performance of the Nordheim Agreements; and (iii) the Debtors' covenant to pay Nordheim a gathering fee. **[**16]** Generally, a covenant may run with the land as a real covenant or as an equitable servitude. Here, the Court preliminarily finds that none of the covenants runs with the land either as a real covenant or as an equitable servitude.

1. Historical Development of Covenants "Running with the Land"[26]

26 *See generally* 9 Richard R. Powell, *Powell on Real Property*, § 60.01 (2015).

As many practitioners have noted, "[i]n U.S. property law, no rules are more arcane and anachronistic than those governing real covenants,"[27] a statement with which every first-year law student undoubtedly agrees. Nevertheless, the use of property covenants is pervasive in the United States, and the law relating to covenants, while archaic, must still be faithfully applied.

27 53 Rocky Mt. Min. L. Inst. § 19.01 (2007).

To inform its analysis of Texas law and its application to the facts here, the Court provides some background on the origins and development of covenants "running with the land" in the United States. The original concept of covenants "running with the land" was introduced in early English law at a time when neither the rights nor the duties created by contract could be assigned. Beginning in the landlord and tenant context, the idea that the benefit and burden **[**17]** of a covenant could run with the ownership interest was applied in other situations, including covenants included in a conveyance of land. These covenants respecting the use of land that ran with the estate came to be known as **[*75]** "real covenants" and were enforceable in the English courts of law.

In the early cases, the courts tended to restrict the expansion of the use of real covenants by adding requirements to be met in order for a successor to recover for breach of a covenant in the original contract. For example, in one of the earliest cases dealing with the running of a burden, *Spencer's Case*,[28] the English court in the year 1583 created two requirements: (1) for a covenant relating to something not in existence to run, it must expressly bind assigns and (2) a covenant must "touch and concern" the land in order for it to run.

28 77 E.R. 72 (1583).

By 1834, the English courts of law had greatly narrowed the scope of legal relief available for breaches of covenants by holding that the running of the burdens on owners in fee violated public policy against encumbering land and restricting alienation. Thereafter, English courts of equity began developing rules for the enforcement of covenants against successive **[**18]** interestholders. Although over time English courts stopped finding that affirmative covenants run with the land, American jurisdictions have generally rejected that approach, instead adopting a policy that the requirements for running with the land should be more strictly applied to affirmative covenants than to negative ones. The covenants that meet the test established by the courts of equity have come to be known as "equitable servitudes."

Over time, the use of covenants, both real and equitable, has become common. Yet, many characterize the law of covenants as an "unspeakable quagmire,"[29] in part because of the continued distinction between real covenants and equitable servitudes even after the union of law and equity, as well as the development in judicial decisions of additional requirements and wrinkles across different jurisdictions. Although the American Law Institute has pursued clarification by adopting the *Restatement (Third) of Property: Servitudes* in 1998, acceptance of some of the newer propositions has not been universal.

29 *See* 9 Richard R. Powell, *Powell on Real Property*, § 60.01 (2015) (citing Edward Rabin, Roberta Kwall, Jeffrey Kwall, and Craig Arnold, *Fundamentals of Modern Real Property Law 489* (6th **[**19]** ed. 2011).

It is in this historical context that the Court has considered the arguments as to the status under Texas property law of the covenants at issue in this case, and has preliminarily concluded that the covenants do not run with the land either as real covenants or as equitable servitudes.

2. Real Covenants

The parties agree that whether the covenants run with the land is a question of Texas law, which is the law governing the Agreements. Unfortunately, there appears to be no applicable binding decision of the Texas Supreme Court on all aspects of the question. What follows is the Court's analysis of the issue based on existing caselaw.

Under Texas law, language in a contract containing a covenant is the primary evidence of the parties' intent, but terminology is not dispositive.[30] Rather, a covenant runs with the land when (1) it touches and concerns the land; (2) it relates to a thing in existence or specifically binds the parties and their assigns; (3) it is intended by the original **[*76]** parties to run with the land; and (4) the successor to the burden has notice.[31] Many courts have also required that the parties have horizontal privity of estate. Neither Nordheim nor HPIP has identified **[**20]** any governing authority that has rejected the horizontal privity requirement, and so the Court has considered the issue of horizontal privity of estate in its analysis.[32]

30 *Musgrave v. Brookhaven Lake Property Owners Ass'n*, 990 S.W.2d 386, 395 (Tex. App. 1999).

31 *Inwood North Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987).

32 *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 910-11 (Tex. 1982).

In their omnibus reply to the objections, the Debtors dispute the existence of three of these elements: (1) that there is horizontal privity of estate between, respectively, Sabine and Nordheim, and Sabine and HPIP; (2) that the relevant covenants "touch and concern" the land; and (3) that the parties intended those covenants to run with the land.

Horizontal privity of estate generally means that there was "simultaneous existing interests or mutual privity" between the original covenanting parties as either landlord and tenant or grantor and grantee.[33] According to the traditional concept, the original covenanting parties seeking to create a covenant "running with the land" would need to have some additional transactional element to their relationship, and not merely be two parties seeking to covenant with one another.[34] The traditional paradigm involves a property owner reserving by covenant, either for itself or another beneficiary, a certain interest out of the conveyance of the property burdened by the covenant. That **[**21]** was the factual context before the Fifth Circuit in its decision in *Newco Energy v. Energytec, Inc.*[35] on which both Nordheim and HPIP rely almost exclusively in support of their argument that the covenants at issue run with the land. In *Energytec*, the owner of a pipeline system assigned its property rights to one party, while reserving by covenant for another party the right to receive a fee for product transported on that property (*i.e.*, through the pipeline) and a right to consent to any assignment of that property -- a clear instance of the promisor seeking to ensure that the conveyance of its property interests did not eradicate an interest in the property of a third party.

33 *Newco Energy v. Energytec, Inc. (In re Energytec, Inc.)*, 739 F.3d 215, 222 (5th Cir. 2013).

34 53 Rocky Mt. Min. L. Inst. § 19.03 (2007).

35 739 F.3d at 221.

The facts here do not fit within that traditional model. In this case, the Debtors did not in the context of a relevant conveyance reserve any interest for Nordheim or HPIP; rather, they simply engaged Nordheim and HPIP to perform certain services related to the hydrocarbon products produced by Sabine from its property. The covenants at issue are properly viewed as identifying and delineating the contractual rights and obligations with respect to the services to be provided, **[**22]** and not as reserving an interest in the subject real property.

Moreover, the Agreements do not grant Nordheim or HPIP a real property interest in the Debtors' mineral estate, which is comprised of five real property rights, or "sticks," under Texas law: "(1) the right to develop (the right of ingress and egress), (2) the right to lease (the executive right), (3) the right to receive bonus payments, (4) the right to receive delay rentals, [and] (5) the right to receive royalty payments."[36] **[*77]** A right to transport or gather produced gas is clearly not one of these "sticks."[37] Therefore, under Texas law, the Debtors have not transferred any portion of their real property interests to Nordheim or HPIP through the Agreements.

36 *Lesley v. Veterans Land Bd.*, 352 S.W.3d 479, 481 n.1 (Tex. 2011) (quoting *Altman v. Blake*, 712 S.W.2d 117, 118 (Tex. 1986)).

37 *Id.* at 481.

The covenants at issue also do not appear to satisfy the "touch and concern" prong. Courts utilize two tests for determining whether that prong is satisfied under Texas law, although these tests are not "absolute."[38] The first test considers whether the covenant "affected the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it."[39] The second test evaluates whether "the promisor's legal relations **[**23]** in respect of the land in question are lessened--his legal interest as owner rendered less valuable by the promise...[and] if the promisee's legal relations in respect to the land are increased--his legal interest as owner rendered more valuable by the promise."[40] The Fifth Circuit, in interpreting Texas law, has stated that "[a]lthough the caselaw is somewhat unclear, it is at least arguable that the benefit requirement has been abandoned by the Texas courts"--meaning that a covenant need only burden the promisor's legal interest in the land to "touch and concern" that land.[41] But, the Fifth Circuit has also explained that it is not enough that a covenant affect the value of the land; "it must still affect the owner's interest in the property or its use in order to be a real covenant."[42] The covenants at issue here do not satisfy either test: they do not impact the value of the land "independent of collateral circumstances" and do not affect any interest in the real property of, or its use by, the owner. Rather, those covenants constitute an undertaking personal to the producer (Sabine) and the midstream service providers (Nordheim and HPIP).

38 *Westland Oil*, 637 S.W.2d at 911.

39 *El Paso Refinery, LP v. TRMI Holdings, Inc. (In re El Paso Refinery, LP)*, 302 F.3d 343, 356 (5th Cir. 2002).

40 *Westland Oil*, 637 S.W.2d at 911.

41 *El Paso*, 302 F.3d at 356. Not only is the caselaw "somewhat unclear," but each **[**24]** of the two tests identified in the caselaw is somewhat analytically circular.

42 *Id.* at 357.

Under Texas law, once minerals are extracted from the ground, such minerals cease to be real property and instead become personal property.[43] The covenants at issue concern only Sabine's interests in the produced "Products." The dedication covenants provide Nordheim and HPIP, as Sabine's service-providers, with the products needed to perform the contracted-for services. This is true even for the Debtors' dedication of certain leases in the HPIP Agreements inasmuch as that dedication is in furtherance of the overarching purpose of the contract, which is to provide product services to the Debtors. Similarly, the gathering fee compensates Nordheim for gathering those Products as part of its provision of those services. Contrary to HPIP's argument, the "dedication" does not constitute a burdening of the Debtors' property interests, but rather an identification of what property and products are the subject of the Agreement and will be made

available to the gatherer **[*78]** in furtherance of the purposes of the Agreements. Under Texas law, such covenants do not have a direct impact upon the real property from which those **[**25]** products were produced and thus do not "touch and concern" the land. They concern only the Products produced from real property and affect only Sabine's personal property rights.[44]

43 *See, e.g., Sabine Prod. Co. v. Frost Nat. Bank of San Antonio*, 596 S.W.2d 271, 276 (Tex. Civ. App. 1980); *Colorado Interstate Gas Co. v. Hunt Energy Corp.*, 47 S.W.3d 1, 10 (Tex. App. 2000), *pet. denied*; *Riley v. Riley*, 972 S.W.2d 149, 155 (Tex. App. 1998); *Phillips Petroleum Co. v. Adams*, 513 F.2d 355, 363 (5th Cir. 1975).

44 An argument might be made that the fact that only "produced" Products are dedicated to the performance of the Agreements does not limit such a dedication to Products extracted from the ground (*i.e.*, personal property) but also includes Products that are still in the ground (*i.e.*, real property) because, under Texas law, a conveyance of oil and gas "produced and saved" is classified as a royalty interest, which is characterized by Texas courts as a real property interest. Such an argument, however, depends on the separate and different conclusion that a conveyance of oil and gas "produced and saved" is a conveyance of oil and gas not extracted from the ground, *i.e.*, the reserves. That conclusion does not logically follow, and therefore any such argument would fail. Moreover, as discussed *infra*, the Debtors' reserves are subject to the liens of their reserve-based lenders.

Another consideration that the Fifth Circuit has examined in determining whether a covenant burdens the land **[**26]** is whether the action triggering the covenant is one that affects the land.[45] In *Westland Oil*, for example, the Texas Supreme Court held that a covenant obligating a third-party to assign part of its interest in certain oil and gas leases "touched and concerned the land" in part because the covenant was triggered by the drilling of a test well on the land.[46] Here, the triggers for the covenants at issue relate to the Products, not to the land itself.

45 *El Paso*, 302 F.3d at 356 (distinguishing *Westland Oil*).

46 *Westland Oil*, 637 S.W.2d at 909.

The dedication covenants are triggered contractually by Sabine's production and saving of the Nordheim and HPIP Products, while the Nordheim gathering fee covenant is triggered by Nordheim's receipt of the Nordheim Products. None of those triggers affects the land from which those products have been produced. Rather, only *the products themselves*, and, importantly, Sabine's rights with respect to those products, are affected by those covenants.[47] The land itself remains unburdened.[48]

47 A question as to the extent of the Debtors' rights under the Agreements or otherwise to transport Products by means other than the gathering systems of Nordheim and HPIP arose at oral argument -- to wit, the Debtors acknowledged that they **[**27]** are in fact using trucks instead of the HPIP gathering system to transport certain HPIP Products, a fact of which HPIP's counsel stated he was unaware. *See* Tr. of 2/2/16 Hearing 105:18-23. The transportation of the HPIP Products other than through HPIP's gathering system, if permissible under the HPIP Agreements, supports the conclusion that the dedication covenants in the HPIP Agreements do not "touch and concern" the land. As of the date hereof, HPIP has not, to the Court's knowledge, sought injunctive relief against the Debtors relating to such activities.

48 *See El Paso*, 302 F.3d at 356 *(citing Mobil Oil Corp. v. Brennan*, 385 F.2d 951, 953 (5th Cir. 1967) (describing covenant preventing mineral estate owner from interfering with surface grazing and from placing pipelines above certain depth)).

On this basis, once again, *Energytec* is distinguishable.[49] First, the right to consent to an assignment in *Energytec* was a clear burden on the land because it restricted the landowner's rights of alienation of its property. Such a burden does not exist here. Second, unlike the Nordheim gathering fee, the transportation fee in *Energytec* was secured by a lien on the entire gas pipeline system, which was owned by the promisor. As the Debtors **[*79]** point out, not only is the Nordheim gathering **[**28]** fee not secured, but the property subject to the Nordheim Agreements is subject to preexisting liens held by the Debtors' secured lenders. Those lienholders did not approve a conveyance of any interest in the land subject to the liens, and they were not informed of any interest being created in those properties.[50] Moreover, while Nordheim and HPIP point to local recordings filed in connection with their respective Agreements, there was no security provided to them with respect to their alleged interests in the property. Contrary to Nordheim's argument that any lien priority dispute is an issue between the Debtors and their lienholders,[51] those facts strongly militate against a finding that the covenants at issue burden the property and thus touch and concern the land.

49 739 F.3d at 221.

50 Tr. of 2/2/16 Hearing 114:6-9.

51 Tr. of 2/2/16 Hearing 119:18-25.

Energytec is also distinguishable by the fact that the obligation to pay the transport fee in that case was triggered simply by the flow of gas through the pipeline. Here, in contrast, the Nordheim gathering fee is triggered by Nordheim's receipt of gas from Sabine into Nordheim's own facilities. Nordheim's gathering fee is thus not as directly tied to the promisor's **[**29]** land as was the case in *Energytec*. The Nordheim gathering fee covenant therefore has no direct connection to or impact on the land or on Sabine's property rights.[52] Neither the property owner's interest in the land (as distinct from the products produced from those lands) nor its use of those lands is affected by such covenants, which, as the Fifth Circuit stated in *El Paso*, do not "compel []or preclude [the owner]...from doing anything on the land itself."[53]

52 *El Paso*, 302 F.3d at 346.

53 *Id.* at 346, 356-57.

Having found preliminarily that the covenants at issue do not (i) readily fit into the traditional paradigm for horizontal privity of estate or (ii) "touch and concern" the Debtors' land, the Court need not further extend its real covenant analysis at this time; accordingly, the Court has not considered the issue of the parties' intent.

3. Equitable Servitudes

Nordheim, in its surreply, alternatively argues that even if the covenants at issue are personal covenants, they constitute equitable servitudes which cannot be rejected pursuant to the Bankruptcy Code. This argument lacks merit. An equitable servitude is enforceable when the contracting parties are in privity of estate at the time of the conveyance and a subsequent party purchases **[**30]** the land with notice of the restriction.[54] However, in the case of an equitable servitude, the restriction sought to be enforced must still "concern the land or its use or enjoyment."[55] Because the Court has concluded that the covenants at issue do not "concern the land or its use," the Court also must conclude that the covenants at issue are likewise not enforceable as equitable servitudes.

54 *Id.* at 358.

55 *Id.*

Conclusion

For all of the foregoing reasons, the Court finds that the decision to reject the Nordheim Agreements and HPIP Agreements is a reasonable exercise of the Debtors' business judgment. Accordingly, the Court authorizes the rejection of those agreements as of the dates requested in the Motion.

As required by *Orion*, in granting the Motion, the Court does not make any final **[*80]** determination as to whether the covenants at issue run with the land or as to any substantive legal issue other than granting authority to reject the contracts under section 365(a). The Court does not at this time grant the Debtors' request to limit the nature of the claims that Nordheim or HPIP may file against the Debtors' estates, nor does it grant Nordheim's request for what is effectively relief from the automatic stay to pursue remedies **[**31]** against Sabine and its property. Nordheim and HPIP may file claims (and, in HPIP's case, amend its previously filed claim) against the Debtors' estates consistent with what each of them believes its legal rights to be, and those claims may be resolved promptly through the Debtors' claims administration process. The parties are directed to submit an order consistent with this decision.

Dated: March 8, 2016

New York, New York

/s/ Shelley C. Chapman

HONORABLE SHELLEY C. CHAPMAN

UNITED STATES BANKRUPTCY JUDGE

TAB 6

In re SABINE OIL & GAS CORP., et al., Debtors. HPIP GONZALES HOLDINGS, LLC, Appellant, -v- SABINE OIL & GAS CORP., et al., Appellees. NORDHEIM EAGLE FORD GATHERING, LLC, Appellant, -v- SABINE OIL & GAS CORP., et al., Appellees.

16-cv-4127 (JSR),16-cv-4132 (JSR),16-cv-4615 (JSR),16-cv-4616 (JSR)

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

567 B.R. 869; 2017 U.S. Dist. LEXIS 38204

March 9, 2017, Decided
March 10, 2017, Filed

PRIOR HISTORY: [1]** Bankr. Nos. 15-11835, 16-01042 & 16-01043(SCC).
In re Sabine Oil & Gas Corp., 547 B.R. 66, 2016 Bankr. LEXIS 720 (Bankr. S.D.N.Y., 2016)
In re Sabine Oil & Gas Corp., 550 B.R. 59, 2016 Bankr. LEXIS 1905 (Bankr. S.D.N.Y., 2016)

CORE TERMS: covenant, dedicated, condensate, gathering, lease, property interest, pipeline, mineral, royalty, touch, processing, deliver, declaratory, adversary proceedings, consolidated, successor, saved, oil, equitable servitudes, collectively, conveyance, burdened, executory contract, dedication, convey, buyer's, real property, right to receive, legal relations, independently

COUNSEL: For HPIP Gonzales Holdings, LLC, Appellant (1:16-cv-04127-JSR, 1:16-cv-04132-JSR): Christopher R. Harris, Keith Adam Simon, LEAD ATTORNEYS, Latham & Watkins, LLP, New York, NY.

For Nordheim Eagle Ford Gathering, LLC., Appellant (1:16-cv-04127-JSR): Mark Robert Wulfe, Michael C. Hefter, Robert G. Burns, LEAD ATTORNEYS, Bracewell LLP, New York, NY; William A Wood, III, LEAD ATTORNEY, PRO HAC VICE, Bracewell LLP, Houston, TX; Yvonne Y Ho, LEAD ATTORNEY, PRO HAC VICE, Bracewell L.L.P., Houston, TX.

For Sabine Oil & Gas Corporation, Appellee (1:16-cv-04127-JSR): Adrianne Katrine Jakola, Ryan Blaine Bennett, LEAD ATTORNEYS, PRO HAC VICE, Kirkland & Ellis LLP (IL), Chicago, IL; Christopher Marcus, James H.M. Sprayregen, Paul Basta, LEAD ATTORNEY, Kirkland & Ellis LLP (NYC), New York, NY; Devon M. Largio, LEAD ATTORNEY, Kirkland & Ellis LLP, Chicago, IL; Gabor Balassa, LEAD ATTORNEY, Kirkland & Ellis LLP (IL), Chicago, IL; Jonathan S. Henes, LEAD ATTORNEY, Kirkland &Ellis LLP (LA), Los Angeles, CA; Anna G. Rotman, Kenneth A. Young, Kirkland & Ellis LLP, Houston, TX.

For Sabine Oil & Gas Corporation, Appellee (1:16-cv-04132-JSR, 1:16-cv-04615-JSR, **[**2]** 1:16-cv-04616-JSR): Adrianne Katrine Jakola, Ryan Blaine Bennett, LEAD ATTORNEYS, PRO HAC VICE, Kirkland & Ellis LLP (IL), Chicago, IL; Christopher Marcus, James H.M. Sprayregen, Paul Basta, LEAD ATTORNEYS, Kirkland & Ellis LLP (NYC), New York, NY; Devon M. Largio, LEAD ATTORNEY, Kirkland & Ellis LLP, Chicago, IL; Gabor Balassa, LEAD ATTORNEY, Kirkland & Ellis LLP (IL), Chicago, IL; Jonathan S. Henes, LEAD ATTORNEY, Kirkland &Ellis LLP (LA), Los Angeles, CA.

For Nordheim Eagle Ford Gathering, LLC, Appellant (1:16-cv-04615-JSR, 1:16-cv-04616-JSR): Robert G. Burns, LEAD ATTORNEY, Bracewell LLP, New York, NY; Yvonne Y Ho, PRO HAC VICE, Bracewell L.L.P., Houston, TX.

JUDGES: JED S. RAKOFF, UNITED STATES DISTRICT JUDGE.

OPINION BY: JED S. RAKOFF

OPINION

[*871] MEMORANDUM ORDER

JED S. RAKOFF, U.S.D.J.

Pending before this Court are the consolidated appeals of HPIP Gonzales Holdings, LLC ("HPIP") and Nordheim Eagle Ford Gathering, LLC ("Nordheim") (collectively "appellants") from three orders by Judge Chapman of the bankruptcy court in the Chapter 11 action of debtor-appellee Sabine Oil & Gas Corp. ("Sabine") and adversary proceedings between each of the appellants and Sabine. The bankruptcy court determined that appellants' agreements **[**3]** with Sabine to provide gathering services did not run with the land under Texas property law, and therefore it granted Sabine's motion to reject the agreements as executory pursuant to 11 U.S.C. § 365(a). The Court now affirms the bankruptcy court's decision for the reasons explained below.

Presuming familiarity with the underlying record and bankruptcy court proceedings, the Court provides a brief overview of the procedural and factual background relevant to this appeal. This dispute arises out of agreements that Sabine, an energy company that explores and develops onshore oil and natural gas properties, entered into with HPIP and Nordheim, "midstream gatherers" that gather, transport, and process oil and gas after they have been extracted from land but before they are refined.

On January 23, 2014, Sabine and Nordheim entered into two substantially similar agreements: the Gas Gathering Agreement, which concerned natural gas, and the Condensate Gathering Agreement, which concerned liquid hydrocarbons (collectively, the "Nordheim Agreements"). **[*872]** See Bankr. Case No. 16-01043, Dkt. 21 Ex. A, B.[1] In each agreement, Sabine "dedicate[d] for gathering and dehydration" and agreed to deliver to Nordheim "all [gas and condensate] **[**4]** produced and saved . . . from wells . . . located within the Dedicated Area," a specified area of land in which Sabine held leases (the "Nordheim Dedicated Area"). Nordheim Dkt. 21, Ex. A at § 1.1. In other words, Sabine agreed to deliver all of the gas and condensate it produced from a particular area to Nordheim. In exchange, Nordheim agreed to receive, treat, dehydrate, and then re-deliver the gas and condensate to Sabine. Id. at § 2.3. Sabine agreed to pay gathering fees for Nordheim's services and to make a "Deficiency Payment" if it failed to deliver a certain minimum volume of gas and condensate each year. Id. at §§ 1.9, 5.1. The Nordheim Agreements expressly state that title to the gas and condensate remains with Sabine, that the agreements shall be "covenant[s] running with [Sabine's] Interests" in the Nordheim Dedicated Area, and that the agreements are binding on Sabine's successors and assigns. Id. at § 1.6, App'x § 3.7.

1 All references in this Memorandum Order to a document in the docket of the adversary proceedings in the bankruptcy court initiated by Sabine against Nordheim, Bankr. Dkt. No. 16-01043, are indicated as "Nordheim Dkt.," followed by the document number. Similarly, documents from the adversary proceedings in the bankruptcy court initiated by Sabine against HPIP, Bankr. Dkt. No. 16-01042, are indicated using "HPIP Dkt.," and those from Sabine's Chapter 11 bankruptcy proceedings, Bankr. Dkt. No. 15-11835, are indicated using "Ch. 11 Dkt."

In addition, the Nordheim Agreements contemplate a separate and subsequent conveyance from Sabine to Nordheim of a tract of land on which Nordheim could construct the facilities and pipelines needed for its gathering services. On March 11, 2014, Sabine conveyed to Nordheim approximately 17 acres **[**5]** of a 38-acre surface tract adjoining the Nordheim Dedicated Area, as well as a 90-foot pipeline and electrical easement over the remaining 21 acres of the surface tract. See Nordheim Dkt. 21, Ex. C.

Sabine also entered into two similar agreements with HPIP (collectively, the "HPIP Agreements"). On May 3, 2013, Sabine and HPIP entered the Production Gathering, Treating and Processing Agreement (the "HPIP Gathering Agreement"). HPIP agreed to perform gathering services with respect to all of the oil, gas, and water produced by Sabine from a "Dedicated Area" over which Sabine held certain leases (the "HPIP Dedicated Area"), and to construct the facilities required for those services. Br. of Appellant HPIP Gonzales Holdings, LLC ("HPIP Br."), Ex. 1 at § 2.1, ECF No. 11. In exchange, Sabine "dedicate[d] and commit[ted] to the performance of this Agreement the Leases and all of [Sabine]'s owned or controlled Production produced and saved from [Sabine]'s operated Wells located on the Leases," and "covenant[ed] to deliver the same to [HPIP]." Id. at § 1.2. Sabine also agreed to pay fees for HPIP's processing services. Id. at

§ 5. Like the Nordheim Agreements, the HPIP Gathering Agreement expressly states that Sabine retains title to the leases in **[**6]** question, that the agreement "constitute[s] a real right and covenant running with the lands and leasehold interests" that it covers, and that the agreement is binding on the parties' successors. Id. at §§ 9.2.1, 9.3. Moreover, it provides that Sabine may not transfer its interests in the leases unless the purchaser agrees to be bound by the agreement. Id. at § 9.2.2. A memorandum of the agreement was recorded in Wilson **[*873]** County, Texas, and Gonzales County, Texas. See HPIP Dkt. 8, Ex. 3.[2]

2 The Water and Acid Gas Handling Agreement, which Sabine and HPIP entered into in May 2014 and which deals with the disposal of water and acid gas produced within the HPIP Dedicated Area, contains substantially similar language to the HPIP Gathering Agreement and therefore the parties' briefing focuses only on the latter. See Consolidated Br. of Appellants ("Consolidated Br.") 4 n.9, ECF No. 14.

On July 15, 2015, Sabine and various affiliates (collectively the "Debtors") filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Ch. 11 Dkt. 1. On September 30, they filed a motion to reject the HPIP Agreements and the Nordheim Agreements (collectively, the "Agreements") pursuant to § 365(a) of the Bankruptcy Code. Debtors' Omnibus Mot. for Entry of an Order Authorizing Rejection of Certain Executory Contracts, Ch. 11 Dkt. 371. Each of the appellants objected to the motion on the ground that the Agreements could not be rejected because they contained covenants that run with the land. On March 8, 2016, the bankruptcy court rejected appellants' arguments and granted the rejection motion. Bench Decision on Debtors' Omnibus Motion to Authorize Rejection **[**7]** of Certain Executory Contracts, Ch. 11 Dkt. 872.

However, the bankruptcy court decided that it was unable to make a definitive decision on substantive legal issues, including whether the covenants at issue run with the land, in the procedural context of a motion to reject, which deals only with whether the trustee or debtor prudently decided to reject a given contract. See id. at 7 (citing Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.), 4 F.3d 1095, 1098 (2d Cir. 1993)).

Accordingly, the Debtors commenced adversary proceedings against each of the appellants seeking declaratory judgments that the covenants contained in the Agreements do not run with the land. Compl. for Declaratory J., HPIP Dkt. 1; Compl. for Declaratory J., Nordheim Dkt. 1. Appellants each asserted counterclaims for declaratory judgments affirming the opposite. Answer, Affirmative Defenses and Countercls., HPIP Dkt. 8; Answer to Compl. for Declaratory J. and Countercls. for Declaratory J., Nordheim Dkt. 5. Each of the appellants moved for judgment on the pleadings with respect to the Debtors' declaratory judgment claims and their own counterclaims, while the Debtors moved for summary judgment with respect to their claims and appellants' counterclaims.

On May 5, 2016, the bankruptcy court granted summary judgment **[**8]** to the Debtors. Mem. Decision on (I) Mots. for J. on the Pleadings and (II) Debtors' Omnibus Mot. for Summ. J., HPIP Dkt. 22; Nordheim Dkt. 20. It concluded, as it had in the course of granting the Debtors' rejection motion, that neither the HPIP Agreements nor the Nordheim Agreements contained covenants that run with the land, either as real covenants or as equitable servitudes. The bankruptcy court entered a final order authorizing rejection of the Agreements, as well as final orders in the adversary proceedings, on May 11, 2016. Ch. 11 Dkt. 1082-84; HPIP Dkt. 23; Nordheim Dkt. 22. Appellants timely filed these appeals on June 2, 2016 and June 17, 2016, respectively, and the appeals were subsequently consolidated.[3]

3 Each of the appellants filed two notices of appeal - one from an order in Sabine's Chapter 11 proceeding and one from an order in the respective appellant's adversary proceeding against Sabine. All four appeals were consolidated together under the docket number 16-cv-4127 (JSR). Order dated July 6, 2016, ECF No. 7.

[*874] On appeal, appellants raise three issues: whether the bankruptcy court erred in (1) deciding that the Agreements did not contain real covenants, (2) deciding that the Agreements did not contain equitable servitudes, and (3) allowing the Debtors to reject the Agreements.[4] The Court has jurisdiction over the appeal pursuant to 29 U.S.C. § 158(a)(1).

4 Only Nordheim raises this third issue.

In a bankruptcy appeal, "[a] district court 'review[s] the bankruptcy court decision independently, accepting its factual findings unless clearly erroneous but **[**9]** reviewing its conclusions of law de novo.'" In re Dreier LLP, 2016 U.S. Dist. LEXIS 92322, 2016 WL 3920358, at *3 (S.D.N.Y. July 15, 2016) (quoting Ball v. A.O. Smith Corp., 451 F.3d 66, 69 (2d Cir. 2006)); see also Fed. R. Bankr. P. 8013.

Under § 365 of the Bankruptcy Code, a debtor in possession, "subject to the court's approval, may assume or reject any executory contract . . . of the debtor." 11 U.S.C. § 365(a). That provision allows a debtor to reject executory contracts between the debtor and another party if it is in the interest of the debtor's business, notwithstanding any adverse effects on the non-debtor contracting party. See Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.), 4 F.3d 1095, 1098 (2d Cir. 1993). However, it is not possible for a debtor to reject a covenant that "runs with the land," since such a covenant creates a property interest that is not extinguished through bankruptcy. The parties here agree on the foregoing, and therefore their dispute comes down to whether the Agreements run with the land and therefore cannot be rejected pursuant to § 365(a).

Appellants first argue that the Agreements run with the land as real covenants under Texas law, here applicable. In Inwood N. Homeowners' Ass'n v. Harris, the Supreme Court of Texas set out four conditions that must be satisfied in order for a covenant to run with the land:

> In Texas, a covenant runs with the land when it touches and concerns the land; relates to a thing in existence or specifically binds the parties **[**10]** and their assigns; is intended by the original parties to run with the land; and when the successor to the burden has notice.

736 S.W.2d 632, 635 (Tex. 1987). At issue here is the first factor, whether the covenant "touches and concerns the land." In making that determination, courts in Texas have applied two tests. First, a covenant touches and concerns the land "if it affect[s] the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affect[s] the mode of enjoying it." Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 911 (Tex. 1982). Second, a covenant touches and concerns the land either "[i]f the promisor's legal relations in respect to the land in question are lessened" or "if the promisee's legal relations in respect to that land are increased." Id. Meeting one of the two tests will satisfy the "touch and concern" requirement.

Applying the second test first, the Court concludes that appellants have not shown that the Agreements either increased their legal relations to the real property interests at issue or decreased Sabine's. Nordheim argues that Sabine's dedication of the gas and condensate that was "produced and saved" in the Nordheim Dedicated Area for gathering by Nordheim conveyed an interest in minerals in the ground, which under Texas law **[**11]** is a property interest. See American Ref. Co. v. Tidal W. Oil Corp., 264 S.W. 335, 338 (Tex. Civ. App. 1924) ("It is settled law in Texas that oil and gas are minerals, and **[*875]** while in place are a part of the realty, and one who acquires an interest in them by proper conveyance has a legal estate and interest in the land under which they are situated."). Nordheim supports this contention with citations to cases featuring the conveyance of a royalty interest in minerals "produced and saved." See, e.g., Miller v. Speed, 248 S.W.2d 250, 256 (Tex. Civ. App. 1952). It reasons that since a royalty interest is undoubtedly a property interest, see Bagby v. Bredthauer, 627 S.W.2d 190, 194 (Tex. Ct. App. 1981) ("A 'royalty interest' . . . is an interest in 'land.'"), and since conveyances of royalty interests refer to minerals produced and saved, then Sabine's dedication of gas and condensate that is "produced and saved" must convey a property interest.

However, even accepting Nordheim's premises, this conclusion does not necessarily follow, since the nature of the interest that Nordheim received is different from a royalty interest. As Nordheim notes in its brief, a royalty interest is "the right to [a] specified proportionate share of production once the minerals are produced," see id., whereas appellants received no right to any share of the gas and condensate that came from the Dedicated **[**12]** Areas, but rather were entitled to process those minerals in exchange for a fee and obligated to re-deliver them to Sabine. American Refining, upon which Nordheim relies, is distinguishable on this same basis. In that case, a contract provided that the buyer would purchase all of a certain type of gas produced from the wells in a particular area from the time of the contract onward, and the court held that since the buyer had acquired an interest in the minerals while they were part of the land, the buyer's interest was in real property. 264 S.W. at 336, 338. Here, in contrast, the appellants have not purchased the minerals underlying the Dedicated Areas but, again, have merely agreed to provide services to the minerals' owner. The logical extension of Nordheim's argument -- that any agreement relating to minerals in the ground constitutes the conveyance of a real property interest -- is not supported by the cited caselaw.

Accordingly, appellants cannot show that they have received a royalty interest in the mineral estate corresponding to the Dedicated Areas, nor have they received any of the other mineral rights or interests recognized under Texas law. See

Altman v. Blake, 712 S.W.2d 117, 118 (Tex. 1936) (listing those interests as "(1) the right to **[**13]** develop (the right of ingress and egress), (2) the right to lease (the executive right), (3) the right to receive bonus payments, (4) the right to receive delay rentals, (5) the right to receive royalty payments").

HPIP argues that, by "dedicat[ing]" "the Leases" to the performance of the HPIP Agreements, Sabine implicated some interest in those leases. See HPIP Br., Ex. 1 at § 2.1, ECF No. 11. However, Sabine clearly disclaimed any intention to convey title to the leases. See id. at § 9.3. At oral argument on this appeal, counsel for HPIP both insisted that the dedication of the leases is significant, see Tr. dated Oct. 26, 2016, at 13, and clarified that HPIP's position is not that the leases were conveyed to it, see id. at 21. Given that HPIP does not identify what kind of property interest it might have obtained in the leases from the HPIP Agreements' vague "dedication" of them to Sabine's performance of those agreements, the Court is unable to conclude that HPIP's legal interest in the leases did in fact increase. Therefore, the Court concludes that the Agreements did not increase appellants' real property interests, but rather granted them the merely contractual right to be the exclusive providers of certain services **[**14]** for gas and condensate produced in certain areas.

[*876] The Court also concludes that the Agreements did not decrease Sabine's legal relation to its real property interests in the Dedicated Areas. Appellants' arguments that Sabine's interests were burdened by its obligation to deliver all of the gas and condensate it produced to appellants are unsuccessful for multiple reasons. First, as noted above, Sabine did not convey real property interests to appellants. Second, notwithstanding the Agreements, Sabine was free to produce as much or as little gas and condensate from the Dedicated Areas as it chose. While failing to deliver the minimum volume set out in the Agreements would require Sabine to make a deficiency payment, that obligation is merely contractual. Third, Sabine's obligations under the Agreements are triggered only once the gas and condensate are produced, at which point those substances are personal, rather than real, property. See Colorado Interstate Gas Co. v. Hunt Energy Corp., 47 S.W.3d 1, 10 (Tex. Ct. App. 2000) ("Once oil or gas has been severed from the ground, it becomes personalty."). Sabine's obligation under the Agreements is simply to use Nordheim's and HPIP's respective gathering and processing services when it does produce and deliver gas and condensate, **[**15]** and that restriction does not limit Sabine's enjoyment of the land itself.

Appellants rely heavily on the Fifth Circuit's recent decision in In re Energytec, Inc., which they argue is on point here. 739 F.3d 215, 221 (5th Cir. 2013). In that case, Energytec's predecessor, Mescalero, agreed to convey its interests in a gas pipeline, its rights-of-way, and a processing plant to Producers Pipeline Corporation ("Producers"). At the same time, Mescalero reserved certain rights for Newco, its subsidiary. Specifically, under the agreement Producers had to pay Newco a transportation fee based on the amount of gas flowing through the pipeline, Newco received a security interest and lien on the pipeline system, and Producers had to obtain Newco's consent before assigning Producers' interest in the pipeline. The Fifth Circuit held that the agreement contained covenants that touched and concerned the land because Newco's interest pertained to "the use of real property, i.e., the traveling of natural gas from a starting point along the length of the pipeline to an endpoint," and because the restriction on the assignment of the pipeline "impact[ed] the owner's interest in the pipeline" and "the pipeline's value in the eyes of prospective **[**16]** buyers." Id. at 224.

Despite some similarities, Energytec is distinguishable from the case before this Court. Whereas, in Energytec, Newco was entitled to the transportation fee upon a use of the land in question, here the obligation to pay a gathering fee is only incurred upon delivery of produced gas and condensate to appellants. In addition, the requirement that Newco consent to any assignment of the use of the pipeline provides a restraint on the owner's right of alienation that is not present in the Agreements here. While the HPIP Agreements provide that any subsequent purchaser of Sabine's interests in the leases covering the HPIP Dedicated Area must assume Sabine's obligations under those agreements, such a provision merely equates to another statement that the agreements are enforceable against Sabine's successors. Thus, while the decision in Energytec is not binding on this Court in any event, its reasoning does not compel the conclusion that the Agreements burdened Sabine's real property interests.

Turning now to the first test for the "touch and concern" requirement -- whether the covenant "affect[s] the nature, quality or value of the thing demised, independently **[*877]** of collateral circumstances, **[**17]** or if it affect[s] the mode of enjoying it," Westland, 637 S.W.2d at 911 -- the Court concludes that the Agreements do not have such effects on Sabine's interests. As discussed above, and contrary to appellants' arguments regarding this test, the Agreements do not reduce Sabine's ability to make use of or alienate its real property interests. Nordheim also contends that the Nordheim Agreements make Sabine's interests "more or less valuable, depending on the price of hydrocarbons and the market rates for gathering." Consolidated Br. 14-15. But those factors are clearly collateral to the terms of the Agreements and would affect the value of any oil-producing land.

Accordingly, since the Agreements satisfy neither of the tests set out in Westland, the Court concludes that the Agreements do not touch and concern the land, and therefore the bankruptcy court did not err in holding that the Agreements do not run with the land as real covenants.[5]

> 5 Because the Court finds that the covenants do not meet the touch and concern requirement, it need not reach the issue of whether a real covenant under Texas law requires horizontal privity, and, if so, whether such privity exists here.

Appellants argue in the alternative that the Agreements constitute equitable servitudes. Under Texas law,

> a covenant that does not technically run with the land can still bind successors to the burdened land as an equitable servitude if: (1) the successor to the burdened land took its interest **[**18]** with notice of the restriction, (2) the covenant limits the use of the burdened land, and (3) the covenant benefits the land of the party seeking to enforce it.

Reagan Nat'l Adver. of Austin, Inc. v. Capital Outdoors, Inc., 96 S.W.3d 490, 495 (Tex. Ct. App. 2002) (internal citations omitted). Appellants' argument in this regard fails because, as discussed above, the Agreements do not limit Sabine's use of its property interests in the Dedicated Areas. Moreover, the Agreements benefit only appellants, not their land. Through the Agreements, appellants are entitled to receive fees for processing delivered gas and condensate, regardless of where that processing takes place, and thus the Agreements themselves do not render more valuable the land on which appellants have located their processing facilities. Accordingly, the Court concludes that the bankruptcy court did not err in holding that the Agreements did not constitute equitable servitudes.

Finally, given the foregoing conclusions, the Court further finds that the bankruptcy court did not err in authorizing the rejection of the Agreements pursuant to 11 U.S.C. § 365(a). Nordheim challenges that decision only on the ground that the Agreements are real covenants that run with the land, and, since the Court has reached the contrary conclusion, Nordheim's **[**19]** argument in this regard has no merit.

Accordingly, the Court hereby affirms the orders of the bankruptcy court. The Clerk of the Court is hereby directed to close the case.

SO ORDERED.

Dated: New York, NY

March 9, 2017

/s/ Jed S. Rakoff

JED S. RAKOFF, U.S.D.J.

TAB 7

2005 CarswellOnt 589
Ontario Court of Appeal

Androscoggin Energy LLC, Re

2005 CarswellOnt 589, [2005] O.J. No. 395, [2005] O.J. No. 592, 137 A.C.W.S. (3d) 246, 195 O.A.C. 51, 75 O.R. (3d) 552, 8 C.B.R. (5th) 11

In the Matter of the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, As Amended

And In the Matter of Androscoggin Energy LLC

Weiler, Goudge, Gillese JJ.A.

Heard: February 14, 2005
Judgment: February 18, 2005
Docket: CA C43081, M32171, M32205

Proceedings: affirming *Androscoggin Energy LLC, Re* (2005), 2005 CarswellOnt 412 (Ont. S.C.J. [Commercial List])

Counsel: Justin R. Fogarty, Renée Brosseau for Pengrowth Corporation, Canadian Forest Oil Ltd., Appellants
Robert Frank for AltaGas Ltd., Appellant
Joseph M. Steiner, Steven G. Golick, Nancy Roberts for Androscoggin Energy LLC, Respondent
Douglas S. Nishimura for Credit Suisse First Boston, Respondent
Barbara L. Grossman, David W. Mann for International Swaps and Derivatives Association, Intervenor
David R. Byers for KPMG as Information Officer

Subject: Insolvency; Natural Resources; Contracts; Corporate and Commercial; Securities
Related Abridgment Classifications
Bankruptcy and insolvency
XIX Companies' Creditors Arrangement Act
XIX.3 Arrangements
XIX.3.d Effect of arrangement
XIX.3.d.ii Stay
Natural resources
III Oil and gas
III.6 Exploration and operating agreements
III.6.i Natural gas contracts
Securities
VII Miscellaneous
Headnote
Bankruptcy and insolvency --- Proposal — Companies' Creditors Arrangement Act — Arrangements — Effect of arrangement — Stay of proceedings
Oil and gas companies ("creditors") entered into certain long-term contracts to supply gas to A Ltd., which operated cogeneration plant in Maine — On November 26, 2004, A Ltd. filed voluntary petition with US Bankruptcy Court — On same date, A Ltd. obtained ex parte order in Ontario under s. 18.6 of Companies' Creditors Arrangement Act ("CCAA") recognizing proceeding in US as "foreign proceeding" — Ontario order stayed all actions against A Ltd. in Canada and, specifically, creditors' rights to terminate gas supply contracts or to enforce other contractual rights — A Ltd. was not in default with respect to creditors' contracts — Creditors moved before Ontario Court of Justice to lift stay under CCAA,

arguing that contracts were "eligible financial contracts" ("EFCs") within meaning of s. 11.1(1) of CCAA — If contract is EFC, s. 11.1(2) of CCAA provides that no order can be made staying or restraining exercise of any right of termination under contract — Court ruled that contracts were not EFCs — Creditors appealed — Appeal dismissed — EFCs serve financial purpose unrelated to physical settlement of contracts — EFCs enabled parties to manage risk of commodity that fluctuated in price by allowing counterparty to terminate agreement in event of assignment in bankruptcy or CCAA proceeding, to offset or net its obligations under contracts to determine value of amount of commodity yet to be delivered in future, and to rehedge its position — Contracts in present case possessed none of hallmarks of financial contracts and could not be characterized as EFCs — Mere pro forma insertion of financial contract terms into contract will not result in its automatic characterization as EFC — Regard must be had to contract as whole to determine its character — Under terms of contracts, creditors could not terminate contracts for event of default so long as A Ltd. made payment of sums due — Even if there was existing breach, that breach would not necessarily entitle creditors to terminate contracts — Only if successful litigation resulted in court order declaring that creditors were entitled to terminate contracts could they do so — Under terms of contracts, creditors were not entitled to terminate contracts even if assignment provision was material or fundamental term and it was violated.

Oil and gas --- Exploration and operating agreements — Natural gas contracts

"Eligible financial contracts" under Companies' Creditors Arrangement Act — Oil and gas companies ("creditors") entered into certain long-term contracts to supply gas to A Ltd., which operated cogeneration plant in Maine — On November 26, 2004, A Ltd. filed voluntary petition with US Bankruptcy Court — On same date, A Ltd. obtained ex parte order in Ontario under s. 18.6 of Companies' Creditors Arrangement Act ("CCAA") recognizing proceeding in US as "foreign proceeding" — Ontario order stayed all actions against A Ltd. in Canada and, specifically, creditors' rights to terminate gas supply contracts or to enforce other contractual rights — A Ltd. was not in default with respect to creditors' contracts — Creditors moved before Ontario Court of Justice to lift stay under CCAA, arguing that contracts were "eligible financial contracts" ("EFCs") within meaning of s. 11.1(1) of CCAA — If contract is EFC, s. 11.1(2) of CCAA provides that no order can be made staying or restraining exercise of any right of termination under contract — Court ruled that contracts were not EFCs — Creditors appealed — Appeal dismissed — EFCs serve financial purpose unrelated to physical settlement of contracts — EFCs enabled parties to manage risk of commodity that fluctuated in price by allowing counterparty to terminate agreement in event of assignment in bankruptcy or CCAA proceeding, to offset or net its obligations under contracts to determine value of amount of commodity yet to be delivered in future, and to rehedge its position — Contracts in present case possessed none of hallmarks of financial contracts and cannot be characterized as EFCs — Mere pro forma insertion of financial contract terms into contract will not result in its automatic characterization as EFC — Regard must be had to contract as whole to determine its character — Under terms of contracts, creditors could not terminate contracts for event of default so long as A Ltd. made payment of sums due — Even if there was existing breach, that breach would not necessarily entitle creditors to terminate contracts — Only if successful litigation resulted in court order declaring that creditors were entitled to terminate contracts could they do so — Under terms of contracts, creditors were not entitled to terminate contracts even if assignment provision was material or fundamental term and it was violated.

Securities and commodities --- Miscellaneous issues

"Eligible financial contracts" under Companies' Creditors Arrangement Act — Oil and gas companies ("creditors") entered into certain long-term contracts to supply gas to A Ltd., which operated cogeneration plant in Maine — On November 26, 2004, A Ltd. filed voluntary petition with US Bankruptcy Court — On same date, A Ltd. obtained ex parte order in Ontario under s. 18.6 of Companies' Creditors Arrangement Act ("CCAA") recognizing proceeding in US as "foreign proceeding" — Ontario order stayed all actions against A Ltd. in Canada and, specifically, creditors' rights to terminate gas supply contracts or to enforce other contractual rights — A Ltd. was not in default with respect to creditors' contracts — Creditors moved before Ontario Court of Justice to lift stay under CCAA, arguing that contracts were "eligible financial contracts" ("EFCs") within meaning of s. 11.1(1) of CCAA — If contract is EFC, s. 11.1(2) of CCAA provides that no order can be made staying or restraining exercise of any right of termination under contract — Court ruled that contracts were not EFCs — Creditors appealed — Appeal dismissed — EFCs serve financial purpose unrelated to physical settlement of contracts — EFCs enabled parties to manage risk of commodity that fluctuated in price by allowing counterparty to terminate agreement in event of assignment in bankruptcy or CCAA proceeding, to

offset or net its obligations under contracts to determine value of amount of commodity yet to be delivered in future, and to rehedge its position — Contracts in present case possessed none of hallmarks of financial contracts and cannot be characterized as EFCs — Mere pro forma insertion of financial contract terms into contract will not result in its automatic characterization as EFC — Regard must be had to contract as whole to determine its character — Under terms of contracts, creditors could not terminate contracts for event of default so long as A Ltd. made payment of sums due — Even if there was existing breach, that breach would not necessarily entitle creditors to terminate contracts — Only if successful litigation resulted in court order declaring that creditors were entitled to terminate contracts could they do so — Under terms of contracts, creditors were not entitled to terminate contracts even if assignment provision was material or fundamental term and it was violated.

Table of Authorities

Cases considered by *Weiler J.A.*:

Androscoggin Energy LLC, Re (2004), 2004 CarswellOnt 5404 (Ont. S.C.J. [Commercial List]) — referred to

Blue Range Resource Corp., Re (1999), 1999 CarswellAlta 652, 72 Alta. L.R. (3d) 196, [1999] 12 W.W.R. 616, 245 A.R. 172, 12 C.B.R. (4th) 173 (Alta. Q.B.) — referred to

Blue Range Resource Corp., Re (2000), 2000 ABCA 239, 2000 CarswellAlta 1004, 192 D.L.R. (4th) 281, 20 C.B.R. (4th) 187, 266 A.R. 98, 228 W.A.C. 98, [2001] 2 W.W.R. 454, 87 Alta. L.R. (3d) 329 (Alta. C.A.) — considered

Statutes considered:

Bankruptcy Code, 11 U.S.C. 1982

Generally — referred to

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36

Generally — referred to

s. 11.1(1) "eligible financial contract" [en. 1997, c. 12, s. 124] — considered

s. 11.1(2) [en. 1997, c. 12, s. 124] — referred to

s. 18.6 [en. 1997, c. 12, s. 125] — referred to

APPEAL by creditors from judgment reported at *Androscoggin Energy LLC, Re* (2005), 2005 CarswellOnt 412, 8 C.B.R. (5th) 1 (Ont. S.C.J. [Commercial List]) with respect to creditors' application for stay of proceedings under *Companies' Creditors Arrangement Act*.

***Weiler J.A.*:**

1 This appeal, like the prior steps in this proceeding, has been conducted as "real time" litigation. Parties depend on the court system to be able to respond, as it has here, despite the inevitable time pressures.

2 The facts giving rise to this appeal are relatively straightforward. The applicants/appellants ("the appellants") entered into certain long-term contracts to supply gas to the respondent, Androscoggin Energy LLC (Androscoggin), who operated a cogeneration plant near Jay, Maine. On November 26, 2004, Androscoggin filed a voluntary petition pursuant to chapter 11 of title 11 of the United States Code (*US Bankruptcy Code*) with the United States Bankruptcy Court, District of Maine (US Bankruptcy Court). On the same date, Androscoggin obtained an *ex parte* order in Ontario under s. 18.6 of the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (CCAA) recognizing the proceeding in the United States as a "foreign proceeding" [*Androscoggin Energy LLC, Re* (2004), 2004 CarswellOnt 5404 (Ont. S.C.J. [Commercial List])]. In addition, the November 26, 2004, order stayed all actions against Androscoggin in Canada and, specifically, the appellants' rights to terminate the gas supply contracts or to enforce other contractual rights. Androscoggin's single most valuable asset is the gas supply contracts. It is common ground that the contract price at which the appellants agreed to supply gas to Androscoggin is below the current market price.

3 On January 6, 2005, the Ontario Superior Court of Justice and the US Bankruptcy Court held a joint hearing. Each court issued orders and a hearing was scheduled before the US Bankruptcy Court for February 22, 2005, to determine,

among other things, the jurisdiction of the US Bankruptcy Court over the appellants and whether the US Bankruptcy Court might allow the assignment of the gas supply contracts.

4 Before the February 22, 2005 hearing, the appellants brought a motion before Farley J. to lift the stay under the CCAA arguing that the contracts were "eligible financial contracts" (EFCs) within the meaning of s. 11.1(1) of the CCAA. Characterizing a contract as an EFC can significantly impact the proceedings. During the period the debtor has to file its proposed plan of compromise under the CCAA, the rights of the non-defaulting counterparty to enforce the terms of the contract are stayed. If, however, the contract is an EFC, s. 11.1(2) provides that no order can be made staying or restraining the exercise of any right of termination under the contract. Thus, the characterization of the contract as an EFC does not automatically allow the counterparty to avoid the effects of the stay and to terminate the contact. The rights of termination contained in the contract are determinative of whether the counterparty can end the contract.

5 The appellants' motion seeking a declaration that the contracts in issue were EFCs was heard on January 24, 2005. On January 26, 2005, Farley J. held that these contracts were not EFCs and dismissed the appellants' motion [*Androscoggin Energy LLC, Re* (2005), 2005 CarswellOnt 412, 8 C.B.R. (5th) 1 (Ont. S.C.J. [Commercial List])]. He further held that, even if the contracts in issue were EFCs, the appellants could not terminate the contracts as a result of Androscoggin's insolvency because under the terms of the contracts, the appellants could terminate the contracts only for non-payment and the respondent was not in default of payment.

6 On February 8, 2005, on the basis of urgency, the appellants moved before Feldman J.A. for an order that the leave to appeal motion be scheduled before a panel of this court on an expedited basis, and that the appeal be heard by the same panel at the same hearing if leave was granted. At the same time, the International Swaps and Derivatives Association (ISDA) brought a motion seeking leave to intervene in any appeal from the order of Farley J. Both the leave motions and the appeal were expedited [*Androscoggin Energy LLC, Re* (2005), 2005 CarswellOnt 419, 8 C.B.R. (5th) 8 (Ont. C.A. [In Chambers])]. On February 14, 2005, the motions and appeal were heard in this court. All parties want to resolve the issues before the February 22, 2005 hearing before the US Bankruptcy Court.

7 Having regard to the urgency and the significance of the issues for this proceeding and for the marketplace, I would grant leave to appeal and leave to the ISDA to intervene. I would, however, hold that Farley J. did not err in refusing to issue the declaration sought and would dismiss the appeal.

8 Although I agree with Farley J. that the gas supply contracts should not be characterized as EFCs, I would not subscribe to the reasons given by Farley J. for his conclusion. Insofar as the terms of the contract are concerned, I agree with Farley J. that even if the contracts are characterized as EFCs, the appellants are not entitled to terminate them. Some elaboration on both these determinations is required.

9 Farley J.'s conclusion that the contracts were not EFCs is based on his holding that the primary thrust of the contracts was for the physical supply of gas and not financial risk management. In so holding, Farley J. states that he favours the interpretation of LoVecchio J. in *Blue Range Resource Corp., Re* (1999), 245 A.R. 172 (Alta. Q.B.), to that of the Alberta Court of Appeal which reversed LoVecchio J. at (2000), 266 A.R. 98 (Alta. C.A.).

10 At para. 30 of his reasons LoVecchio held:

> A distinction between "physical" and "financial" contracts has pervaded the discussion in this case. The question whether contracts are one or the other is to be resolved by the intention of the parties. Simply put, if the purpose of the contract is to lead to the actual delivery of the commodity then you do not have a contract which is financial in nature but one which is physical and it should not be found to be an "eligible financial contract". If the purpose of the contract is only financial in nature and is not intended to lead to the actual delivery of the commodity, then you have a contract which is financial in nature not physical and it should be found to be an "eligible financial contract".

11 In a carefully considered and instructive judgment for the court, Fruman J.A., rejected the notion that all contracts to be settled by the physical delivery of the commodity are not EFCs. She noted that risk management companies offer

a wide range of cash settled and physically settled commodity instruments to customers, who may be producers, end-users, or other financial intermediaries, and that market participants placed little emphasis on the distinction between physically and financially settled transactions. Although some end-users eventually take delivery of the gas, trades along the way are normally settled by title transfers. Systems such as the NOVA Inventory Transfer System play a role similar to a security depository and facilitate the title transfers. Importantly, the definition of eligible financial contracts in s. 11.1(1) of the CCAA includes contracts that can be settled only by physical delivery, not financial payment. That definition includes spot contracts, which provide only for immediate physical delivery of a commodity. The definition also includes repurchase contracts. These are contracts to sell a security combined with a simultaneous agreement by the original seller to repurchase the security at a later date thus contemplating the physical return of the security for cash.

12 Fruman J.A. further held that an interpretation of s. 11.1(1) that rejected a distinction between physically settled and financially settled contracts as the basis for determining whether a contract was an EFC made commercial sense. If all physically settled instruments are not EFCs, an important part of the derivatives market would be vulnerable to insolvency, weakening the Canadian risk management structure.

13 The appellants and the ISDA submit that Fruman J.A. was correct in not drawing a distinction between physically settled and financially settled transactions as the basis for characterizing EFCs. I agree with Fruman J.A.'s analysis of the interpretation of s. 11.1(1) and, as a result, I would accept the submission of the appellants and the ISDA on this point.

14 Recognizing that not all forward commodity contracts, that is, contracts for the sale of a specified amount of a commodity at a specific price in the future, are EFCs, Fruman J.A. held that the commodity in question must be a fungible commodity in a volatile or liquid market. Such an interpretation was fair, she held, because it allowed the non-defaulting party to terminate the contract and net out its position thereby crystallizing its losses and enabling it to avoid further losses likely to arise in a volatile gas market by dealing with its exposure through further rehedging. She stated at para 20 that,

> In order to further hedge their risk, many gas producers enter into a series of agreements with the same gas marketing and risk management companies, providing for the sale of gas at different prices, on different dates and at different points of delivery. Each of these contracts has its own calculable value. At any point in time, some of these will be "in the money", others "out of the money". Termination and netting out or set-off provisions permit the purchaser to terminate all the agreements upon a triggering event. The purchaser may then "calculate the value of all the transactions as of the termination date and...net the positive and negative values to determine a lump sum termination amount payable by one party to the other." : M.E. Grottenhaler and P.J. Henderson, The Law of Financial Derivatives in Canada (Toronto: Carswell, 1999) at 5.1.

15 The appellants submit that their contracts are EFCs within s. 11.1(1) of the CCAA as interpreted by Fruman J.A. in *Blue Range Resource Corp.*, *supra.* I disagree. The contracts in issue before Fruman J.A. served a financial purpose unrelated to the physical settlement of the contracts. The reasons in *Blue Range Resource Corp.* indicate that the contracts Fruman J.A. examined enabled the parties to manage the risk of a commodity that fluctuated in price by allowing the counterparty to terminate the agreement in the event of an assignment in bankruptcy or a CCAA proceeding, to offset or net its obligations under the contracts to determine the value of the amount of the commodity yet to be delivered in the future, and to re-hedge its position. Unlike the contracts found to be EFCs in *Blue Range Resource Corp.*, *supra*, the contracts in issue here possess none of these hallmarks and cannot be characterized as EFCs. However, mere *pro forma* insertion of such terms into a contract will not result in its automatic characterization as an EFC. Regard must be had to the contract as a whole to determine its character.

16 I now turn to the second basis on which Farley J. dismissed the appellants' motion, namely, that the terms of the contract did not entitle the appellants to terminate them except for non-payment.

17 The terms of the contracts define an event of default as including a petition to reorganize that is not dismissed within 60 days. Under the terms of the contracts the appellants cannot, however, terminate the contracts for an event of default

so long as Androscoggin makes payment of the sums due, something Androscoggin continues to do. The appellants have further compromised their ability to terminate the contracts for insolvency by their consent to assignments to Credit Suisse First Boston, a lender to Androscoggin. Androscoggin submitted that, as a result, this proceeding was moot, because the appellants can point to no right to terminate that they could exercise if the stay under the CCAA was lifted.

18 Before us, the appellants accepted that they could not terminate the contracts on account of the insolvency of Androscoggin so long as payments were made. The appellants submitted, however, that the appeal was not moot because Farley J. erred in holding that non-payment was the only basis on which the contracts could be terminated. They submitted that they were entitled to terminate the contracts at common law for fundamental breach. By way of example, the appellants submitted that if the contracts were assigned without their consent, which they say is a real possibility, the assignment would be a fundamental breach of the contract. The contracts provide that the agreements cannot be assigned without the consent of the appellants, such consent not to be unreasonably withheld.

19 Androscoggin objected to the argument of fundamental breach being raised for the first time on appeal. However, having regard to the extent of submissions made by both sides respecting the substance of the argument, I propose to deal with it.

20 There are several answers to the appellants' submission. The first is that the appellants cannot point to any breach of the contracts. The second is that even if there were an existing breach, that breach would not necessarily entitle the appellants to terminate the contracts. Only if successful litigation resulted in a court order declaring that the appellants were entitled to terminate the contracts could they do so. No such order exists. The third is that although the contracts provide that the failure by a party to perform fully any material provision of the agreement is an event of default, the "Seller has no right to terminate this Agreement on account of an Event of Default on the part of Buyer so long as Buyer makes payment of sums due to Seller under this Agreement". Thus, under the terms of the contract, the appellants are not entitled to terminate the contracts even if the assignment provision is a material or fundamental term and it were violated. (In connection with the assignment provision I would point out that at the hearing before Farley J., Androscoggin represented to the Court, on the basis of sworn evidence, that, before the US Bankruptcy Court would authorize it to assign the contracts, Androscoggin would be required to satisfy the US Bankruptcy Court that there was "reasonable assurance of performance" of the contracts by a proposed assignee and that, as a practical matter, the assignee would be required to post letters of credit with the appellants that met the requirements of the contracts. Farley J. acknowledged the submission in his reasons and observed that if for some reason the assignee did not have the financial resources to make the payments Androscoggin would have a problem getting a vesting order in Canada to effect the assignment.)

21 Farley J. was correct that in this case the rights of the respondents and the appellants are not affected by the characterization of the gas supply agreements as EFCs because the terms of the contracts do not entitle the appellants to terminate the contracts. I would dismiss the appeal.

22 Inasmuch as the respondents were successful on the appeal, I would order the appellants to pay the respondents the costs of the appeal including costs of the motion for leave to appeal which I would fix on a partial indemnity scale at $24,000 for Androscoggin and $8,000 for Credit Suisse First Boston both inclusive of disbursements and GST. I would make no other order as to costs.

***Goudge J.A.*:**

I agree.

***Gillese J.A.*:**

I agree.

Appeal dismissed.

End of Document

TAB 8

2006 ABQB 153
Alberta Court of Queen's Bench

Calpine Canada Energy Ltd., Re

2006 CarswellAlta 446, 2006 ABQB 153, [2006] A.W.L.D. 1915,
[2006] A.J. No. 412, 152 A.C.W.S. (3d) 833, 19 C.B.R. (5th) 187

In the Matter of the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as Amended

In the Matter of Calpine Canada Energy Limited, Calpine Canada Power Ltd., Calpine Canada Energy Finance ULC, Calpine Energy Services Canada Ltd., Calpine Canada Resources Company, Calpine Canada Power Services Ltd., Calpine Canada Energy Finance II ULC, Calpine Natural Gas Services Limited, and 3094479 Nova Scotia Company (Applicants)

Romaine J.

Judgment: February 24, 2006
Docket: Calgary 0501-17864

Counsel: Larry B. Robinson, Q.C., Sean F. Collins, Derek Kearl for Applicants / Cross Respondents
Joseph Pasquariello, Jay A. Carfagnin for Applicants / Cross Respondents
Douglas S. Nishimura for Respondents / Cross Applicants, Pengrowth Corporation and Progress Energy Ltd.
Patrick McCarthy, Q.C., Joseph Krueger for Monitor

Subject: Corporate and Commercial; Civil Practice and Procedure; Insolvency

Related Abridgment Classifications

Business associations
V Legal proceedings involving business associations
V.2 Partnerships
V.2.b Actions by or against partnership
V.2.b.ii Practice and procedure
V.2.b.ii.I Miscellaneous
Civil practice and procedure
XVI Disposition without trial
XVI.3 Stay or dismissal of action
XVI.3.d Application

Headnote

Business associations --- Legal proceedings involving business associations — Partnerships — Actions by or against partnership — Practice and procedure — Miscellaneous issues

Predecessor agreed to sell certain oil and natural gas rights and assets on lands to corporation — Parties simultaneously signed call on production agreement which provided predecessor with reoccurring right of first refusal to purchase any portion of gas or oil produced from lands that were sold on market terms and conditions — On same date agreement was executed, partnership replaced predecessor as purchaser of gas and oil — Partnership was granted initial order restraining persons from terminating or suspending obligations under agreements as long as normal prices were paid by partnership for goods and services provided under such agreements — Corporation gave notice of suspension of delivery of natural gas to partnership under agreement — Corporation alleged that agreement was eligible financial contract and thus exempt from application of stay set out in order — Partnership brought motion for declaration that stay of proceedings contained in initial order applied to agreement — Motion granted — Balance of convenience

favoured granting of stay — Irreparable harm could occur given extremely complex corporate and debt structure of partnership, nature of proceedings and evidence of value of partnership assets — If termination of agreement remained stayed, corporation were no worse off than other suppliers of goods and services to partnership — Agreement lacked characteristics or hallmarks of eligible financial contract — Agreement formed part of consideration for sale of lands under original agreement and therefore was not just stand-alone supply contract.

Table of Authorities

Cases considered by *Romaine J.*:

Androscoggin Energy LLC, Re (2005), 2005 CarswellOnt 589, 8 C.B.R. (5th) 11, 195 O.A.C. 51, 75 O.R. (3d) 552 (Ont. C.A.) — considered

Blue Range Resource Corp., Re (2000), 2000 ABCA 239, 2000 CarswellAlta 1004, 192 D.L.R. (4th) 281, 20 C.B.R. (4th) 187, 266 A.R. 98, 228 W.A.C. 98, [2001] 2 W.W.R. 454, 87 Alta. L.R. (3d) 329 (Alta. C.A.) — followed

Campeau v. Olympia & York Developments Ltd. (1992), 14 C.B.R. (3d) 303, 14 C.P.C. (3d) 339, 1992 CarswellOnt 185 (Ont. Gen. Div.) — referred to

Lehndorff General Partner Ltd., Re (1993), 17 C.B.R. (3d) 24, 9 B.L.R. (2d) 275, 1993 CarswellOnt 183 (Ont. Gen. Div. [Commercial List]) — considered

Statutes considered:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36

Generally — referred to

s. 11.1 [en. 1997, c. 12, s. 124] — considered

s. 11.1(1) "eligible financial contract" [en. 1997, c. 12, s. 124] — considered

s. 11.1(1) "eligible financial contract" (h) [en. 1997, c. 12, s. 124] — considered

s. 11.1(1) "eligible financial contract" (k) [en. 1997, c. 12, s. 124] — considered

s. 11.1(1) "eligible financial contract" (m) [en. 1997, c. 12, s. 124] — considered

MOTION by partnership for declaration that stay of proceedings contained in order applied to agreement.

***Romaine J.*:**

Introduction

1 The issues in this application and cross-application are:

a) whether a Call on Production ("COP") Agreement between Pengrowth Corporation and Calpine Canada Natural Gas Partnership is an "eligible financial contract" within the meaning of Section 11.1 of the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended, and

b) whether the stay imposed with respect to the Calpine Energy Services Canada Partnership by the initial order under the *Companies' Creditors Arrangement Act* should be removed or lifted because this entity is a partnership and not a corporation.

2 I have decided that the COP Agreement is not an eligible financial contract and thereby is stayed by the initial order. I declined to lift the stay on the partnership. These are my reasons.

A. Is the COP Agreement an eligible financial contract within the meaning of Section 11.1 of the CCAA?

Facts

3 By agreement effective September 14, 2002, the Calpine Canada Natural Gas Partnership (the "CCNG Partnership") sold certain oil and natural gas rights and assets located on lands in British Columbia to Pengrowth. It was a term of the purchase and sale agreement that Pengrowth and the CCNG Partnership would enter into a COP Agreement upon closing of the purchase and sale. The COP Agreement is dated October 1, 2000.

4 The COP Agreement provides the CCNG Partnership with a reoccurring right of first refusal to purchase any portion of the gas or oil produced from the lands that were sold on market terms and conditions. The agreement remains in force for as long as gas and oil are produced from the lands, unless terminated sooner by the parties. It provides for a fixed delivery point and a price for the production spelled out by reference to current market prices. It does not compel Pengrowth to produce gas or oil from the lands. The CCNG Partnership has the right to reduce the volumes of production it is entitled to purchase on notice to Pengrowth, and thereafter Pengrowth may market such released volumes elsewhere.

5 On the same date the COP Agreement was executed, the Calpine Energy Services Canada Partnership (the "CESCA Partnership") replaced the CCNG Partnership as purchaser of the gas and oil, and shortly after that, Progress Energy Ltd. was partially novated into the agreement by Pengrowth with the consent of the CCNG Partnership.

6 On December 20, 2005, the Calpine applicants sought, and were granted, an initial order under the CCAA which, together with other relief, restrained persons from terminating or suspending their obligations under agreements with the applicants during the term of the order, as long as the applicants paid the normal prices for the goods and services provided under such agreements.

7 On December 21, 2005, Pengrowth provided notice to the CESCA Partnership that, effective December 23, 2005, it would suspend delivery of natural gas to the CESCA Partnership under the COP Agreement. In that notice, Pengrowth took the position that Calpine's filing for protection under the CCAA constituted a "Triggering Event" as defined in the COP Agreement that allowed suspension and termination of the agreement as of December 27, 2005. In another letter later the same day, Pengrowth alleged that the COP Agreement was an eligible financial contract, and thus exempt from the application of the stay set out in paragraph 9(d) of the initial order.

8 The Calpine applicants brought a motion for a declaration that the stay of proceedings contained in the initial order applies to the COP Agreement, that this agreement is not an eligible financial contract within the meaning of the CCAA, and for damages against Pengrowth and Progress as a result of their improper termination of services under the agreement. Pengrowth and Progress in turn brought an application to vary the initial order by removing or lifting the stay with respect to the CESCA Partnership on the basis that the CCAA does not apply to partnerships. The question of damages against Pengrowth and Progress was not addressed at the hearing of these motions.

Analysis

9 The Alberta Court of Appeal considered the definition of "eligible financial contract" under the CCAA in the case of *Blue Range Resource Corp., Re*, [2000] A.J. No. 1032 (Alta. C.A.). In that case, the first to consider the definition, there were seven contracts at issue involving Blue Range, which was then under the protection of the CCAA. Two of them were "master agreements" that contemplated that the parties would enter into gas purchase and sale agreements from time to time, to be evidenced at the time of specific sales by confirmation letters. The other agreements were gas purchase and sale agreements between third parties and the wholly-owned subsidiary of Blue Range and guarantees by Blue Range of its subsidiary's obligations under these contracts. According to the Court of Appeal, all of these agreements contained netting out or set-off provisions, although subsequent commentary on the case suggests that some of these provisions were limited. The Court characterized the key issue as whether the long term gas purchase and sale contracts in the case were forward commodity contracts, as it was conceded in the appeal that, if they were, the master agreements and guarantees would be caught by the language of subsections 11.1(k) and (m) of the Act.

10 Fruman, J.A. started her analysis by describing the agreements in question in general terms, noting that the sellers were looking for price certainty and limited downside exposure, predicting that the market price for gas would decline, and that the buyers were gambling that the price would rise such that on delivery they would purchase gas at a price that was below market value. She described at paragraphs 18 to 20 how, at any particular time, the contract might be "in the money" when the market price of gas exceeded the purchase price specified in the contract, or "out of the money" when the market price was less than the purchase price. She described this as the contract being "marked to market", assigning a positive or negative value to the contract. As she noted, gas producers, to hedge risk, might enter into a series of such contracts at different prices for delivery on different dates, some of which would be "in the money" and others of which would be "out of the money". As she stated, "(t)ermination and netting out or set-off provisions permit the purchaser to terminate all the agreements upon a triggering event", thereby allowing the calculation of a termination amount payable by one party to the other. She comments further at paragraph 23:

> Forward commodity contracts and other derivatives have a financial value that can readily be calculated; they are commercial hedging contracts that can be used to manage various types of risk, including changes in commodity prices, exchange rates, interest rates and market risks.

11 Fruman, J.A. rejected the distinction between physically-settled and financially-settled contracts in determining whether a contract falls within the definition of eligible financial contracts: at para. 36. However, she also recognized that if the term "forward commodity" contract was interpreted to include physically-settled transactions, it could potentially include every contract to buy or sell on a future date, any "thing produced for use or sale": para. 39. As the Court of Appeal recognized at para. 39, interpreting the term "eligible financial contract" so broadly would defeat the very purpose of the CCAA, to provide an insolvent corporation with the time and opportunity to reorganize its affairs as a viable operation. Fruman, J.A. concluded, at para. 39:

> Section 11.1(1) is an exception to a statutory protection which must "be interpreted in light of [the] underlying rationale and not used to undermine the broad purpose of the legislation...": Driedger, 3rd ed., at 369-70. See *National Trustco v. Mead* (1990), 71 D.L.R. 4th 488 at 497-99 (S.C.C.). This dictates a narrower construction of provisions which are excepted from a stay order: *Re Smith Brothers Contracting Ltd.* (1998) 53 B.C.L.R. (3d) 264 at 272 (S.C.).

12 The Court found a narrower construction of the term "forward commodity contract" in the concept of "commodity", which it defined as being interchangeable and:

> ...readily identifiable as fungible commodities capable of being traded on a futures exchange or as the underlying asset of an over-the-counter derivative transaction. Commodities must trade in a volatile market, with a sufficient trading volume to ensure a competitive trading price, in order that forward commodity contracts may be "marked to market" and their value determined. [*Blue Range Resource Corp., Re* at para.45]

Even so, the Court recognized that not every contract involving the purchase and sale of gas was a forward commodity contract within the meaning of the exception set out in Section 11.1 of the CCAA: at para. 50.

13 Fruman, J.A. referred to industry and expert definitions of forward commodity contracts to aid her in her analysis. Specifically, she focussed on two definitions, as follows:

> [Mark E.] Haedicke and [Alan B.] Aronowitz, ["Gas Commodity Markets" in Energy Law and Transactions Vol. IV (New York: Matthew Bender & Co. Inc., 1999)] at 88:74-75 define a "forward contract" for the energy industry as:
>
> > A customized contract to buy or sell a commodity for delivery at a certain future time for a certain price. It is customized by individual negotiations between two parties, rather than standardised and traded on a board of trade. The parties to the forward contract usually know each other, and in most cases the contract is settled by actual delivery of the commodity.

James Joyce, a specialist in energy risk assessment who provided an expert report in this case, identified the key elements of a forward commodity contract in the natural gas industry to include:

a) a buyer of natural gas;

b) a seller of natural gas;

c) a defined contract term longer than the next day;

d) a defined volume of natural gas;

e) a defined delivery and receipt point (including any transportation requirements, as applicable); and;

f) a defined price or pricing mechanism.

[*Blue Range Resource Corp., Re* at paras. 48 and 49]

14 As the Court noted, the Joyce definition would not capture standard gas utility contracts that do not commit a purchaser to a specific volume of gas for a specified price. However, the contracts at issue in the Blue Range appeal met all of the elements of both the *Haedicke* and *Joyce* definitions, and the Court of Appeal found that they were therefore forward commodity contracts: at paras. 50 and 51.

15 Fruman, J.A. indicated that there is a final test - the fairness of the result. In her analysis of the Blue Range contracts, she found that both parties were fairly treated even though the appellants were allowed to terminate the contracts: *Blue Range Resource Corp., Re*, at paras. 52-53.

16 Fruman, J.A.'s approach was accepted by the Ontario Court of Appeal in the next case to consider the definitions eligible financial contracts, *Androscoggin Energy LLC, Re*, [2005] O.J. No. 592 (Ont. C.A.), in which that Court also rejected the distinction between "physically-settled" and "financial settled" contracts adopted by both the Alberta and Ontario chambers judges.

17 In the Ontario case, the appellants had entered into long term contracts to supply gas to Androscoggin, a corporation under CCAA protection. Androscoggin operated a gas-fuelled co-generation plant. The contract price at which the appellants had agreed to supply gas was below the current market price of gas. The Court of Appeal agreed with the chambers judge that the contracts should not be characterized as eligible financial contracts, but on a different basis, stating:

The contracts in issue before Fruman J.A. served a financial purpose unrelated to the physical settlement of the contracts. The reasons in *Blue Range Resource Corp*. indicate that the contracts Fruman J.A. examined enabled the parties to manage the risk of a commodity that fluctuated in price by allowing the counterparty to terminate the agreement in the event of an assignment in bankruptcy or a CCAA proceeding, to offset or net its obligations under the contracts to determine the value of the amount of the commodity yet to be delivered in the future, and to re-hedge its position. Unlike the contracts found to be EFCs in *Blue Range Resource Corp.*, *supra*, the contracts in issue here possess none of these hallmarks and cannot be characterized as EFCs. However, mere *pro forma* insertion of such terms into a contract will not result in its automatic characterization as an EFC. Regard must be had to the contract as a whole to determine its character. [emphasis added]

Androscoggin, at para. 15.

18 Analysing the COP Agreement as a whole, it is clear that it lacks the characteristics or hallmarks of an eligible financial contract. It does not fall within the definitions of "forward commodity contracts" cited by Fruman, J.A. in *Blue Range Resource Corp., Re* when the terms "certain price" and "defined price" in those definitions are read as synonymous

with "pre-determined" or "fixed" (as I believe is the intent), rather than the broader "able to be determined" meaning submitted by Pengrowth. It is clear that the COP Agreement does not meet the fixed price requirement, but instead depends upon market pricing. In the same vein, the term of the contract is uncertain, not "defined" as required by the Joyce definition, and the volume of gas to be produced, and therefore purchased under the COP Agreement cannot be defined in any real sense. Moreover, although in a sense the COP Agreement gives the CESCA Partnership some certainty of source of supply, Pengrowth is neither obliged to produce, nor obliged to produce at any specific rate.

19 The COP Agreement, due to its nature, cannot be "marked to market", which is contrary to the characteristic noted at paragraph 46 of *Blue Range Resource Corp., Re* that "(f)orward gas contracts ... have a calculable cash equivalent". The COP Agreement, again due to its nature, has no offsetting or netting provisions. Both the *Blue Range Resource Corp., Re* and *Androscoggin Energy LLC, Re* decisions refer extensively to the importance of such netting-out provisions to the concept of eligible financial contracts: *Blue Range Resource Corp., Re* at paras. 8, 9, 13, 20, 21, 27, 30 and 53; *Androscoggin Energy LLC, Re* at para. 15. Without suggesting that such provisions are necessary in every case before a contract is found to be an eligible financial contract, or that every contract that includes such provisions must be a priori be an eligible financial contract, the importance of such provisions to the determination of whether the contract is truly a derivative or risk management instrument cannot be overemphasized.

20 The price of gas under the COP Agreement is the current market price as determined by various industry measurements, less toll charges. This is not a predetermined, fixed price that in the normal course could prudently be hedged by an off-setting contract. The respondents did not adduce evidence of any hedging of the COP Agreement. While tey certainly had no obligation to do so, the lack of such evidence tends to support the conclusion that the COP Agreement is not the type of contract that is part of the forward contract trade.

21 The history or context of the COP Agreement is also note worthy. It was entered into as a condition of the purchase and sale of the lands, an obligation upon Pengrowth that would always be burdensome to it and valuable to the Calpine applicants, given the toll "kicker" in favour of the CCNG Partnership. In that sense, the COP Agreement forms part of the consideration for the sale of the lands, and is not just a stand-alone supply contract.

22 The COP Agreement in its essential terms is analogous to the type of contract specifically exempted from the category of eligible financial contract by Fruman, J.A. at para. 50 in *Blue Range Resource Corp., Re*, a standard gas utility contract. The demand, price and quantity of gas to be purchased is based solely upon the purchaser's needs from time to time at prices that fluctuate.

23 Pengrowth and Progress also submit that the COP Agreement can be characterized as a series of spot contracts for the supply of gas, and that since spot contracts are also listed in s. 11.1(1)(h) of the *Act*, the COP Agreement qualifies as an eligible financial contract even if it is not a forward commodity contract. However, in the same way that all forward commodity contracts are not eligible financial contracts given the underlying purpose of the CCAA, neither are all spot contracts. As noted at para. 36, footnote 14 in *Blue Range Resource Corp., Re*, spot contracts contemplate only immediate, physical delivery and have no financial character. While spot contracts because of their nature are unlikely to be an important issue in a CCAA context, their inclusion in the list of types of contracts referred to in s. 11.1(1) highlights the importance of the Ontario Court of Appeal's direction to have regard to the contract as a whole when determining its character.

24 Given that the CCAA's predominate purpose as a remedial statute dictates a narrower construction of section 11.1(1) than the mere enquiry if a contract could fall within one of its "comprehensive and intimidating" list of categories, (*Blue Range Resource Corp., Re*, at para. 10), and given the ingenuity and innovation of those who deal in the derivatives market, there can be no "bright-line" definition that will determine whether a contract falls within the exception set out in the CCAA. While some contracts clearly will fall within the exception, either by their nature or by reason of existing case law, there are others that do not fit so clearly and that may necessitate a more searching analysis by CCAA parties and the court.

25 The respondents point out that the COP Agreement contains a provision for termination upon an insolvency of CESCP, Calpine Corporation or any general partner of CESCP. They submit that this is a critical hallmark of a eligible financial contract which was notably missing in *Androscoggin Energy LLC, Re*, but is present here. The lack of a termination-upon-insolvency provision in *Androscoggin Energy LLC, Re* was a secondary ground for both the chambers and appeal courts to find that the CCAA stay should not be lifted, because the terms of the contracts in that case did not entitle the applicants to terminate except for non-payment. This finding did not make the presence or absence of a termination-upon-insolvency provision a necessary hallmark of an eligible financial contract. The presence of such a provision in this case does not outweigh the other factors to which I have referred.

26 The respondents also point out that intermediary Calpine entities are involved in the process of transporting the gas, or its equivalent volume, to an eventual end-user, and that some of these intermediaries may be characterized as risk management and gas marketing companies. That being said, they concede that a Calpine entity is likely the end-user of the gas, to the extent that this concept has meaning in the complex business of gas transportation. It is not unexpected that Calpine has risk management subsidiaries, as do most fully integrated gas and electricity companies. The characterization of the purchaser as a forward contract merchant, or not, is not determinative of the Canadian definition of eligible financial contracts, as it is in the United States. As pointed out by Rupert H. Chantrand and Robin B. Schwill in "Shades of Blue: Derivatives in Re *Blue Range Resource Corp.*, 16 B.F.L.R. 427 at p. 431, gas purchasers rarely if ever are the direct end-users of the gas they purchase, whether or not their contract provides for physical settlement.

27 There may well be criticism of a broad spectrum approach to the determination of whether a contract that is otherwise on a strict interpretation of section 11.1(1) an eligible financial contract is in reality such a contract in character and in the context of the CCAA itself. Such an approach may lead to uncertainty and a greater risk of litigation, at least until a body of case law is established. With respect to such concerns, a simple test that allows the purpose of the CCAA to be undermined with respect to certain types of commodity producers and those who deal with them is not the answer. In the absence of a more refined definition of eligible financial contract, the courts and CCAA parties will have to continue to deal with the difficult nature of the issue.

28 The last part of the analysis directed by the Court of Appeal in *Blue Range Resource Corp., Re* is the fairness of result test. While this test is not always easy to apply, it appears clearer in this situation than in many. If the respondents were allowed to terminate the COP Agreement, they would derive a benefit from being able to enter into long-term, fixed price contracts for the gas produced from the lands, or selling in the spot market without the burden of transportation costs. The Calpine applicants would derive no benefit from the termination. Although the COP Agreement has value to the Calpine applicants, no amount would be payable to the CESCA Partnership on its termination. They would lose a valuable contractual asset without compensation. Moreover, the COP Agreement was part of the consideration extracted when Calpine sold the lands to Pengrowth. Therefore, termination of the contract would deprive the Calpine applicants and their creditors of the ongoing benefit of the sale of the lands. Finally, the CESCA Partnership would lose a relatively secure supply of gas at market price.

29 On balance, termination would not meet the fairness of result test. If, however, termination of the COP Agreement remains stayed, the respondents are no worse off than other suppliers of goods and services to the Calpine applicants. The respondents have not adduced evidence that a failure to be able to terminate the contract will cause any prejudice to their hedging strategy. Calpine's creditors as a group will benefit from the value of this contractual asset.

B. Should the stay imposed by the Initial Order extend to the Calpine Energy Services Canada Partnership?

30 The initial order of December 20, 2005 grants the usual stay of proceedings sought in CCAA applications for the benefit of, not only the corporate Calpine entities that applied, but also the CESCA Partnership, CCNG Partnership and the Calpine Canadian Saltend Limited Partnership. Pengrowth and Progress apply pursuant to the come-back provision of the initial order to vary it with respect to the CESCA Partnership. The onus is on the Calpine applicants to justify the extension of the stay to the CESCA Partnership.

31 At the time of the initial application, the Calpine applicants provided an overview of the Calpine group that made it clear that, at least from a corporate organizational prospective, the business affairs of the partnerships are significantly inter-twined with the Calpine corporations and, in some cases, with each other. Calpine submitted that the partnerships are important to the value of the Canadian operations of the Calpine group, and that their value and their key contractual assets should be preserved during the reorganization of the Canadian operations.

32 Currently, the Monitor and Calpine are working together to prepare an analysis of intercorporate debt which will enable the court and Calpine's creditors to better evaluate a proposed plan of restructuring. As indicated by Farley, J. in *Lehndorff General Partner Ltd., Re* (1993), 17 C.B.R. (3d) 24 (Ont. Gen. Div. [Commercial List]) at page 4, "(o)ne of the purposes of the CCAA is to facilitate ongoing operations of a business where its assets have a greater value as part of an integrated system than individually". While it is early in this CCAA proceeding to make the determination that this is the case with certainty, the evidence adduced so far by Calpine appears to indicate that the treatment of the Calpine group as an integrated system will result in greater value.

33 Although the CCAA does not give a court the power to stay proceedings against noncorporate entities, this court has the inherent jurisdiction to grant a stay of proceedings where it is just and convenient to do so: *Lehndorff General Partner Ltd., Re*, supra at pg. 7; *Campeau v. Olympia & York Developments Ltd.*, [1992] O.J. No. 1946 (Ont. Gen. Div.), at pp. 4-7.

34 It is clear that Calpine has a more than arguable case that a stay involving the Partnerships is necessary and appropriate. It is also likely, given the extremely complex corporate and debt structure of the Calpine group, the cross-border nature of these proceedings, and the evidence I have heard so far in the proceedings of the value of partnership assets, that irreparable harm may accrue to the Calpine group if the stay is not granted. The balance of convenience certainly favours a stay. I find that it is just, reasonable and appropriate in this case to exercise this court's inherent jurisdiction to stay proceedings against the Calpine partnerships.

C. Future Sales or Credit

35 Although relief under this heading was not sought in their Notice of Motion, Pengrowth and Progress have asked for a direction that they are not obliged to deliver gas to the CESCA Partnership on credit and are entitled to immediate payment for any gas delivered after the date of the initial order.

36 This application is premature, and I adjourn consideration of the issue until the parties have had time to discuss the implications of my decisions relating to the COP Agreement.

Motion granted.

TAB 9

2003 ABQB 243
Alberta Court of Queen's Bench

Bank of Montreal v. Dynex Petroleum Ltd.

2003 CarswellAlta 399, 2003 ABQB 243, [2003] A.J. No. 349, 121 A.C.W.S. (3d) 1160, 1 C.B.R. (5th) 188

BANK OF MONTREAL (Plaintiff) and DYNEX PETROLEUM LTD., ALBERTA ENERGY COMPANY LTD., ARDMORE INVESTMENTS LTD., TRANSCANADA PIPELINES LTD., AMOCO CANADA PETROLEUM LTD., ATCORE LTD., CRESTAR ENERGY INC., DANA DISTRIBUTORS LTD., ENCHANT RESOURCES LTD., VIMYVIEW LTD., COL-SYB HOLDINGS LTD., HEXAM HOLDINGS LTD., DAVIDS INVESTMENTS LTD., EDWARD W. HADWAY, ESTATE OF HARRY VEINER, VICTOR SOPKIW, NANCY OIL & GAS LTD., STANILOFF OIL & GAS LTD., CORY OILS LTD., DORAN INVESTMENTS LTD., ENCOR ENERGY CORPORATION INC., EPIC RESOURCES LTD., KIRRIEMUIR RESOURCES LTD., MERIDIAN OIL INC., NORTH CANADIAN OILS LIMITED, ODESSA NATURAL CORPORATION PRECAMBRIAN SHIELD RESOURCES LIMITED, STAR OIL AND GAS LTD., SUNCOR INC., D.S. WILLNESS, EARL GORDON, ANTELOPE LAND SERVICES LTD., BRANNIGAN RESOURCES CANADA (1992) LTD., JIM BRUCE CONSULTANTS, SASKATCHEWAN OIL & GAS CORPORATION, SASK OIL RESOURCES INC., LANDSEA OIL & GAS LTD., INTENSITY RESOURCES LTD., DEANE ENTERPRISES LTD., SHELL CANADA RESOURCES LTD., CHANNEL LAKE PETROLEUM LTD. AND ENRON OIL CANADA LTD. (Defendants)

Hawco J.

Heard: September 30, 2002; October 1, 2002
Judgment: March 14, 2003
Docket: Calgary 9301-08195

Counsel: Christopher R. Murphy for Plaintiff
Richard B. Jones for Plaintiff
James C. Crawford, Q.C. for Defendant
Richard C. Dixon for Ernst & Young Inc.

Subject: Natural Resources; Contracts; Insolvency
Related Abridgment Classifications
Natural resources
III Oil and gas
III.6 Exploration and operating agreements
III.6.a Royalty agreement
III.6.a.ii Gross overriding royalty
Headnote
Oil and gas --- Exploration and operating agreements — Royalty agreement — Interpretation — Gross overriding royalty
Defendants entered into royalty agreements with predecessor of bankrupt corporation — Assets of bankrupt were sold by receiver — Trial of issue was held to determine whether defendants had interest in land pursuant to agreements — Defendants had only contractual right to royalties — Parties to agreements had no intention to create interest in land

— Agreements did not contain plain and unmistakable language indicating such intention — Agreements in some cases superseded others containing broader language — Similar agreements were not considered to create interests in land at time these agreements were made — Defendants did not register caveats until after proceedings were commenced.

Table of Authorities

Cases considered by *Hawco J.*:

Bank of Montreal v. Dynex Petroleum Ltd., 182 D.L.R. (4th) 640, 1999 CarswellAlta 1271, 74 Alta. L.R. (3d) 219, [2000] 2 W.W.R. 693, 2 B.L.R. (3d) 58, 15 C.B.R. (4th) 5, 15 P.P.S.A.C. (2d) 179, (sub nom. *Bank of Montreal v. Enchant Resouces Ltd.*) 255 A.R. 116, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 220 W.A.C. 116, 1999 ABCA 363 (Alta. C.A.) — referred to

Bank of Montreal v. Dynex Petroleum Ltd., 2002 SCC 7, 2002 CarswellAlta 54, 2002 CarswellAlta 55, 19 B.L.R. (3d) 159, 208 D.L.R. (4th) 155, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 281 N.R. 113, 30 C.B.R. (4th) 168, 1 R.P.R. (4th) 1, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 299 A.R. 1, (sub nom. *Bank of Montreal v. Enchant Resources Ltd.*) 266 W.A.C. 1, [2002] 1 S.C.R. 146 (S.C.C.) — referred to

Canco Oil & Gas Ltd. v. Saskatchewan, 89 Sask. R. 37, [1991] 4 W.W.R. 316, 1991 CarswellSask 177 (Sask. Q.B.) — considered

Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd., 3 D.L.R. (3d) 630, 1969 CarswellAlta 107 (Alta. C.A.) — considered

Scurry-Rainbow Oil Ltd. v. Galloway Estate, 8 Alta. L.R. (3d) 225, 138 A.R. 321, [1993] 4 W.W.R. 454, 1993 CarswellAlta 298 (Alta. Q.B.) — considered

Vandergrift v. Coseka Resources Ltd., 67 Alta. L.R. (2d) 17, 95 A.R. 372, 1989 CarswellAlta 76 (Alta. Q.B.) — considered

Statutes considered:

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3

Generally — referred to

s. 2(1) "property" [renumbered 1997, c. 12, s. 1(1)] — referred to

RULING on whether oil and gas royalty agreements created interests in land.

***Hawco J.*:**

1 This action was originally commenced to determine whether the plaintiff (BofM) had priority as against all of the above named defendants by virtue of a general assignment of book debts (formerly referred to as a section 82 security) granted by one of the defendants in these proceedings, Dynex Petroleum Ltd. (Dynex), to the plaintiff. The only defendants remaining who have an interest in the proceedings are Enchant Resources Limited (Enchant) and the Estate of D.S. Willness (Willness).

2 The lands which were charged the section 82 security included oil and gas interests which were subject to overriding royalties in favour of the defendants. These overriding royalties had been granted by the predecessor in title to Dynex. As a result of the bankruptcy of Dynex, the lands have been sold. The purpose of these proceedings is to determine whether those overriding royalties were "interests in land". If they were, they will be binding upon the purchaser of the lands. If they were not, the defendants seek compensation from the plaintiff for the loss of those interests.

BACKGROUND

3 Given the history of this litigation, there having been three decisions by my colleague Justice J.D. Rooke, dealing with the issues of priority and whether the overriding royalties can constitute interests in land, and appeals to our Court of Appeal and to the Supreme Court of Canada, some background is necessary.

4 Enchant was owned by Mr. Hilton Westmore, a professional engineer and geologist active in the oil and gas business in Alberta in the 60's and onward until his death shortly before trial. Enchant acquired a number of mineral rights

through the Crown and certain individuals in the Medicine Hat area of the province. It then would farm the interests out or assign them, often reserving unto itself a gross overriding royalty ranging from one and one third percent to fifteen percent. The manner in which the royalties were reserved will be referred to in greater detail later. In some instances, Mr. Westmore acquired a royalty through his assistance to others, such as the predecessor to Dynex, M-P Petroleum Ltd. In one instance, when an individual (Mr. Willness) was of some assistance to him in his obtaining mineral rights, Enchant granted an overriding royalty to him. In all the lands which became the subject matter of these proceedings, M-P Petroleum Ltd. acquired title and took the lands subject to the various overriding royalties. M-P Petroleum Ltd. subsequently either assigned the rights to Dynex or Dynex became, through corporate re-organization, the owner of the interest.

5 Dynex borrowed substantial sums from the Bank of Montreal (in excess of $60 million dollars, with interest). When it was unable to meet its obligations when they became due, it was placed in bankruptcy. On May 26, 1993 a receiving order under the ***Bankruptcy and Insolvency Act*** was granted by this court. Ernst and Young (E&Y) was appointed trustee in bankruptcy. On June 25, 1993, Justice Forsyth granted an order appointing E&Y the receiver of all petroleum and natural gas properties, rights and interests of Dynex in certain oil and gas assets, which included the gross overriding royalty agreements (GORs), under which Enchant and Willness hold their interests.

6 Pursuant to Justice Forsyth's order, E&Y was to set aside those amounts which would have been payable by Dynex as royalties and was to keep those funds in a separate interest-bearing account until further order.

7 On August 20, 1993, in two separate orders, Justice Forsyth approved the sale of the assets of Dynex by E&Y to Channel Lake Petroleum Ltd. and declared BofM to have a valid first and second change on all of the assets of Dynex subject to a determination of the claims of the defendants.

8 On September 1, 1993 Justice Forsyth ordered that:

> 2. Subject to the Disputed Interests (the interests of the defendants) and the Permitted Encumbrances (the GORs) the Assets be and are hearby vested in Channel Lake Petroleum Ltd. free from the claims, right, title and interest of any person whatsoever...
>
> . . .
>
> 5. The granting of this Order is without prejudice to the issue of whether the Receiver was, on August 4, 1993, lawfully entitled to sell the Assets free and clear of the Disputed Interests. In particular, the sale and transfer of the Assets to Channel Lake Petroleum Ltd. pursuant to this Order does not affect parties existing rights or create any new rights to be raised against the Disputed Interests when their validity is subsequently judicially determined.
>
> . . .
>
> 8. Following the final judicial determination of the validity of any of the Disputed Interests,
>
> > a) if it is determined that the Receiver was lawfully entitled to sell the assets free and clear of a Disputed Interest, then, upon Channel Lake Petroleum Ltd. paying to the Receiver the designated incremental amount pertaining to that disputed interest:
> >
> > > i) the Assets shall thereafter and without further Order be vested in Channel Lake Petroleum Ltd. free and clear of such Disputed Interest;
>
> . . .
>
> b) if it is determined that the Receiver was not lawfully entitled to sell the Assets free and clear of the Disputed Interest, then:

> i) Channel Lake Petroleum Ltd. shall thereafter make payments pertaining to the Disputed Interest to the holder of the Disputed Interest;

9 On September 15, 1993, Enchant and Willness filed a statement of defence and counterclaim. In that pleading, the defendants claimed that they held a property interest in the lands which were the subject matter of the GORs and claimed that those interests were unaffected by any security BofM may have held with respect to the indebtedness of Dynex, as the plaintiff had known of the existence of the GORs owned by the defendants and recognized and took its security subject to the interest of the defendants.

10 In its counterclaim, Enchant referred to the four GORs which it had entered into with M-P Petroleum Ltd. Those agreements were dated June 1, 1974, November 30, 1974, January 22, 1975 and January 24, 1975. Willness referred to an agreement which it had entered into on February 27, 1974 with Enchant whereby Willness was granted 2.5 % of overriding royalty in a portion of the lands acquired by Dynex.

11 The defendants claimed that the GORs granted to them an interest in the lands and as such their rights were not subject to BofM's security. Further, the defendants stated that at the time of taking the security, BofM had knowledge of their rights and that BofM had recognized those rights in the security which it had taken from Dynex.

12 The defendants claimed in the alternative that Dynex had held their interest in trust for them and as such the interests were trust property and not distributable as property of Dynex within the meaning of the ***Bankruptcy and Insolvency Act.***

13 Other alternative claims were advanced in the counterclaim. However, it appears that the substance of the defendants' claims are those described briefly above.

14 The GORs will be looked at in more detail further in these reasons. For now, it is sufficient to simply state that Enchant received its GORs as a result of a series of petroleum and natural gas acquisitions and assignments and that Willness received its overriding royalty from Enchant for a role which Willness had played in enabling Enchant to acquire certain of the lands.

15 On December 19, 1995, Justice Rooke rendered a decision holding that the interests of the defendants under the GORs did not constitute interests in land.

16 On December 20, 1995 Justice Rooke considered an application by the defendants for summary judgment against the plaintiff. That application was dismissed as Justice Rooke was of the view that there were triable issues. During the course of rendering that decision, Justice Rooke referred to the fact that there were still some issues remaining to be addressed as to what the priority was as between the bank on the one hand and the defendants on the other.

17 Later on the same day, having heard further submissions by counsel, he ruled that BofM should have no priority over the overriding royalty interests and that it took its security subject to those interests. In his view, the security of BofM granted by Dynex was subordinate to the overriding royalties and net profit interests. As Justice Rooke stated:

> I find that the clauses in question to which I have referred, and which are incorporated (by reference) in the section 82 agreements, by their terms, contemplate a subordination of the debenture holder's interest to the previously granted interests to the overriding royalty and net profits interest holders. Not implicitly, but explicitly, they allow those holders to rank ahead of the debenture holders in regards to those particular interests and, indeed, any others specifically consented to by the Bank in the future. Equally consistently, the commercial reality in the oil and gas industry, in conjunction with the financial industry, requires that documents of this nature be given that effect.

18 On April 4, 1997, Justice Rooke rendered another decision following an application by the parties to these proceedings to determine the effect of the bankruptcy of Dynex on the competing interest of the duly registered and crystallized debenture holder, the plaintiff, as against the overriding royalty and net profits interest of the defendants. His conclusion was that the priorities between BofM and the defendants relate less to the status of the parties in the

bankruptcy (as a secured creditor and unsecured creditors respectively) than to the effect of the bankruptcy on the subordination. He found that the subordination of BofM to the defendants survived the bankruptcy of Dynex and that the defendants are entitled to recover any of their loss in bankruptcy from BofM.

19 These decisions of Justice Rooke were appealed to our Court of Appeal. [(1999), 182 D.L.R. (4th) 640 (Alta. C.A.)] On December 17, 1999, that court rendered its reasons for judgment. The issues, as stated by that Court were:

> 1. Can net profits and overriding royalty interests constitute interests in land?
>
> 2. If they are not interests in land, are the debenture security interests and similar interests granted to the bank subordinated to the overriding royalty interests?
>
> 3. If the bank's interests are subordinated to the overriding royalty interests, does the bankruptcy affect the subordination of the bank's security interest to the overriding royalty interests and does the bank continue to be obliged to hold in trust proceeds received prior to the sale of the oil and gas properties.

20 The court's conclusion was that the parties may create overriding royalties that are interests in land if they manifested their intention to do so. It went on to state that in order to determine the parties' intentions, findings of fact must be made. As indicated by the court, various *indicia* can be used to identify whether or not an interest in land was intended. It set out, at paragraph 84 of the decision, the following *indicia*, which it stated was not exhaustive but may be relevant. Those were:

> 1. The underlying interest is an interest in land (corporeal or incorporeal);
>
> 2. The intentions of the parties, as evidenced by the language of the grant and any admissible evidence of the surrounding circumstances or behaviour, indicate that it was understood that an interest in land was created/ conveyed;
>
> 3. The interest is capable of lasting for the duration of the underlying estate.

Other possible *indicia* were set out by Evans, Newman and Smith, *supra*, at pp. 447-456 in their proposed model form overriding royalty. They include wording in the overriding royalty clause which create:

> 1. A reservation of interest in the petroleum substances by the farmor in the working interest to be earned by the farmee.
>
> 2. The farmee as agent of the farmor for the farmor's share of petroleum production.
>
> 3. Remedies against the interest of the farmee through a lien.

21 The court then went on to state that both Enchant and BofM had agreed that the matter would have to go back for trial with respect to the issue of whether it was the intention of the parties to create an interest of land. However, the court stated that the parties also agreed that should the matter go back for trial on this issue; "then any equitable remedies that Enchant and Willness may have against the bank may be raised and Willness and Enchant should be allowed to adduce evidence and argue any and all equitable remedies which they might have against the bank". The court went on to state:

> Since the first issue must be determined by a trial, which may render the second and third issues wholly or partially moot, it is preferable that those two issues be determined in the context of the trial evidence, and in conjunction with any other issues, equitable or otherwise which might impact on the result relating to those issues.
>
> For that reason, the second and third issues are directed to be tried together with the first. In the result, the appeal is allowed on the first issue but the second and third issues are to be determined at trial in accordance with the preceding paragraph...

22 The matter then proceeded by way of further appeal to the Supreme Court of Canada. [(2002), 208 D.L.R. (4th) 155 (S.C.C.)]On January 24, 2002, the Supreme Court (Major, J.) issued a decision stating that it (he) agreed that an overriding royalty interest can constitute an interest of land if intended by the parties for substantially the same reasons in that given by the Court of Appeal. Justice Major quoted with approval the following statement of Justice Virtue in *Vandergrift v. Coseka Resources Ltd.* (1989), 67 Alta. L.R. (2d) 17 (Alta. Q.B.) at page 26:

> It appears reasonably clear that under Canadian Law a "royalty interest" or an "overriding royalty interest" can be an interest in land if:
>
> 1. The language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of interest in land, rather than a contractual right to a portion of the oil and gas substances recovered from the land;
>
> 2. The interest out of which the royalty is carved is itself an interest in land.

23 The matter was therefore directed to return to trial to determine whether it was the parties intention in the GORs to create an interest in land. That trial was held before me on September 30 and October 1, 2002. On October 2, 2002, the parties agreed that they would submit written argument. Written argument was completed on December 20.

ISSUES

24 The primary issue, of course, is whether it was the intention of the parties to the relevant GORs to create an interest in land. If it was, that ends the matter. If it was not, then it must be determined whether the defendants have retained any interest in those lands which have been sold to Channel Lake Petroleum Ltd. If they have not retained any interest, are they entitled to any compensation from the plaintiff?

DECISION

25 For the reasons set forth, I find that there was no intention on the part of the parties to the GORs to acquire an interest in land. The GORs constitute only a contractual right to the defendants to revenue derived from production and sale of oil and gas from the lands sold by BofM to Channel Lake Petroleum Ltd. On the issue of what equitable remedies the defendants may have against the plaintiff, it has been agreed by counsel that further representations will be made. It appears that the parties are in agreement that the plaintiff did acquire its interests subject to the interests of the defendants. What is yet to be determined is whether, as a result of the plaintiff taking subject to those rights, it must compensate the defendants for the loss of future income arising from the sale of the lands to Channel Lake Petroleum Ltd.

REASONS

26 The agreements under which the defendants claim their interests are as follows:

> Firstly, an agreement dated February 27, 1974 between Willness and Enchant. Under that agreement Enchant granted Willness a 2.5% overriding royalty in consideration of the assistance that Mr. Willness had given to Mr. Westmore in Enchant acquiring the lands from what is known as the Minor Estate. That agreement provided:
>
> a) in the event of gas production, the gross royalty shall be computed on the basis of net petroleum substances produced, saved and sold from the lands after deduction by the grantors of any direct costs incurred to compress the gas to pipeline requirements or transported beyond the boundaries of the said lands.

27 The assistance that Mr. Willness rendered was, apparently, letting the people who were negotiating on behalf of the Minor Estate with Mr. Westmore know that Mr. Westmore was a reputable person.

28 Secondly, an agreement dated January 22, 1975 between M-P Petroleum Ltd. and Enchant. This agreement related to crown leases which M-P Petroleum Ltd. had acquired from the crown, based on information and advice that Mr. Westmore had given to M-P Petroleum Ltd. The agreement stated, in its recitals, that M-P Petroleum Ltd. had acquired and was a holder as lessee of certain petroleum and natural gas leases and that Enchant was entitled to an overriding royalty of 3%. The recitals went on to state:

> And WHEREAS the Grantor and Grantee wish to and do hereby enter into this Agreement to define the Grantee's overriding royalty interest and this Agreement shall supercede any agreement or interest that the Grantee has had (if any) in the lands by overriding royalty or otherwise.

I quote the exact wording of that recital because it is common to all four of the agreements between M-P Petroleum Ltd. and Enchant to which I will refer.

29 The wording of the overriding royalty is set out as well because it also is common to all four agreements. The overriding royalty clause stated:

> 2. Overriding Royalty
>
> a) The Grantor hereby agrees to pay or cause to be paid to the Grantee, an overriding royalty of three percent (3%) of the proceeds (subject to the deductions hereinafter referred to) received by the Grantor on the sale of all petroleum substances produced, saved and marketed from the said lands.
>
> b) The royalty payable under paragraph (a) of this clause 2 shall be payable on the 25th day of each month in respect to the products saved and marketed in the previous month and each statement thereof shall be accompanied by a statement of the petroleum substances produced and marketed or used as herein provided during the month for which such payment is made.
>
> . . .
>
> 3. Deductions
>
> a) It is further hereby understood and agreed that the royalty payable and the provisions of this agreement shall be computed and payable on the proceeds received on the sale of petroleum substances produced, saved and marketed from the said lands after deducting the following...

30 Thirdly, an agreement dated January 24, 1975 made between M-P Petroleum Ltd. and Enchant. That agreement concerns what is referred to as the Michaelis Lands. That agreement referred, in the recitals, to M-P Petroleum Ltd. acquiring its interest in the lands from Graham Michaelis Petroleum Ltd. and to Enchant having been instrumental in M-P Petroleum Ltd. acquiring the interest. It went on to recite that Enchant was entitled to an overriding royalty pursuant to a prior agreement of one and one third percent of the proceeds (if any) received by Graham Michaelis Petroleum Ltd. on the sale of petroleum substances produced, saved and marketed from the lands.

31 The agreement under which Enchant was entitled to receive the 1 and 1/3% overriding royalty referred to in the recitals was an agreement between Graham Michaelis Petroleum Ltd. and Enchant dated April 5, 1968. That agreement stated, in the recitals, that Graham Michaelis Petroleum Ltd. had agreed to assign and pay to Enchant: "a gross overriding royalty of one and one third percent (1 and 1/3%) of all petroleum substances which may be produced, removed, saved and sold from (the said lands) subject to the covenants, conditions and agreements herein contained. The granting provision of the April 5, 1968 agreement provided as follows:

> 1. The Assignor hereby agrees to pay to the Assignee, subject to the conditions hereinafter set forth and the right of the Assignee to take its share of the petroleum substances in kind as hereinafter provided, a gross overriding royalty

> of one and one third percent (1 and 1/3%) of the proceeds received by the Assignor on the sale of all petroleum substances produced, saved and sold from the said section...
>
> 2. Subject as hereinafter provided any sale of the petroleum substances by the Assignor shall include the said royalty share of the Assignee. The Assignee may on giving ninety (90) days written notice to the Assignor, elect to take its said royalty share of petroleum substances in kind...

32 This agreement between M-P Petroleum Ltd. and Enchant dated January 24, 1975 contained the same recital referred to above to the effect that this agreement was to supercede any agreement or interest that Enchant had by way of overriding royalty or otherwise. It then went on to provide, with respect to the overriding royalty, the following:

> 2. Overriding Royalty
>
> > a) The Grantor hereby agrees to pay or cause to be paid to the Grantee an overriding royalty of one percent (1%) of the proceeds (subject to the deductions hereinafter referred) received by the Grantor on the sale of all petroleum substances produced, saved and marketed by the said lands, save and except only the petroleum substances produced, saved and marketed from Section 31, Township 14, Range 4, W4M.
> >
> > b) The Grantor hereby agrees to pay or cause to be paid to the Grantee an overriding royalty of two and one third percent (2 and 1/3%) which percentage is inclusive of the previously existing one and one third percent of the proceeds (subject to the deductions hereinafter referred to) received by the grantor on the sale of all petroleum substances produced, saved and marketed from Section 31, Township 14, Range 4, W4M.

33 The fourth agreement is undated. It appears that it may have been entered into on or about June 1, 1974 or November 30, 1974, although it will be noted that it is dated the _____ day of _____, 1975. In any event, this agreement covers what are referred to as the Dana lands. These are lands that Dana Distributors Ltd. had acquired from Enchant by way of a farm-in agreement. Enchant in turn, had originally acquired them by crown lease from the province of Alberta. The recitals refer to M-P Petroleum Ltd. having acquired its interest from Dana Distributors Ltd. and refer to Enchant as having been instrumental in M-P Petroleum Ltd. having acquired its interest in these lands. Again, there appears the clause providing that the agreement would supercede any agreement or interest that Enchant had in the lands by way of overriding royalty agreement or otherwise.

34 The overriding royalty clause of the agreement was the same as that set forth in the agreement of January 22, 1975, above referred to, other than in this case the overriding royalty was five percent of the proceeds on the sale of all petroleum substances produced, saved and marketed from the lands.

35 Finally, we have another agreement apparently made in 1975, but undated. It deals with the Minor Estate lands. It is again between M-P Petroleum Ltd. and Enchant. The recitals to this agreement refer to M-P Petroleum Ltd. having acquired its interest in the lands from Enchant, Dana Distributors Ltd. and others pursuant to an agreement dated the 31 st day of May, 1974.

36 That agreement was made between Enchant, Dana Distributors Ltd. and seven other parties as assignors and M-P Petroleum Ltd. as assignee. It referred to Enchant having been the holder of an undivided one hundred percent working interest in and to the Minor Lands. These are the same lands covered by the Willness GOR referred to above. It referred to Enchant having entered into an agreement with Dana Distributors Ltd. whereby the assignors, other than Enchant, earned an interest in some of the lands being purchased by M-P Petroleum Ltd. It provided for the sale by all of the assignors to M-P Petroleum Ltd. of the properties described in the agreement. Of significance is the fact that all of the assignors, including Enchant, reserved to themselves 40 percent of the net profits realized by M-P Petroleum Ltd. from oil and gas produced, saved and sold from the properties. "Net profits" was defined as follows:

> In this agreement forty percent (40%) of the net profits means an interest in the lands entitling the assignors to receive monthly an amount equal to 40% of the proceeds from the sale of petroleum substances produced from or allocated to the lands...

37 Again, the parties agreed that this agreement, that is, the undated 1975 agreement, was to supercede any other agreement or interest that Enchant had in the lands by way of overriding royalty or otherwise. It then went on to provide for an overriding royalty in the same terms as referred to in the previous agreements, other than this overriding royalty was 15% of the proceeds received by M-P Petroleum Ltd. on the sale of petroleum substances, produced and marketed from the lands.

38 I have set forth the agreements in some detail to show the language used in the GORs under which the defendants claim their interests and, in two instances, to compare the language in the current agreements to the language in prior agreements dealing with two of the original overriding royalties.

39 Looking at all of the GORs and considering the *indicia* referred to by the Court of Appeal, it is seen that the underlying interests are interest in land. The person or entity granting the overriding royalties owns the rights to the petroleum and natural gas underlying the lands.

40 The language used in all of the agreements is much the same. In each case the Grantor agrees to pay or cause to be paid an overriding royalty of a certain percentage of the proceeds received by the Grantor on the sale of petroleum substances, produced, saved and marketed from the lands. As contrasted with the agreement of April 5, 1968 (the Michaelis lands) and the language of the agreement of May 31, 1974, both of which agreements were superceded by their present agreements, there is no right to take any part of the petroleum substances in kind and there is no language which evidences an agreement to grant an interest in land.

41 I am aware of the caution issued by the Court of Appeal in these proceedings to the effect that I should be wary of "searching for some magic words". But I must also bear in mind that when these five agreements were prepared, there had been an obvious intent to grant an interest in land in two of the preceding agreements and there was a notable change in the language used in the present agreements, one or more which were signed within six or seven months of the May 31, 1974 agreement.

42 The defendants speak of the importance of classifying an overriding royalty as an interest in land as opposed to a contractual right because, as the Court of Appeal stated, one consequence of a ruling that overriding royalties are not interests in land is that some oil and gas companies with leases encumbered by overriding royalties may be worth more to a bank holding those leases as security if the company is petitioned into bankruptcy and the lease is sold free of the overriding royalties. I take no issue with this. However, with due respect to the defendants' argument, it is not for the Courts to "classify" an interest as an interest in lands. It is for the parties to do so.

43 The defendants have urged this Court to heed the passage by Professor Ellis, quoted in their brief:

> It may not be going too far to say that no one in the oil and gas business, who thought about what he was doing, would intentionally create a royalty that was merely a contract.

44 Again, I tend to agree. However, as directed by our Court of Appeal and the Supreme Court of Canada in the earlier proceedings, I must look to the language used in describing the interest to determine what the parties intended. Justice Major, at paragraph 15 of that Court's decision also quoted from Professor Ellis' work, "Property Status of Royalties in Canadian Oil and Gas Law" as follows:

> Royalties, as used in the oil and gas industry, make sense only if they are property interest in unproduced minerals. Owners of mineral rights should be able to create them as such if they make clear their intent to do so.

45 Justice Major also referred to an article by J.F. Newman who concluded that most parties to an overriding royalty interest intend for such interest to be an interest in land, "evidence of this is the common practice of registering caveats in the Land Titles Of Alberta seeking to protect that interest."

46 To refer again to the Court of Appeal decision in the earlier proceedings, "an overriding royalty, properly drafted, can be an interest in land".

47 I am advised by the plaintiff that at the time these agreements with Enchant were negotiated, the sole text authority published in Canada respecting petroleum and natural gas leases and royalty clauses for use in oil and gas agreements was, "The Oil and Gas Lease in Canada" by John Ballem, published in 1973. In that first edition of that text, at page 119, Mr. Ballem comments on the type of royalty clause under which there is an agreement to pay a percentage of the value of the substances produced, saved and sold from referenced lands. Mr. Ballem states:

> This type of clause where the obligation is only to pay would appear not to create an interest in land, but only a contractual right.

48 In 1969, our Court of Appeal in *Emerald Resources Ltd. v. Sterling Oil Properties Management Ltd.* (1969), 3 D.L.R. (3d) 630 (Alta. C.A.), refused to find that an overriding royalty granted as compensation for services was an interest in land. It only gave rise to rights in contract. That was the state of the law in this province when the GORs were prepared and signed.

49 There was no evidence called by the defendants at the trial to show any intention or understanding that would vary the effect and intention of the agreements apart from the documents themselves. Mr. John Westmore, the son of Mr. Hilton Westmore, did give evidence as did Dr. Ed Hadway (of Dana Distributors Ltd.). An affidavit which Mr. Hilton Westmore swore in November of 1994 was submitted. Mr. Westmore himself was examined for discovery and some of his evidence was read-in by the plaintiff. Other than Dr. Hadway, this evidence was not helpful.

50 Dr. Hadway's evidence was to the effect that Mr. Westmore always maintained that he (or his group) were to have an interest in land. Quite frankly, I was and am quite sceptical of Dr. Hadway's recollection of discussions held more than 25 years earlier. Mr. Westmore was, unfortunately, unable to give evidence directly and to admit that evidence or place any weight on it at all would, in my respectful opinion, be dangerous and unjust. I have not placed any weight upon it.

51 At paragraph 43 of the defendants brief, they agree that the parties must use plain and unmistakable words to create an interest in land. They argue that the following evidence supports such a finding in this case: firstly, the net profits agreement of May 31, 1974; secondly, normal rules of contractual interpretation, viewed with an understanding of the context and purpose of the oil and gas industry. They go on to argue that it is unfair to criticize past legal drafters for not using clear and unmistakable words when trying to draft overriding royalties, because "until the law is "clear and unmistakable" it is difficult to find wording that is "clear and unmistakable".

52 With respect, the net profits agreement was quite clear and does not, in my respectful view, support the defendants' position. The second and third groups of "evidence" referred to is not evidence but argument. And it is not persuasive argument.

53 I do not, to use the words of Matheson, J. in *Canco Oil & Gas Ltd. v. Saskatchewan* (1991), 89 Sask. R. 37 (Sask. Q.B.), find any wording or type of wording which may have "manifested an intention to create an interest in the lands".

54 I do find a significant change in the language used in the earlier agreements as opposed to "minuscule differences in language", to quote from Hunt, J. (as she then was) in *Scurry-Rainbow Oil Ltd. v. Galloway Estate*, [1993] 4 W.W.R. 454 (Alta. Q.B.).

55 I see no caveat filed except one in January of 1977 by Enchant claiming an interest in lands pursuant to a lease. I see a caveat filed on July 14, 1993, after these proceedings were initiated.

56 In fact, I find nothing other than language which appears to me to be an intention to receive a certain amount of money once the petroleum substances are taken out of the ground and sold.

57 The parties could have created an interest in land had they intended to do so. In my respectful view, the language they used (apparently through legal counsel) does not appear to me to intend such a consequence.

58 In the end result, the gross overriding royalties to which the defendants were parties did not create or constitute an interest in the lands. The defendants were therefore unsecured creditors.

59 Given the defendants position as to its entitlement as to compensation in any event, the parties are given the right to make further representations.

Order accordingly.

End of Document

TAB 10

2016 BCSC 1746
British Columbia Supreme Court

Walter Energy Canada Holdings, Inc., Re

2016 CarswellBC 2658, 2016 BCSC 1746, [2016] B.C.W.L.D. 6974, [2016] B.C.W.L.D. 7053, [2016] B.C.W.L.D. 7074, 271 A.C.W.S. (3d) 22, 39 C.B.R. (6th) 292

In the Matter of the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 as Amended

And In the Matter of the Business Corporations Act, S.B.C. 2002, c. 57, as Amended

And In the Matter of a Plan of Compromise or Arrangement of Walter Energy Canada Holdings, Inc. and the Other Petitioners Listed on Schedule "A"

Fitzpatrick J., In Chambers

Heard: August 15-16, 2016
Written reasons: September 23, 2016
Docket: Vancouver S1510120

Counsel: Marc Wasserman, Mary I.A. Buttery, Patrick Riesterer, Lance Williams, for Petitioners
John Sandrelli, Tevia Jeffries, for United Mine Workers of America 1974 Pension Plan and Trust
Craig D. Bavis, Stephanie Drake, for United Steelworkers, Local 1-424
Aaron Welch, for Her Majesty the Queen in Right of the Province of British Columbia
Kathryn Esaw, Angela Crimeni, for Morgan Stanley Senior Funding, Inc.
Peter J. Reardon, Wael Rostom, for KPMG Inc., Monitor
Kieran Siddall, for Pine Valley Mining Corporation
Heather Jones, for Kevin James
David Wachowich, Leanne Krawchuk, for Conuma Coal Resources Limited

Subject: Civil Practice and Procedure; Contracts; Corporate and Commercial; Insolvency; Natural Resources; Property

Related Abridgment Classifications

Bankruptcy and insolvency
XIX Companies' Creditors Arrangement Act
XIX.3 Arrangements
XIX.3.b Approval by court
XIX.3.b.i "Fair and reasonable"
Judges and courts
XVII Jurisdiction
XVII.10 Jurisdiction of court over own process
XVII.10.e Sealing files
Natural resources
II Mines and minerals
II.3 Ownership and acquisition of mineral rights
II.3.e Mining lease
II.3.e.iv Rents and royalties
II.3.e.iv.A Interpretation of lease or agreement

Headnote

Bankruptcy and insolvency --- Companies' Creditors Arrangement Act — Arrangements — Approval by court — "Fair and reasonable"

Debtors operated number of significant mining properties, all of which had been idle — Debtors were granted protection under Companies' Creditors Arrangement Act, and sales and investment solicitation process (SISP) was subsequently approved — SISP led to proposed transaction that would see going-concern sale of three major mining properties to purchaser — Sole stakeholder who opposed approval of transaction was individual J who was party to royalty sharing agreement (RSA) relating to one mine — Debtors brought application for order approving transaction and for ancillary relief including extension of stay and approval of claims process — Application granted — Transaction was best transaction in circumstances for benefit of debtors and their stakeholders as whole — It was also apparent that debtors had broadly consulted with creditors or potential creditors, and discussions had taken place with certain regulators, key suppliers, and some counter-parties to key contracts — There was no unfairness in transaction being approved without reference to J's rights under RSA — Proposed claims process order treated all potential claim holders fairly and equally and was appropriate in circumstances — Extension of stay was appropriate.

Natural resources --- Mines and minerals — Ownership and acquisition of mineral rights — Mining lease — Rents and royalties — Interpretation of lease or agreement

Royalty sharing agreement — Debtors operated number of significant mining properties, all of which had been idle — Debtors were granted protection under Companies' Creditors Arrangement Act, and sales and investment solicitation process (SISP) was subsequently approved — SISP led to proposed transaction that would see going-concern sale of three major mining properties to purchaser — Sole stakeholder who opposed approval of transaction was individual J who was party to royalty sharing agreement (RSA) relating to one mine — Debtors brought application for order approving transaction and for ancillary relief including extension of stay and approval of claims process — Application granted — There was no unfairness in transaction being approved without reference to J's rights under RSA — Parties to RSA had not intended J to have interest in land, as opposed to contractual right to royalty stream from production under coal licenses — Fact that J was to be paid royalty based on what was "produced" from coal licenses was not compelling in terms of persuading that he was granted interest in coal licenses — J had no direct rights in respect of coal licenses and had relinquished any further control in respect of them — Perpetual obligation under RSA did not assist J since it was not entirely unusual that agreement was perpetual in sense of requiring payment with no set end date — Clauses requiring J's consent to assignment, and that RSA was binding on permitted assigns, were also not unusual in commercial context, and these clauses did not detract from essential nature of right granted to J nor enhance J's ability to control debtors' disposition of properties.

Judges and courts --- Jurisdiction — Jurisdiction of court over own process — Sealing files

Debtors operated number of significant mining properties, all of which had been idle — Debtors were granted protection under Companies' Creditors Arrangement Act, and sales and investment solicitation process (SISP) was subsequently approved — SISP led to proposed transaction that would see going-concern sale of three major mining properties to purchaser — Debtors brought application for order approving transaction and for ancillary relief including sealing order for particular affidavit and particular Supplementary Report of monitor — Application granted — Disclosure of sensitive financial terms of bids received as result of SISP would pose serious risk to commercial interests of stakeholders, particularly if transaction did not proceed — This conclusion also applied in relation to detailed disclosure by monitor in its Supplementary Report as to liquidation bids that had been received and how those bids compared to recovery arising under transaction — Finally, salutary effects of sealing order outweighed any prejudice to stakeholders, given conclusion that all stakeholders were able to fully consider matter, given clear statements of monitor as to benefits of transaction.

Table of Authorities

Cases considered by *Fitzpatrick J., In Chambers*:

Bank of Montreal v. Dynex Petroleum Ltd. (2002), 2002 SCC 7, 2002 CarswellAlta 54, 2002 CarswellAlta 55, 19 B.L.R. (3d) 159, 208 D.L.R. (4th) 155, *(*sub nom. *Bank of Montreal v. Enchant Resources Ltd.)* 281 N.R. 113, 30 C.B.R. (4th) 168, 1 R.P.R. (4th) 1, *(*sub nom. *Bank of Montreal v. Enchant Resources Ltd.)* 299 A.R. 1, *(*sub nom. *Bank of Montreal v. Enchant Resources Ltd.)* 266 W.A.C. 1, [2002] 1 S.C.R. 146, 2002 CSC 7 (S.C.C.) — considered

Bensette v. Reece (1973), [1973] 2 W.W.R. 497, 34 D.L.R. (3d) 723, 1973 CarswellSask 38 (Sask. C.A.) — distinguished

Blue Note Mining Inc. v. Merlin Group Securities Ltd. (2008), 2008 NBQB 310, 2008 CarswellNB 469, 337 N.B.R. (2d) 116, 864 A.P.R. 116 (N.B. Q.B.) — considered

Bul River Mineral Corp., Re (2014), 2014 BCSC 1732, 2014 CarswellBC 2702, 16 C.B.R. (6th) 173 (B.C. S.C.) — referred to

Canco Oil & Gas Ltd. v. Saskatchewan (1991), 89 Sask. R. 37, [1991] 4 W.W.R. 316, 1991 CarswellSask 177 (Sask. Q.B.) — considered

Fawcett v. Western Canadian Coal Corp. (2009), 2009 BCSC 446, 2009 CarswellBC 827, 56 B.L.R. (4th) 242 (B.C. S.C. [In Chambers]) — considered

Fawcett v. Western Canadian Coal Corp. (2010), 2010 BCCA 70, 2010 CarswellBC 306, 3 B.C.L.R. (5th) 13, 67 B.L.R. (4th) 165, 283 B.C.A.C. 182, 480 W.A.C. 182, [2010] 8 W.W.R. 431 (B.C. C.A.) — considered

Sahlin v. Nature Trust of British Columbia Inc. (2010), 2010 BCCA 516, 2010 CarswellBC 3510, 296 B.C.A.C. 126, 503 W.A.C. 126 (B.C. C.A. [In Chambers]) — referred to

Saskatchewan Minerals v. Keyes (1971), [1972] S.C.R. 703, [1972] 2 W.W.R. 108, 23 D.L.R. (3d) 573, 1971 CarswellSask 96, 1971 CarswellSask 115 (S.C.C.) — considered

Scurry-Rainbow Oil Ltd. v. Galloway Estate (1993), 8 Alta. L.R. (3d) 225, 138 A.R. 321, [1993] 4 W.W.R. 454, 1993 CarswellAlta 298 (Alta. Q.B.) — considered

Scurry-Rainbow Oil Ltd. v. Galloway Estate (1994), 23 Alta. L.R. (3d) 193, 157 A.R. 65, 77 W.A.C. 65, [1995] 1 W.W.R. 316, 1994 CarswellAlta 216 (Alta. C.A.) — referred to

Sierra Club of Canada v. Canada (Minister of Finance) (2002), 2002 SCC 41, 2002 CarswellNat 822, 2002 CarswellNat 823, (sub nom. *Atomic Energy of Canada Ltd. v. Sierra Club of Canada)* 211 D.L.R. (4th) 193, (sub nom. *Atomic Energy of Canada Ltd. v. Sierra Club of Canada)* 18 C.P.R. (4th) 1, 44 C.E.L.R. (N.S.) 161, 287 N.R. 203, 20 C.P.C. (5th) 1, 40 Admin. L.R. (3d) 1, (sub nom. *Atomic Energy of Canada Ltd. v. Sierra Club of Canada)* 93 C.R.R. (2d) 219, 223 F.T.R. 137 (note), [2002] 2 S.C.R. 522, 2002 CSC 41 (S.C.C.) — referred to

St. Andrew Goldfields Ltd. v. Newmont Canada Ltd. (2009), 2009 CarswellOnt 4582 (Ont. S.C.J.) — considered

St. Andrew Goldfields Ltd. v. Newmont Canada Ltd. (2011), 2011 ONCA 377, 2011 CarswellOnt 3148, 282 O.A.C. 106 (Ont. C.A.) — referred to

St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd. (1963), [1963] S.C.R. 482, 45 W.W.R. 26, 41 D.L.R. (2d) 316, 1963 CarswellAlta 78 (S.C.C.) — considered

Timminco Ltd., Re (2014), 2014 ONSC 3393, 2014 CarswellOnt 9328, 14 C.B.R. (6th) 113 (Ont. S.C.J.) — referred to

Vandergrift v. Coseka Resources Ltd. (1989), 67 Alta. L.R. (2d) 17, 95 A.R. 372, 1989 CarswellAlta 76 (Alta. Q.B.) — considered

Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd. (1977), [1977] 2 W.W.R. 66, 4 A.R. 251, 72 D.L.R. (3d) 734, 1977 CarswellAlta 192 (Alta. T.D.) — considered

Walter Energy Canada Holdings, Inc., Re (2016), 2016 BCSC 107, 2016 CarswellBC 158, 23 C.C.P.B. (2nd) 201, 33 C.B.R. (6th) 60 (B.C. S.C.) — referred to

Walter Energy Canada Holdings, Inc., Re (2016), 2016 BCSC 1413, 2016 CarswellBC 2117 (B.C. S.C.) — referred to

Western Canadian Coal Corp. v. Fawcett (2006), 2006 BCSC 463, 2006 CarswellBC 709 (B.C. S.C. [In Chambers]) — referred to

Statutes considered:

Coal Act, R.S.B.C. 1996, c. 51

Generally — referred to

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36

Generally — referred to

s. 11.02(2) [en. 2005, c. 47, s. 128] — referred to

s. 11.02(3) [en. 2005, c. 47, s. 128] — referred to

s. 32 — considered

s. 36 — considered

s. 36(3) — considered
Criminal Code, R.S.C. 1985, c. C-46
Generally — referred to

s. 347(2) "interest" — considered
Employee Retirement Income Security Act, 1974, 29 U.S.C.
Generally — referred to

APPLICATION by debtors for order approving transaction and for ancillary relief including extension of stay and approval of claims process.

***Fitzpatrick J., In Chambers* (orally):**

1 *THE COURT:* These are proceedings brought by the petitioners pursuant to the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (the "*CCAA*").

2 The background of this matter is outlined in my earlier decisions, indexed as *Walter Energy Canada Holdings, Inc., Re*, 2016 BCSC 107 (B.C. S.C.) and *Walter Energy Canada Holdings, Inc., Re*, 2016 BCSC 1413 (B.C. S.C.). I will not repeat the details in these reasons.

3 In brief, the petitioners operate a number of significant mining properties in northeast British Columbia, all of which have been idle since early 2014. I granted an initial order in favour of the petitioners on December 7, 2015. In January 2016, I approved a sales and investment solicitation process ("SISP"), and appointed William Aziz as the chief restructuring officer ("CRO"). Finally, I approved the retainer of PJT Partners LP ("PJT"), to facilitate the sales process. In conjunction with the SISP, parallel efforts were also to be made by the CRO, with the assistance of the Monitor, to explore liquidation scenarios.

4 There are a number of applications before me. The principal application is to approve a transaction which will see a going-concern sale of the mining properties of the petitioners to Conuma Coal Resources Limited ("Conuma"). Other applications of the petitioners that follow from the disposition of that application include an extension of the stay, approval of a claims process, and the granting of enhanced powers to the Monitor to allow matters to proceed smoothly after a conclusion of the sale to Conuma.

CONUMA SALE APPROVAL

The Evidence

5 There are extensive materials before the Court relating to the proposed sale by the petitioners to Conuma in accordance with the asset purchase agreement dated August 8, 2016 (the "APA"). These include Mr. Aziz's affidavit #3 sworn August 9, 2016 and the Monitor's Fourth Report dated August 11, 2016.

6 No stakeholder objects to the Conuma transaction, save for Kevin James. Mr. James is a party to a royalty agreement relating to coal licenses connected to the Wolverine mine of the petitioners.

7 Before I address the specifics of the proposed transaction, it is important to note that financial details of the Conuma offer are confidential. A redacted form of the APA was circulated to the service list. Nevertheless, fulsome materials are before the Court in the form of Mr. Aziz's affidavit #4, sworn August 9, 2016, which attaches the un-redacted APA and

PJT's report dated August 8, 2016 on the proposed sale. In addition, the Monitor's Supplementary Report to the Fourth Report dated August 11, 2016 also provides a confidential detailed financial analysis of the Conuma offer.

8 As a preliminary matter, the petitioners and the Monitor sought to seal Mr. Aziz's affidavit #4 and the Monitor's Supplementary Report to the Fourth Report.

9 Having heard submissions, I was satisfied that disclosure of the sensitive financial terms of the bids received as a result of the SISP, including that of Conuma, would pose a serious risk to the commercial interests of the stakeholders, particularly if the Conuma sale did not proceed. This conclusion also applied in relation to the detailed disclosure by the Monitor in its Supplementary Report as to the liquidation bids that had been received and how those bids compared to the recovery arising under the Conuma offer. Finally, I was satisfied that the salutary effects of the sealing order outweighed any prejudice to the stakeholders, given my conclusion that all stakeholders were able to fully consider the matter, given the clear statements of the Monitor as to benefits of the Conuma offer, as I will discuss below. See *Sierra Club of Canada v. Canada (Minister of Finance)*, 2002 SCC 41 (S.C.C.) and *Sahlin v. Nature Trust of British Columbia Inc.*, 2010 BCCA 516 (B.C. C.A. [In Chambers]).

10 Accordingly, on August 15, 2016, I granted a sealing order in relation to Mr. Aziz's affidavit #4 and the Monitor's Supplementary Report to the Fourth Report.

The APA

11 Not surprisingly, the APA is a comprehensive document addressing a myriad of issues that arise in the anticipated complex sale and purchase transaction relating to the petitioners' assets. I do not intend to address all terms of the transaction; I will highlight the most important aspects of the APA.

12 The purchased assets relate to the three major mining properties owned by the petitioners, being the Brule, Willow Creek and Wolverine coal mines. The specific assets include certain real property, mineral tenures, buildings, equipment, current assets, water rights, intellectual property and cash collateral currently held by the secured creditor to secure certain letters of credit. Certain "Assigned Contracts" are to be assigned to Conuma and, if required, the petitioners will seek consent to such assignments from the counterparties. If any consent is not obtained, it is anticipated that the court may be asked to address any issues that arise.

13 There are complex provisions in the APA in relation to the transfer of assets to Conuma. Pending Conuma obtaining the necessary permits and other government approvals to operate the coal mines, Conuma is to be granted the right to conduct mining operations under a contract mining agreement. Conuma is to provide an indemnity in respect of such operations that will be secured against the real property by a court-ordered charge.

14 The "Assigned Contracts" include the petitioners' interest in Belcourt Saxon Limited Partnership ("BSLP"). The petitioners have the option of requiring Conuma to purchase their interest in BSLP. Both parties to the APA anticipate that there will be further negotiations between Conuma and the other joint venture partner, Peace River Coal Limited Partnership ("Peace River"), given that Peace River holds a right of first refusal and certain "tag-along" rights. Also, there are royalty agreements relating to the coal properties operated by BSLP, including an agreement with Pine Valley Mining Corporation ("PVM"). No specific issues arise in relation to these royalty agreements at this time. The petitioners and PVM have agreed that PVM has reserved its rights in relation to its royalty agreement pending anticipated negotiations between PVM and Conuma.

15 Assets which are not part of the APA include cash on hand and the interests of the petitioners in the U.K. Finally, there are certain "Excluded Contracts" which are not being assumed by Conuma. One of these is a royalty agreement with Mr. James relating to the Wolverine mine, which I will discuss in more detail below.

Relevant Factors

16 I will discuss the Conuma offer in the context of the factors set out in the *CCAA*, s. 36(3):

> Factors to be considered
>
> In deciding whether to grant the authorization, the court is to consider, among other things,
>
> (a) whether the process leading to the proposed sale or disposition was reasonable in the circumstances;
>
> (b) whether the monitor approved the process leading to the proposed sale or disposition;
>
> (c) whether the monitor filed with the court a report stating that in their opinion the sale or disposition would be more beneficial to the creditors than a sale or disposition under a bankruptcy;
>
> (d) the extent to which the creditors were consulted;
>
> (e) the effects of the proposed sale or disposition on the creditors and other interested parties; and
>
> (f) whether the consideration to be received for the assets is reasonable and fair, taking into account their market value.

17 There are no issues arising from the process by which the bids were received under the SISP. As detailed in my earlier reasons, the SISP was a comprehensive process and substantial steps in Phase 1 were taken to invite non-binding letters of intent and allow potential purchasers to assess the assets. Phase 2 of the SISP began in March 2016, by which qualified bids were to be received by June. Bids were received by the later deadline of July 21, 2016.

18 There has been substantial professional assistance in the conduct of the SISP, as provided by the CRO and PJT, with additional input and oversight by the Monitor. The Monitor raises no issue with the process, noting that it has "been run as designed." The Monitor also confirms that the APA was rigorously negotiated between the petitioners and Conuma. By all accounts, the Monitor has been extensively involved throughout the SISP process leading to the Conuma bid being received and successfully negotiated.

19 Both the CRO and the Monitor set out the reasons why the Conuma bid was selected:

> a) the overall purchase price was the highest offer arising from the SISP;
>
> b) the bid will produce higher value or net cash proceeds for the stakeholders than any other bid;
>
> c) a substantial deposit of 10% of the purchase price has been received;
>
> d) the bid will result in Conuma assuming substantial liabilities that would otherwise be borne by the estate, including reclamation obligations relating to the mines and obligations under the Assigned Contracts. In addition, current employees will be hired by Conuma, and Conuma is to assume the employment obligations relating to the re-hired employees. Finally, Conuma has agreed that it will be a successor employer in accordance with the relevant legislation and bound by the existing collective bargaining agreement;
>
> e) Conuma has agreed to honour the petitioners' commitments to First Nations groups;
>
> f) there will be substantial other benefits to the larger stakeholder group, given Conuma's stated intention to resume operations at certain of the mines in the future. Conuma is to assume the environmental stewardship of the mine properties which, understandably, has been of some concern to the environmental regulators as a result of the insolvency of the petitioners. In the event of a start-up of the mine(s), suppliers and customers of the mine properties will be positively impacted. Local communities, including First Nation groups, will also see benefits from a recommencement of mining operations;

g) Conuma is a B.C. limited liability corporation created for this transaction; however, other corporations related to Conuma have provided guarantees for Conuma's obligations under the APA, including the indemnity under the contract mining agreement; and

h) the bid provides for a fairly short period before completion which is required to occur no later than September 15, 2016.

20 In addition, the Monitor has done an extensive analysis of the Conuma bid in relation to the liquidation bids. The Conuma bid will realize a greater return than any liquidation scenario, principally arising from the greater holding costs in conducting a liquidation of the assets and the additional claims that would be advanced against the estate in that scenario.

21 Having reviewed the matter, I unreservedly agree with the CRO and the Monitor that the Conuma transaction is the best transaction in the circumstances for the benefit of the petitioners and their stakeholders as a whole.

22 It is also apparent that the petitioners have broadly consulted with the creditors or potential creditors. The Monitor reports that consultation has taken place with the United Steelworkers, Local 1-424 (the "Union"), and the United Mine Workers of America 1974 Pension Plan and Trust (the "1974 Pension Plan"), both of whom advance substantial claims against the petitioners. In addition, discussions have taken place with certain regulators, key suppliers, and some counter-parties to key contracts.

23 In summary, leaving aside the issues raised by Mr. James on this application, in my view, it is manifestly the case that the Conuma transaction is the best attainable in the circumstances and represents the best alternative available to the stakeholders as a whole. I find that the consideration under the APA is fair and reasonable.

MR. JAMES' ROYALTY RIGHTS

24 As stated above, the only opposition to the approval of the Conuma transaction is advanced by Mr. James. He takes the position that his royalty rights run with the land, such that the petitioners may not transfer the Wolverine coal licenses to Conuma without regard for those rights. Mr. James further says that any approval and vesting order relating to the Wolverine coal licenses cannot result in an extinguishment of his rights.

25 During the hearing, Mr. James' counsel sought certain amendments to the draft approval and vesting order, including a declaration that Mr. James had an interest in the Wolverine coal properties, and that such interest took priority over the petitioners' interest in those properties. Other suggested wording was to the effect that the vesting of such properties in Conuma would be subject to his royalty interest.

26 Mr. James also advances procedural arguments in opposition to approval of the Conuma transaction.

27 The petitioners dispute that Mr. James holds an interest in land (i.e. the Wolverine coal licenses). They say that his interest is only a contractual one, being the right to receive certain monies in the event of production and sale of coal by the petitioners arising from the Wolverine coal licenses.

28 Both the petitioners and Mr. James wish to decide the royalty issue at this time, given the need to determine whether the Conuma transaction will proceed, or not.

Background Facts

29 Mr. James is a geologist and was a founding member, officer, and director of Western Canadian Coal Corporation ("WCC"). David Fawcett was another director of WCC.

30 In the late 1990s, Mr. James and Mr. Fawcett identified certain coal licenses, which were eventually acquired in Mr. James' name. Some licenses (Burnt River/Brule) were sold to WCC after payment by WCC of Mr. James' out-of-pocket expenses; with respect to others (West Brazion), WCC did not have the funds to obtain the licenses, so Mr. James and Mr. Fawcett paid to acquire them. They then granted WCC an option to purchase the licenses in exchange for payment of out-of-pocket expenses and a 1% royalty on coal produced from those properties.

31 In 1999, Mr. James and Mr. Fawcett identified further promising coal properties in the Wolverine area. Again, WCC lacked the funds to purchase them. A transaction was then structured such that Mr. James and Mr. Fawcett gave up their royalty interest in West Brazion if WCC exercised an option to acquire the Wolverine licenses. In consideration, WCC agreed to pay a 1% royalty on the West Brazion and Wolverine properties to be shared by Mr. James, Mr. Fawcett and another WCC investor, Mark Gibson.

32 This agreement resulted in the execution of a royalty sharing agreement on March 31, 2000 (the "RSA"), by WCC (the "Company"), and Mr. James, Mr. Fawcett and Mr. Gibson (the "Investors"). In clause 1 of the RSA, the Investors confirm that they have advanced funds to WCC for the "Properties" (defined below), totalling $80,000, with Mr. James having advanced $17,500.

33 The salient terms of the RSA are as follows:

> **WHEREAS:**
>
> A. The Company has made application for and expects to become the beneficial owner of a 100% interest in and to certain coal interests in the West Brazion, Burnt River, Wolverine and Mount Spieker properties . . . (the "Properties").
>
> B. Each of the Investors have assisted the Company in acquiring and maintaining the Properties;
>
> C. The Company wishes to pay a royalty to the Investors for the Investors' contributions on the terms and conditions herein contained.
>
> . . .
>
> **THIS AGREEMENT WITNESSES THAT** in consideration of the payment by the Purchaser to the vendors of $1.00 and other good and valuable consideration, receipt of which is hereby acknowledged, the parties mutually covenant and agree as follows:
>
> . . .
>
> **2. CONSIDERATION**
>
> 2.1 As consideration for advancing the funds, the Company will pay a royalty (the Royalty") of one percent (1%) of the price bracket (FOBT at Port) for all product tonnes produced from the West Brazion, Mount Spieker and Wolverine coal properties on a quarterly basis to the Investors as set out in Schedule "2.1" . . . [Mr. James - 21.9%; Mr. Fawcett - 40.6%; Mr. Gibson - 37.5%]
>
> **3. THE COMPANY'S REPRESENTATIONS AND WARRANTIES**
>
> 3.1 The Company represents and warrants to and covenants with the Investors as follows:
>
> . . .

> (c) the Company is or will be the beneficial owner of all of the coal licenses comprising the Properties (the "Coal Licenses"), free and clear of all liens, charges and claims of others and no taxes or rentals are or will be due in respect of any thereof;
>
> . . .
>
> **4. COAL LICENSES**
>
> 4.1 Upon the Coal Licenses being granted and recorded under it in the Company's name, the Company will maintain the Coal Licenses in good standing with the mining recorder, or such other entity with jurisdiction over such matters.
>
> 4.2 In the event that any of the Coal Licenses comprising the Properties are not granted or the Company decides to cancel any applications prior to the Coal Licenses being granted, the Investors will be repaid proportionately immediately upon the funds being returned by the government.
>
> 4.3 Any forfeiture of the Coal Licenses shall be by mutual consent of the Parties to this Agreement, and such consent shall not be unreasonably withheld. In the event that the Company forfeits the Coal Licenses, the Company will assign the Coal Licenses to the Investors for a minimum period of 30 days prior to the date the forfeiture is to become effective.
>
> . . .
>
> **8. ASSIGNMENT**
>
> 8.1 This agreement may not be assigned without the written consent of all the parties, which consent shall not be unreasonably withheld.
>
> **9. GENERAL**
>
> 9.1 This Agreement will enure to the benefit of and be binding upon the parties and their respective successors, heirs, executives, administrators and permitted assigns.

34 The RSA confirms, in clause 6, that the funds for the Burnt River property had been repaid, but that all of the other funds advanced by the Investors for the other Properties would be repaid within two years.

35 The RSA was prepared by WCC's corporate counsel, clearly upon the instructions of the directors, which included Mr. James. Mr. Fawcett was one of the authorized signatories signing on behalf of WCC.

36 The above background facts are a summary of the important facts set out in Mr. James' affidavit filed in support of his position. A more detailed review of the circumstances leading to the execution of the RSA has been set out in various court decisions, as I will now describe.

37 In 2006, WCC launched a court proceeding attacking the validity of the RSA. This proceeding addressed WCC's argument that there was lack of corporate compliance in the execution of the RSA by WCC under the relevant legislation. WCC's petition was dismissed by this Court: *Western Canadian Coal Corp. v. Fawcett*, 2006 BCSC 463 (B.C. S.C. [In Chambers]).

38 In March 2007, WCC suspended payments under the RSA on the basis that the royalty payments under the RSA constituted "interest" within the meaning of s. 347 of the *Criminal Code*, R.S.C. 1985, c. C-46, such that it would result in the Investors receiving a criminal interest rate. As a result, Mr. Fawcett brought a proceeding before this Court in 2009 seeking a declaration that the royalty under the RSA did not offend the *Criminal Code* provision. Mr. James' counsel appeared at the hearing and supported Mr. Fawcett.

39 In *Fawcett v. Western Canadian Coal Corp.*, 2009 BCSC 446 (B.C. S.C. [In Chambers]) [*Fawcett 2009*], Pearlman J. considered the criminal interest rate issue. In deciding the interpretation issue arising from the RSA, he considered the terms of the RSA as a whole and also the relevant factual matrix surrounding the execution of the RSA (para. 80). Both of these interpretation approaches are equally relevant now in relation to a determination of the nature of the rights acquired by Mr. James under the RSA.

40 Justice Pearlman's comments on the substance of the RSA provisions are also relevant:

> [104] . . . In essence, [WCC], in consideration for its acquisition of the interests of Messrs. Fawcett and James in West Brazion, agreed to pay the royalty and to reimburse those Investors for the application costs they had previously incurred.
>
> . . .
>
> [108] By paragraph 9.4, the parties agreed that the terms and provisions of the RSA constituted their entire agreement and superseded all previous oral or written communications. Upon entering into the RSA, the Investors relinquished any rights they each had with respect to particular coal properties in exchange for their shared interest in the royalty payable under the RSA.
>
> . . .
>
> [125] . . . In substance, the RSA was an agreement by which the Investors assisted [WCC] in acquiring potentially valuable coal licenses in consideration for a shared royalty interest in those licenses. The royalty was not in substance a cost paid by [WCC] in order to receive credit. Rather, the royalty was the principal consideration flowing from [WCC] to the Investors for their contributions to [WCC]'s acquisition of the coal licenses. . . .
>
> [Emphasis added]

41 In *Fawcett v. Western Canadian Coal Corp.*, 2010 BCCA 70 (B.C. C.A.) [*Fawcett 2010*], Pearlman J.'s decision was largely upheld, in that only a portion of Mr. Fawcett's share of the royalty was found to be a criminal rate of interest. Mr. James' share of the royalty was not affected by the ruling: see paras. 47-48.

42 On April 1, 2011, one of the petitioners, Walter Energy Canada Holdings, Inc. ("Walter Energy"), the general partner of Walter Canadian Coal Partnership, acquired all of the outstanding common shares of WCC. As such, it is acknowledged that Walter Energy is a successor to WCC as contemplated by clause 9.1 of the RSA.

43 Until the Wolverine mine became idle in May 2014, Walter Energy paid royalties to Mr. James in accordance with the RSA arising from coal production from that mine.

44 Despite these previous proceedings and court decisions, it is common ground that there has not been a determination as to the proper characterization of Mr. James' rights to the royalty under the RSA; specifically, there has not yet been a determination as to whether Mr. James holds an interest that runs with the Wolverine coal licenses that must be recognized in a transfer of those licenses by Walter Energy, such as to Conuma.

45 At some point, Mr. Gibson sold his royalty rights under the RSA back to WCC. As present, Mr. James and Mr. Fawcett continue to retain rights under the RSA as to a 0.219% and 0.15% royalty respectively (total 0.369%).

46 In April 2016, Mr. James' counsel notified petitioners' counsel of her view that the royalty due to Mr. James under the RSA "runs with the land", and should be part of any purchase and sale of the coal properties. Petitioners' counsel responded that it was yet undetermined how the RSA would be treated in the *CCAA* proceedings and, also, it was yet unknown how any potential purchaser would wish to deal with the matter.

47 The application materials to approve the Conuma transaction were filed on August 11, 2016, and delivered to parties on the service list, including Mr. James. Mr. Aziz's affidavit and the Monitor's Fourth Report both confirmed that a "royalty agreement related to the Wolverine mine is not being assumed" by Conuma and that it is an "Excluded Liability". Everyone, including Mr. James, understands that this refers to the RSA. Petitioners' counsel anticipates that the RSA will be disclaimed by Walter Energy in the future, and any claims arising will be addressed in the claims process.

Discussion

48 Walter Energy and Mr. James agree that the royalty due under the RSA is a "gross overriding royalty", in that the royalty amount is not tied to any profitability arising from mine production. In *Bank of Montreal v. Dynex Petroleum Ltd.*, 2002 SCC 7 (S.C.C.) at para. 2, the Court described this as a "royalty granted normally by the owner of a working interest to a third party in exchange for consideration which could include, but is not limited to, money or services . . . "

49 The Court in *Dynex* also confirmed earlier Canadian authorities to the effect that such a royalty interest *can be* an interest in land. Quoting *Vandergrift v. Coseka Resources Ltd.* (1989), 67 Alta. L.R. (2d) 17 (Alta. Q.B.) at 26, the Court, affirmed that:

> [22] . . . it appears reasonably clear that under Canadian law a "royalty interest" or an "overriding royalty interest" can be an interest in land if:
>
> > 1) the language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the oil and gas substances recovered from the land; and
> >
> > 2) the interest, out of which the royalty is carved, is itself an interest in land.

50 Walter Energy agrees that the requirement in item 2 is met, in that its interests in the Wolverine coal licenses are themselves interests in land.

51 The issue then becomes whether, on a proper interpretation of the RSA, it can be said that the parties intended Mr. James to have an interest in land, as opposed to a contractual right to the royalty stream from production under the Wolverine coal licenses.

52 Mr. James points to various factors which he says supports the former interpretation: that he is to be paid based on product that is "produced" from the land (i.e. the Properties) (clause 2.1); that he was entitled to obtain the coal licenses back upon forfeiture (clause 4.3); that the royalty has no end date and therefore would last in perpetuity; and, that the RSA was binding on Walter Energy's successors and assigns (clause 9.1).

53 I conclude that the first point, that Mr. James was to be paid the royalty based on what is "produced" from the coal licenses, is not compelling in terms of persuading me that he was granted an interest in the coal licenses.

54 One of the early decisions on the issue is found in *St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd.*, [1963] S.C.R. 482 (S.C.C.). The Court was considering a participation agreement which provided, in clause 10b, that the participant would be paid a "percentage of net proceeds of production".

55 The Court found, in *St. Lawrence*, at p. 488, that these rights were rights to receive money as a matter of contract, and not an interest in land:

> I have reviewed the contents of the two agreements of July 15, 1951, in some detail because clause 10b must be considered in relation to and as a part of each agreement considered as a whole. The essence of each agreement is that, by participating in the cost of drilling a producing well upon the lands in question to the extent of the stipulated percentage of cost, the Participant would become entitled to receive the stipulated percentage of the net proceeds of

> production of such well. "Net proceeds of production" as defined clearly refers to an amount of money. They are the proceeds from the sale of the Company's share of the production from the well after making those deductions which are provided for in clause 1(*c*). The Company's share of production referred to in this para. (*c*), is, obviously, the 25 per cent interest in production which it could earn under the terms of the Farm-out Agreement. The appellants are, therefore, entitled, as a matter of contract, to a percentage of certain monies to be obtained from the sale of the production from any well in respect of whose drilling costs they have contributed their required portions.

56 This same interpretation exercise was before the Supreme Court of Canada in *Saskatchewan Minerals v. Keyes* (1971), [1972] S.C.R. 703 (S.C.C.). There, the Court was considering a royalty agreement which provided for a royalty per ton on all anhydrous salt "produced and sold from the said leasehold property". At 709, Martland J., for the majority, doubted that the use of the word "royalty"' implied any intention to create an interest in land. While not deciding the point, the majority thought the relevant provision was similar to what had been considered in *St. Lawrence* such that only a contractual right, and not an interest in the land, arose.

57 Similarly, in *Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd.*, [1977] 2 W.W.R. 66 (Alta. T.D.), the Court found that the language used - payment of a royalty based on production - was an obligation to pay money rather than an interest in the land. In this case, and others that followed *Vanguard*, an important factor was that the royalty was to be paid only once the substances had been removed from the lands.

58 In *Vanguard*, the Court stated at p. 74:

> Clause (1) of the royalty agreement, Ex. 2, states that the owners (Westersunds) will pay to the grantee (Vanguard) a gross royalty of seven per cent of the proceeds of sale of the petroleum substances that may be produced, saved and marketed out of the said lands. This is an obligation to pay Vanguard a sum of money out of the proceeds of sale of the petroleum substances *after* they have been removed from the land. The wording in the royalty agreement herein cannot be construed as an interest in situ. In my view, the royalty herein is on the proceeds of the sale of the petroleum substances after removal from the land. In other words, the owner and the grantee agreed to share in the proceeds of the sale of mineral substances after removal. This amounts to an obligation to pay by the owner to the grantee a sum of money based on a percentage of the sale proceeds.
>
> [Emphasis added]

59 This same reasoning was followed in *Vandergrift*, where the royalty was to be paid on petroleum substances "recovered" from the land. Again, the Court, at p. 28, found that the language used evidenced that the parties intended only a contractual right to the payment of the royalty, rather than a conveyance of, or reservation of, an interest in land:

> In reading the agreement one is struck by the fact that the first reference to the nature of the interest to be conveyed used the expression "royalty on all petroleum substances recovered from the lands", not petroleum within, upon and under the lands, but, those substances "recovered" from the lands. The next reference, in para. 2, is to a royalty on "petroleum substances found". Again, the reference is not to petroleum substances within, upon or under the lands, but to substances "found" within, upon or under the lands. The other references in agreement are to royalty in terms of "a share of production", "petroleum substances sold", "petroleum substances produced". Taken as a whole, I am of the view that the agreement conveys a contractual right to the payment of a royalty on petroleum substances produced from the lands, that is, a share of the petroleum after it has been removed, rather than on interest in land.

60 This type of language is to be distinguished from that discussed in *Bensette v. Reece*, [1973] 2 W.W.R. 497 (Sask. C.A.), a decision upon which Mr. James relies. In that case, at p. 500, the words "royalty in all the . . . minerals . . . which may be found in, under or upon the lands" were found to be sufficient to support the conclusion that there was a conveyance of an interest in the minerals themselves *in situ* and, therefore, an interest in the land.

61 Various other decisions also consider the formality of the conveyancing language in relation to the land itself. In that respect, Mr. James refers to two other decisions, which I consider to be distinguishable from the circumstances here.

62 In *Canco Oil & Gas Ltd. v. Saskatchewan*, [1991] 4 W.W.R. 316 (Sask. Q.B.), the Court found that the royalty was an interest in the land. That determination, however, was based on the use of the words "grant, assign, transfer and convey", and also the clear statement in the agreement that the interest conveyed was an interest in land and was to run with the land.

63 Similar formal words of conveyance are found in *Blue Note Mining Inc. v. Merlin Group Securities Ltd.*, 2008 NBQB 310 (N.B. Q.B.). There, the agreement provided:

> [7] . . . East West Caribou Mining Limited . . . hereby grants to East West Minerals N.L. . . . a freely assignable 10% net profits interest in the mine . . . .
>
> [Emphasis added]

The highlighted portions of the above agreement were found to evidence an intention to establish an interest in the land.

64 As a further example, Walter Energy refers to *Scurry-Rainbow Oil Ltd. v. Galloway Estate*, [1993] 4 W.W.R. 454 (Alta. Q.B.); aff'd (1994), [1995] 1 W.W.R. 316 (Alta. C.A.). The lower court undertook an extensive review of the authorities, including the cases I have discussed above. The court referred to such formal language as establishing an interest in land:

> [102] In my opinion O'Leary J. did not give sufficient weight to some of the other words used in cl. 2. I refer in particular to the verbs "grant, bargain, sell, assign, transfer and set over"; to the descriptors "all the estate, right, title, interest, claim and demand whatsoever, both at law and equity"; the words "to have and to hold"; and the words "unto the Trustee, its successors and assigns forever". Taken together, these words seem to me more like words describing in perpetuity property rights than they do words describing a relatively temporary arrangement (such as a contractual right) which would be unenforceable against the Owner once he sold the property.

65 The final case to which I will refer is *St. Andrew Goldfields Ltd. v. Newmont Canada Ltd.*, [2009] O.J. No. 3266 (Ont. S.C.J.); aff'd 2011 ONCA 377 (Ont. C.A.), where much of the above reasoning in the authorities was discussed and applied:

> [98] Royalty interests can be interests in land if the language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the substances recovered from the land, and the interest, out of which the royalty is carved, is itself an interest in land. The intentions of the parties, judged by the language creating the royalty, determine whether the parties intended to create an interest in land or to create contractual rights only. (*Bank of Montreal v. Dynex Petroleum Ltd.*, [2002] 1 S.C.R. 146, at paras. 12, 14 and 22.)
>
> [99] Turning then to the language of the Barrick royalty agreement, Newmont "***covenants and agrees . . . to pay*** . . . a net smelter return royalty . . . with respect to all valuable minerals ***produced*** from mining rights and surface leases known as the Holt-McDermott mining claims and leases" (my emphasis added).
>
> [100] While I agree with Newmont that there is no magical "incantation" that must be used to create an interest in land, it is trite to say that language used in an agreement is intended to have and does have a certain meaning. As all the witnesses at this hearing acknowledged, each royalty agreement is different. It is therefore necessary to examine the specific wording used by the parties to determine the meaning that they ascribed to the royalty in this case and the rights that they intended to create.
>
> [101] The use of the words "covenants and agrees to pay" and "produced" in the description of the Barrick royalty is the first indication that the parties intended to create only contractual rights to the payment of a royalty and not an interest in land.

[102] The case law that the parties have submitted makes a valid distinction between the "granting" of royalties attached to or "in" the land or the minerals themselves, thus creating an interest in the land, and the payment of royalties attached to the minerals or revenues "produced" or "removed" from the land, resulting in the creation of contractual rights to the payment of a share of the revenue from the minerals after they have been extracted: see, for example, *Bensette and Campbell v. Reece*, [1973] 2 W.W.R. 497 (Sask.C.A.), at p. 500; *Vandergrift v. Coseka Resources Limited* (1989), 67 Alta. L.R. (2d) 17 (Alta.Q.B.), at pp. 26 to 28; *Guar. Trust Co. v. Hetherington* (1987), 50 Alta. L.R. (2d) 193 (Alta.Q.B.), at pp. 216 to 222 and 224; *St. Lawrence Petroleum Limited v. Bailey Selburn Oil & Gas Ltd. (No. 2)* (1963), 45 W.W.R. 26 (S.C.C.), at pp. 31 to 33; and *Blue Note Mining Inc. v. Fern Trust (Trustee of)*, [2008] N.B.J. No. 360 (N.B.Q.B.), at paras. 34 and 40.

[103] Other relevant factors to determine the parties' intention to create contractual rights or an interest in land are: whether the royalty holder retains a right to enter upon the lands to explore for and extract the minerals: *Vandergrift v. Coseka Resources Limited*, *supra*, at pp. 28 to 29; and whether the owner of the lands is in complete control of its interest in the lands acquired with the only right in the royalty holder being to share in the revenues produced from the minerals extracted from the lands: *St. Lawrence Petroleum Limited v. Bailey Selburn Oil & Gas Ltd.* (*No. 2*), *supra*, at pp. 32 to 33.

[104] Under the Barrick royalty agreement, the royalty holder retains no interest in or control over the kind of operations or activities that the owner of the property may carry out and, as an express condition or limitation of the royalty, the royalty holder has no right to claim a reversionary interest in any of the property should the owner seek to relinquish all or any portion of the property. The royalty holder's rights to re-enter upon the property are only for accounting and auditing purposes with respect to the protection of the royalty holder's contractual rights to payment of the royalty.

. . .

[106] From my reading of the provisions of the Barrick royalty agreement, I cannot see that the parties intended by the royalty to create an interest in land. The provisions are consistent with the creation only of a contractual right to payment of the royalty. It would have been a very simple thing for the parties to have used specific language to create an interest in land. The effect of the Barrick royalty agreement is to create only a contractual right to the payment of the royalty.

66 Based on the principles arising from the above authorities, and considering the RSA provisions as a whole, I conclude that the RSA was not intended to grant Mr. James an interest in the Wolverine coal licenses; rather, the RSA simply represented a contractual right to payment on the part of Mr. James as the consideration for which he transferred his rights in the Properties to Walter Energy.

67 I rely upon the following:

a) Walter Energy is specifically stated to have "acquired" the licenses and to be the beneficial owner of them free of any "claims of others" (Recital B and clause 3.1(c));

b) I agree with Mr. James that he gave up valuable consideration for the royalty and that he shared the risk of recovery going forward. However, as Pearlman J. noted at para. 126 in *Fawcett 2009*, Mr. James had no direct rights in respect of the coal licenses and he relinquished any further control in respect of them. Mr. James had no assurance that he would gain any consideration under the royalty if the Properties were never put into production;

c) clause 2.1 does not include any formal conveyancing language to, for example, "grant, assign, transfer or convey" any rights to Mr. James in relation to the coal licenses (*contra Canco*, *Blue Note* and *Scurry-Rainbow*). No such words, or similar words, are used; rather, it is simply an obligation to *pay* the royalty;

d) with Mr. James having some control over WCC at the time, it would have been a simple matter to have included clear language to the effect that Mr. James was to be granted a royalty that would "run with the land" (see *Canco*). As in *Vandergrift*, at p. 27, the choice of language was within his control but no such clear language was used;

e) the reference to the payment of the royalty being based on what is "produced" from the coal properties is simply the means by which the parties agreed to calculate the amount of the royalty. It is not a reference to a royalty *in* the "Properties" or coal licenses: see *St. Lawrence*, *Saskatchewan Minerals*, *Vanguard*, *Vandergrift* and *St. Andrew Goldfields*. I note that the parties disagree as to whether the royalty is due upon production (i.e. once removed from the land), or upon the coal being shipped to port and priced at that time for the purposes of calculating the 1% royalty. In my view, this is not a relevant distinction as, in any event, the coal would have been severed from the lands by that time;

f) clause 4.3 of the RSA indicates that the parties did consider what rights the Investors would have in relation to the coal licenses in the future. Those rights were specifically addressed in the context of a forfeiture of the Properties, likely under the *Coal Act*, R.S.B.C. 1996, c. 51 (since repealed in 2004), a circumstance which is not relevant here. Further, the RSA does anticipate that any assignment of the RSA by WCC would require the consent of Mr. James (clauses 8.1/9.1). However, that circumstance is not what is happening here, since no one has sought to assign the RSA, let alone without Mr. James' consent; and

g) importantly, the RSA does not restrict the ability of Walter Energy to sell the Properties, and it also contains no obligation on the part of Walter Energy to require any purchaser of the Properties to assume its obligations under the RSA.

68 As stated above, Mr. James also points to the perpetual obligation under the RSA although, presumably, the obligation to pay the royalty would be tied to the life of the mine in terms of its ability to produce coal. He also refers to the dissent of Laskin, J., as he then was, in *Saskatchewan Minerals* where he relied, to some extent, on a clause similar to clause 9.1 of the RSA, which stated that the agreement was to be binding on successors and assigns of the parties, at p. 716 and 726. A similar comment was made in *Scurry-Rainbow* at para. 88.

69 In my view, however, these aspects of the RSA do not assist Mr. James. It is not entirely unusual that an agreement is perpetual in the sense of requiring payment with no set end date. Further, the clauses requiring Mr. James' consent to assignment, and that it is binding on permitted assigns, is also not unusual in a commercial context. These clauses do not detract from the essential nature of the right granted to Mr. James found in clause 2.1, nor do they enhance his ability (or lack of ability) to control the petitioners' disposition of the Properties after his transfer of them.

70 As the petitioners argue, Mr. James had other means by which he could have obtained the right to control any further disposition of the Properties by WCC. For example, the PVM royalty agreement includes a restriction on the sale of the properties or interests subject to the royalty, and requires that any purchaser of the properties assume the royalty obligations to PVM.

71 Further, paragraph 18 of PVM's royalty agreement requires the granting of a security interest to PVM in respect of certain mineral titles to secure the obligations under that agreement. Mr. James could have obtained a security interest in relation to WCC's obligations to pay the royalty under the RSA; he chose not to do so despite having control of WCC at the time: see *Fawcett 2010* at para. 17.

72 Further, these clauses relating to successors and assigns cannot be controlling in the context of the insolvency proceedings that are currently underway. The RSA is an executory contract, and as with other agreements to which the petitioners are parties, it is subject to being dealt with under the *CCAA* and court orders granted under that statutory jurisdiction. That includes the possibility that the petitioners may disclaim the RSA in accordance with s. 32 of the *CCAA*.

Procedural Issues

73 Turning to the procedural issues, Mr. James asserts that he was not consulted regarding the Conuma transaction and that he does not understand why the RSA is not to be assumed. He argues that there is no persuasive reason as to why the RSA is not being assumed by Conuma, and that to exclude it from the APA is "improper, unjust and unfair".

74 Despite Mr. James' assertions about a lack of transparency, I consider that the application materials clearly set out that Conuma does not intend to assume any obligations arising from the RSA. Mr. James' view is that he should be given some explanation as to why that decision was taken by Conuma, although I am not sure that that is either necessary or beneficial. If it was not already clear enough from the application materials, Conuma's counsel has now clearly stated, on the record, that it has no intention of assuming any obligations under the RSA. Clearly, Conuma has exercised its business judgment on a cost/benefit basis (as it would do in relation to any of the contracts held by the petitioners), and made a business decision that it is not in Conuma's interest to do so.

75 Likewise, I see no concern arising from the BSLP transaction. Mr. James refers to a share purchase agreement dated October 31, 1997 by which he, and others, agreed to sell his shares in Western Coal Corp. to WCC. In consideration of those transfers, WCC agreed to pay a royalty of 0.75% of the selling price of coal sales from certain Belcourt properties. The Belcourt put option has been described in the APA. It is an option in respect of the petitioners' interests in the BSLP joint venture. Mr. James has not put forward any evidence that he has an interest in BSLP and I see nothing in the APA that addresses, negatively or positively, this royalty agreement.

76 In any event, it remains to be seen whether, and on what terms, Conuma may acquire the petitioners' interest in BSLP and how the royalty agreement may be affected.

Conclusion

77 I find that, when read as a whole, the RSA and the rights to a royalty thereunder do not convey to Mr. James any interest in the coal licenses or Properties; rather, Mr. James was granted a contractual right to receive a payment of a royalty on coal products produced from the relevant coal licenses. Accordingly, as with any other contract held by an insolvent debtor who has sought protection under the *CCAA*, the RSA may be addressed by the petitioners in accordance with the *CCAA* and the orders granted in this proceeding.

78 I also see no unfairness in the Conuma transaction being approved without reference to Mr. James' rights under the RSA. As in any such transaction, a purchaser will assess the cost/benefit of assuming any contracts held by the debtor and make a determination on that basis. While Mr. James has been on the losing end of that assessment by Conuma in relation to the RSA, that does not mean that the process was unfair or unreasonable.

79 It certainly does not lead to the conclusion that the Conuma transaction is not supported by the *CCAA*, s. 36 factors, as alleged by Mr. James. I agree that the RSA is a consideration for the court in the context considering that transaction. However, in the overall context of the APA, and the admittedly overwhelming benefit to the entire stakeholder group (which includes Mr. James), Mr. James' disappointment in the outcome cannot rule the day.

80 Accordingly, the proposed approval and vesting order in respect of the Conuma transaction, as sought by the petitioners, is granted.

OTHER ORDERS

81 Given the impending sale of their major assets to Conuma, the petitioners also seek a claims process order. As was anticipated at the outset, determining the validity and quantum of claims in order to make a distribution to the creditors through such a claims process is important in liquidating *CCAA* proceedings: *Bul River Mineral Corp., Re*, 2014 BCSC 1732 (B.C. S.C.) at para. 36; *Timminco Ltd., Re*, 2014 ONSC 3393 (Ont. S.C.J.) at para. 41.

82 The proposed claims bar date is October 5, 2016. It is anticipated that if any disputes as to claims arise, these will be brought before the court on a *de novo* basis in the first week of January 2017.

83 The claims process is to be implemented and run by the Monitor, with input from the CRO, and with assistance of certain soon-to-be former key employees of the petitioners. These key employees are to remain accessible to the petitioners and the Monitor even after the sale to Conuma closes under a transition services agreement.

84 The proposed order is in fairly standard terms; however, specific processes are to be put in place for certain stakeholders.

85 Claims of individual employees will be determined by the Monitor, and upon being notified of the amount of their claim, they need only respond if they dispute the amount. The Union will receive notice of the claims and may dispute the amount on behalf of any employee. As I anticipated in my earlier reasons from June 2016 (*Walter Energy Canada Holdings, Inc., Re*, 2016 BCSC 1413 (B.C. S.C.) at para. 33), this aspect of the claims process has arisen from fruitful discussions between the petitioners, the Monitor and the Union, with the latter providing input on the most efficient way of adjudicating these claims.

86 The unique claim of the 1974 Pension Plan poses some procedural challenges for the parties. Again, this is a substantial claim (some $1.4 billion) which, if valid, has the potential to overwhelm most other claims against the estate. This claim is asserted as a liability of the petitioners based on the provisions of U.S. legislation, being the *Employee Retirement and Income Security Act of 1974*, 29 U.S.C.]§ 1001, as amended, (commonly referred to as "*ERISA*"). There has been some exchange of materials between the parties. As matters stand, the petitioners dispute that they are liable under U.S. law (or *ERISA*), and that this is a valid claim against the Canadian petitioners in any event.

87 After some negotiations, it is intended that, rather than file a proof of claim, the 1974 Pension Plan will file a notice of civil claim in a separate proceeding in this court to assert the claim. Thereafter, the petitioners, and anyone else on the service list, will be entitled to file a response to that claim. Once the issues are framed, it is intended that the parties will come before the court to determine the procedures and timing by which the parties will develop and present their evidence and legal arguments and how the issues are best resolved. The present thinking is that the issues are likely suitable for disposition by summary trial, although that remains to be seen. The parties are cognizant of the need to adjudicate the issues as soon as possible so as not to delay any distribution to the creditors.

88 I am satisfied that the proposed claims process order here treats all potential claim holders fairly and equally and is appropriate in the circumstances. In particular, the proposed timeline is reasonable and will afford claimants ample opportunity to formulate their materials and submit them to the Monitor.

89 This process will also address any claim that may be advanced by Mr. James as a "Restructuring Claim" arising from any disclaimer of the RSA by Walter Energy. In the event of a disclaimer of the RSA, Mr. James will be provided with a proof of claim at the appropriate time in the claims process to give him an opportunity to prove his claim.

90 Aside from Mr. James, there were no other objections to the proposed order. The claims process order is granted.

91 Given the granting of the above orders, the petitioners apply for an extension of the stay of the proceedings to January 17, 2017. This date has been chosen to accommodate not only the closing of the Conuma transaction, but also to coincide with the anticipated time frame by which any disputed claims are to be resolved by the court, if necessary. During that time, the Monitor will continue with the claims process. The Monitor will also file a report within a reasonable time after the claims bar date of October 5, 2016 so that the stakeholders are updated not only on the results of the sale, but also on the results of the claims process (including inter-company claims). The CRO will remain involved over this period of time to assist the Monitor, as need be, and also to arrange for the sale of assets that are not being purchased by Conuma (such as the U.K. assets).

92 The evidence confirms that the petitioners will have sufficient cash flow to continue operations, as currently conducted, to the extension date; although, of course, there will be substantially reduced operating expenditures upon the closing of the sale to Conuma.

93 Despite the long extension period, the petitioners anticipate that there will continue to be oversight by the court in the interim period. At a minimum, the parties anticipate a further hearing in October to consider the procedural issues arising in relation to the 1974 Pension Plan claim. Obviously, if the Conuma sale has not closed by September, I would anticipate that a court application would be scheduled soon thereafter to consider next steps.

94 Both Mr. Aziz and the Monitor, in its Fourth Report, confirm the unchallenged view that the petitioners are acting in good faith and with due diligence. Accordingly, I am satisfied that an extension of the stay to January 17, 2017 is appropriate at this time and that is granted: *CCAA*, s. 11.02(2) and (3).

95 Finally, the petitioners apply for certain miscellaneous orders. The first order is approval of an amendment of the PJT engagement letter which was earlier approved. I am satisfied that the amendment accords with the intention of the parties as to PJT's compensation for their role in the SISP. The amendment reflects what was already determined to be a fair and reasonable compensation for PJT. The second order is to enhance the powers of the Monitor to not only implement the claims process, but to take control of certain of the petitioners' financial affairs. The latter powers are particularly appropriate given the anticipated transfer of the petitioners' employees to Conuma upon closing. The Monitor supports proceeding in this fashion so as to move as quickly and expeditiously as possible toward the monetization of the assets and a distribution to the creditors. Both orders are granted as sought.

Application granted.

End of Document

TAB 11

1963 CarswellAlta 78, [1963] S.C.R. 482, 41 D.L.R. (2d) 316, 45 W.W.R. 26

1963 CarswellAlta 78
Supreme Court of Canada

St. Lawrence Petroleum v. Bailey Selburn Oil & Gas Ltd.

1963 CarswellAlta 78, [1963] S.C.R. 482, 41 D.L.R. (2d) 316, 45 W.W.R. 26

St. Lawrence Petroleum Limited et al (Plaintiffs) Appellants v. Bailey Selburn Oil & Gas Ltd. (Defendant) Respondent and H. W. Bass & Sons Inc. (Respondent) (No. 2) *

Cartwright, Abbott, Martland, Judson and Hall, JJ.

Judgment: October 2, 1963

Counsel: *S. J. Helman, Q.C.*, and *R. R. Neve*, for plaintiffs, appellants.
J. M. Robertson, Q.C., for defendant, respondent, Bailey Selburn Oil & Gas Ltd.

Subject: Natural Resources; Civil Practice and Procedure
Related Abridgment Classifications
Natural resources
III Oil and gas
III.6 Exploration and operating agreements
III.6.f Participation agreement
Headnote
Oil and Gas --- Exploration and operating agreements — Participation agreement
Deeds and Documents — Construction — Extrinsic Evidence — Difficulty of Interpretation Not Synonymous with Ambiguity.
Mines and Minerals — Oil and Gas — "Participation Agreements" Construed.
Appeal from the judgment of the Alberta appellate division, (1963) 41 W.W.R. 210, which dismissed an appeal from the judgment of Milvain, J., (1961-62) 36 W.W.R. 167, dismissed.

The judgment of the court was delivered by *Martland, J.*:

1 By two letter agreements dated May 18, 1951, and accepted respectively on June 28, 1951, and August 20, 1951, Seaboard Oil Co. of Delaware and the British American Oil Co. Ltd., who were the lessees under two crown leases, Nos. 76745 and 76746, in respect of lands located in the Buck Lake area in the province of Alberta and who had applied to have the natural gas rights formerly comprised in reservations Nos. 531 and 532 reserved from other disposition pending the drilling of a well on the land comprised in the leases, granted to A. G. Bailey Co. Ltd. and Great Plains Development Co. of Can. Ltd. the right to earn, by the drilling of a test well in accordance with the provisions of the agreement, as to each, an undivided 25 per cent interest in the leases and in any natural gas licences that could be obtained out of the reservations.

2 The present litigation affects only the 25 per cent interest acquired pursuant to these agreements by A. G. Bailey Co. Ltd.

3 On July 15, 1951, that company entered into two similar agreements, one with St. Lawrence Syndicate and the other with Theodore W. Bennett. The interest of St. Lawrence Syndicate was later acquired by St. Lawrence Petroleum Ltd., one of the appellants in this case. The interest of Theodore W. Bennett was obtained by him on behalf of himself and his brother, James G. Bennett, both of whom are also appellants.

4 The respondent, Bailey Selburn Oil & Gas Ltd., (hereinafter referred to as "the respondent") is the assignee of A. G. Bailey Co. Ltd. The other respondent, H. W. Bass & Sons, Inc., was party to an agreement with the respondent respecting the purchase from the respondent of casinghead gas, and was made a party to the litigation by the appellants only with a view to having that agreement set aside. No other relief was claimed as against it and it was not represented on this appeal.

5 The case involves the interpretation of the two agreements of July 15, 1951. In each agreement A. G. Bailey Co. Ltd. was described as "the company" and the other party as "the participant," and those descriptions will be used sometimes hereafter when referring to the contents of the two agreements.

6 The recitals in each agreement refer to the letter agreements of May 18, 1951, therein and hereafter referred to as "the farm-out agreement" and to the lands to which they relate. They also recite that:

> ... the Participant desires to participate with the Company in the drilling of the test well and in the further development of the said lands, upon the terms and conditions hereinafter set forth; ....

7 Clause 1 of these agreements is the definition clause and in par. (c) defines the phrase "Net proceeds of production" as follows:

> 'Net proceeds of production' as used in this agreement and in any Schedule hereto, shall with respect to any well mean the proceeds from the sale of the Company's share of the production therefrom after deduction therefrom of the amount of all royalties and taxes payable or required to be deducted therefrom by the Company or any other person, and the Company's cost of or (as the case may be) reasonable charges for the operation of the said well, and after deducting from the balance then remaining ten percent of such balance. Provided, however, that until the Participant has received pursuant to paragraphs 5 and/or 9a hereof an amount out of the proceeds of production from such well equal to the total of the Participant's percentage of the drilling costs actually paid by the Participant the 'net proceeds of production' shall be calculated without deducting the 'ten percent of such balance' last above referred to. Where such well is, after being placed on production, operated by some person other than the Company, the Company's costs of the operation of such well shall include not only the Company's proportion of the operating costs, but also a reasonable fee to cover operational supervision and management of the Company's share of the production therefrom or proceeds from the sale thereof.

8 Clause 2 provides as follows:

> The Company shall in accordance with the provisions of the Farm-out Agreement drill the test well and shall subject to the provision of the Farm-out Agreement conduct all operations, including production operations, at the test well in accordance with good oil field practice and in compliance with the laws of the Province of Alberta and regulations and orders enacted and passed thereunder by any competent body, and shall take production from the said lands to the full extent allowed by government regulations and consistent with good oil field practice and market conditions, and all of such operations shall be under the Company's exclusive management, control and direction, except as otherwise provided by the Farm-out Agreement.

9 Clause 3 provides that the participant shall contribute to the drilling costs of the test well, the percentage of such costs set forth in sched. 3 to the agreement. The relevant portions of that schedule provide:

> *In respect of Test Well*:

Participant's percentage of net proceeds of production from test well	20%
Participant's percentage of drilling costs	20%
Amount of first contribution to drilling costs	$15,000.00.

10 Clauses 3, 4 and 4a then go on to provide for the method of payment of the participant's share of the costs and the consequences which arise from the failure to pay the same when required.

11 Clause 5 provides:

> Subject to the provisions hereinbefore contained, in the event of production being obtained in the test well, the Participant shall be entitled to receive the percentage of net proceeds of production from the said well set forth in Schedeule '3' hereto.

12 Clause 6 provides that the company shall be the sole judge of the character, necessity and extent of the expenses for the drilling and operating of the test well.

13 Clause 7 provides:

> On or before the last day of each month the Company shall render to the Participant a statement for the preceding calendar month showing all expenditures for which the Company shall have a right to reimbursement and as to which it shall not then have been reimbursed, and showing also the volume of production of petroleum and natural gas and the income from such products and their derivatives, calculated as herein provided, and the amount if any payable to the Participant for such month, together with a cheque for such amount.

14 Clause 8 gives to the participant the right to examine the company's books of account in reference to operations at the test well at intervals of not less than 30 days.

15 Clause 9 provides for participation by the participant in further wells which might be drilled upon the leased lands to the extent of the percentage provided in sched. 3.

16 Clause 10 gives to the company the right to grant other rights of participation so long as they do not interfere with the rights of the participant under the agreement.

17 Clause 10a provides as follows:

> If the Company shall make any disposition of any of the said lands with respect to the development of which the Participant would at time of disposition thereof have been entitled to participate pursuant to the combined operation of the provisions of paragraphs 3, 4 and 9 of this Agreement (other than a disposition pursuant to numerical paragraph 10 hereof), then the Participant shall be entitled to receive such percentage of ninety per cent of the net proceeds actually received by the Company from such disposition, as is equivalent to the Participant's 'percentage of net proceeds of production' as fixed by Schedule C hereof.

18 Clause 10b will be recited in full later as it is the interpretation of that clause which is the main issue in these proceedings.

19 Clause 11 provides that the agreement should be subject to the terms and provisions of the reservations, leases, statutes and regulations applicable thereto and to the terms and provisions of the farm-out agreement or any more formal farm-out agreement substituted therefor.

20 Clauses 12 and 13 deal with the method of making payments under the agreement by the company to the participant.

21 The subsequent clauses of the agreements are not relevant to the issue in this appeal.

22 I now revert to clause 10b, which provides as follows:

> Subject to the underlying Agreements and subject to the obtaining of any required consent, the Company hereby assigns to the Participant such an undivided interest in the petroleum and natural gas and related hydrocarbons other than coal within upon or under the said lands as will, upon the said lands being operated by the Company and the production therefrom being sold all as in this Agreement provided yield to the Participant the percentage of net proceeds of production as herein defined specified in numerical paragraph 5 hereof. The Company agrees to hold its interest in the said petroleum natural gas and related hydrocarbons in trust for the purposes of this Agreement and the Participant agrees to reassign to the Company from time to time all or such portion of the Participant's said undivided interest as may be necessary to revest such interest in the Company insofar as the same relates to any portion of the said lands in which the Participant ceases by virtue of numerical clause 4 or 9 hereof, to be entitled to a share in the net proceeds of the production therefrom.

23 It is the contention of the appellants that this clause gives to them an assignable interest in the lands defined in the agreements, capable of registration, and with a right to receive and sell their share of production from the lands. They brought this action to obtain a declaration to that effect. The position of the respondent is that under clause 10b the appellants acquired no more than a limited equitable interest, by way of charge, to secure to them the money payments to which, as a matter of contract, they might become entitled under the provisions of the agreements. The respondent contends that the appellants' participation in production from the lands is limited to the receipt of the prescribed portion of the proceeds of sale of production by the respondent.

24 The learned trial judge agreed with the respondent and dismissed the action, (1961-62) 36 W.W.R. 167. At the trial the appellants, contending that the provisions of clause 10b were ambiguous, tendered, subject to objection, extrinsic evidence to support their interpretation of it. The learned trial judge held this evidence to be inadmissible, but went on to hold that even if it had been admissible, his decision would have been the same.

25 The appellants appealed to the appellate division of the supreme court of Alberta. Their appeal was dismissed by a unanimous decision of that court, (1963) 41 W.W.R. 210. It is from that judgment that the present appeal is brought.

26 At the conclusion of the argument by counsel for the appellants, counsel for the respondent was advised that it would not be necessary for him to deal with the issue of the admissibility of the extrinsic evidence. This court agreed with the view of both the courts below that clause 10b, while presenting difficulties of interpretation, was not ambiguous and that the evidence was inadmissible. Counsel for the respondent was also advised that he would not have to argue the question of equitable estoppel which had been raised in the pleadings by the appellants' reply.

27 The sole issue remaining, therefore, is as to the meaning and effect of clause 10b.

28 I have reviewed the contents of the two agreements of July 15, 1951, in some detail because clause 10b must be considered in relation to and as a part of each agreement considered as a whole. The essence of each agreement is that, by participating in the cost of drilling a producing well upon the lands in question to the extent of the stipulated percentage of cost, the participant would become entitled to receive the stipulated percentage of the net proceeds of production of such well. "Net proceeds of production" as defined clearly refers to an amount of money. They are the proceeds from the sale of the company's share of the production from the well after making those deductions which are provided for in clause 1 (c). The company's share of production referred to in this par. (c), is, obviously, the 25 per cent interest in production which it could earn under the terms of the farm-out agreement. The appellants are, therefore, entitled, as a matter of contract, to a percentage of certain moneys to be obtained from the sale of the production from any well in respect of whose drilling costs they have contributed their required portions.

29 The company, under clause 2, is to conduct all operations regarding the well, save as otherwise provided in the farm-out agreement, and it is to take the production from the lands to the full extent permitted by government regulations, good oil field practice and market conditions.

30 Clause 7 provides for the furnishing of monthly statements by the company to the participant showing income from the products and their derivatives, the amount payable to the participant for such month, together with a cheque for such amount.

31 Clause 10a enables the company to dispose of lands in respect of which the participant would have had a right of participation upon payment to the participant of the stipulated percentage of 90 per cent of the net proceeds of such sale.

32 All of these provisions are consistent only with the company being in complete control of its interest in the lands acquired pursuant to the farm-out agreement, with a right in the participant only to share in the money proceeds obtained either from the sale of the products by the company or from the sale by the company of the lands themselves.

33 It is against this background that clause 10b must be interpreted. Under its provisions the company presently assigns *such* an interest in the petroleum, natural gas and related hydrocarbons other than coal within, upon or under the lands in question as *will*, after production is obtained by the company's operations and sold, yield to the participant his percentage of the net proceeds of production from the lands. In my opinion, this clause says that the participant is to have an interest in the petroleum, natural gas and related hydrocarbons equivalent to the percentage of moneys constituting the net proceeds of production which he is entitled to receive under the agreement. The purpose of the clause is apparently to provide that the moneys to which the participant becomes entitled under the agreement represent the proceeds of the sale of products in which he has an equivalent interest.

34 The interest created by this clause, however it may be defined, is only an equitable interest, because the clause goes on to provide that the company shall hold its interest in the petroleum, natural gas and related hydrocarbons in trust for the purposes of the agreement.

35 I would, therefore, construe the clause as doing no more than to make the respondent a trustee of the interest which it acquired under the farm-out agreement for the purposes of these agreements and to make the appellants beneficiaries in respect of equitable interests which should be equivalent to their shares of the money proceeds of the sale of production.

36 I agree with the conclusion stated by the learned trial judge in the following terms:

> I cannot see that the parties contemplated or agreed to the Participant becoming owner of a fractional interest in the said lands capable of assignment and registration. Had it been intended to convey such an interest it would have been a very simple thing to do in plain and unmistakable words. The effect of Clause 10b cannot do more than confer some intangible equitable interest in the lands occupied by a producing well in which the Participant has participated.

37 The appellants have not obtained, by virtue of clause 10b, an undivided interest in land capable of assignment by itself. It is an interest which is tied to an interest in the moneys to be derived from the sale of production; an interest which will yield a certain percentage of a part of the income from each producing well in which the participant has participated. In my opinion, it would be capable of assignment only as a part of an assignment by the appellants of their interest in the agreements themselves.

38 The appellants' interest could not be registered under *The Mines and Minerals Act, 1962*, 1962, ch. 49.

39 Sec. 176 (1) of that Act permits the registration of a transfer with respect to an agreement in these terms:

176. (1) A transfer with respect to an agreement that the lessee is not prohibited from transferring or agreeing to transfer by any provision of this Act or any regulation or by the terms of the agreement, may be registered by the Minister if the transfer conveys

(*a*) the whole of the agreement,

(*b*) a specified undivided interest in the agreement, or

(*c*) a part of the location contained in the agreement.

"Agreement" is defined in sec. 2 (1) (*a*) as follows:

(*a*) 'agreement' means any lease, licence, reservation, permit or other agreement made or entered into under

(i) this Act or the former Act, or

(ii) *The Provincial Lands Act* [RSA, 1942, ch. 62, repealed by *The Public Lands Act*, 1949, ch. 81, now RSA, 1955, ch. 259] or the *Dominion Lands Act* [RSC, 1927, ch. 113, repealed by *Territorial Lands Act*, 1950, ch. 22, now RSC, 1952, ch. 263] and relating to a mineral, but does not include a unit agreement under Part VIII; ....

40 Clause 10b does not provide for a specified undivided interest in the relevant crown leases or reservations, but for an indeterminate interest in the petroleum, natural gas, and related hydrocarbons within, upon or under the lands themselves. The interest described is such an interest as will, in certain events, yield a certain percentage of net proceeds of production from such lands. This, in my view, is certainly not a specified undivided interest in a lease as contemplated by sec. 176 (1) (*b*).

41 Finally, it also follows that the appellants are not entitled under clause 10b to obtain and market a portion of the actual production of a well. The intention of the whole agreement, including clause 10b, is that the operation of each well and the production and marketing of its products is to be under the sole control of the respondent.

42 For these reasons, I would dismiss the appeal with costs.

Footnotes

* For (No. 1) see (1963) 41 W.W.R. 210.

End of Document

TAB 12

Province of Alberta

MINES AND MINERALS ACT

Revised Statutes of Alberta 2000
Chapter M-17

Current as of December 6, 2016

Office Consolidation

Alberta Queen's Printer
Suite 700, Park Plaza
10611 - 98 Avenue
Edmonton, AB T5K 2P7
Phone: 780-427-4952
Fax: 780-452-0668

E-mail: qp@gov.ab.ca
Shop on-line at www.qp.alberta.ca

(ii) bonds or debentures of a corporation, or

(iii) the performance of the obligations of a guarantor under a guarantee given in respect of all or any part of the indebtedness referred to in subclause (i) or all or any part of amounts owing on bonds or debentures referred to in subclause (ii),

but does not include an operator's lien;

(f) "security notice" means a security notice in the form determined by the Minister.

(2) For the purposes of this Division,

(a) the registration of a notice of financial transaction under this Part during the period commencing October 1, 1980 and ending immediately before December 16, 1981, and

(b) the registration of an instrument giving a security under section 82 of the *Bank Act* (Canada), SC 1953-54 and RSC 1970, as that section was in force between April 6, 1955 and October 1, 1980, a copy of such an instrument, or a caution, caveat or memorial in respect of the rights of a bank under that section, if it was registered under this Part before October 1, 1980,

continue under this Division as the registration of a security notice in respect of the same security interest.

(3) On the registration of a notice of assignment pursuant to section 96, a reference in this Division to the secured party under a registered security notice shall, with respect to the security notice to which the assignment relates, be read as a reference to the assignee named in the notice of assignment.

1981 c55 s7;1997 c17 s31

Registration of security notice

95(1) A security notice in respect of a security interest may be submitted to the Minister for registration.

(2) The Minister shall register a security notice submitted to the Minister for registration unless

(a) the regulations are not complied with, or

(b) it shows on its face that it relates to a security interest acquired by a person other than a bank prior to December 16, 1981.

(3) If a security interest was acquired before December 16, 1981 by a person other than a bank, the registration of a security notice is void to the extent that it relates to that security interest.

(4) A security interest in respect of which a security notice is registered has priority

(a) over any other security interest acquired before the registration of that security notice unless a security notice in respect of that other security interest is registered before the registration of the first-mentioned security notice,

(b) over any transfer acquired before the registration of that security notice unless that transfer is registered before the registration of that security notice,

(c) over any builder's lien acquired before the registration of that security notice unless that builder's lien is registered before the registration of that security notice, and

(d) over any interest, right or charge acquired after the registration of that security notice.

(5) Notwithstanding subsection (4), if a security interest is acquired by a person other than a bank and a security notice is registered in respect of that security interest, the priority of that security interest is, in relation to a builder's lien, subject to the *Builders' Lien Act*.

(6) If a security interest was acquired before December 16, 1981 otherwise than pursuant to section 426 of the *Bank Act* (Canada) or section 177 of the *Bank Act* (Canada), RSC 1985 cB-1, as that section was in force prior to June 1, 1992, and after December 1, 1980 or section 82 of the *Bank Act* (Canada), RSC 1970 cB-1, as that section was in force prior to December 1, 1980,

(a) subsection (4) does not apply to that security interest, and

(b) any priority of the secured party in relation to that security interest

(i) is not affected by the secured party's inability to obtain a valid registration of a security notice relating to that security interest, and

(ii) must be determined as if this Division had not been enacted.

(7) A security notice shall provide for an address for service for the secured party named in it for the purposes of this Division.

(8) The secured party under a registered security notice may submit to the Minister for registration a notice of any change of the secured party's address for service under the security notice.

(9) If a security notice is registered against an agreement, the registration

(a) does not restrict or in any manner affect any right or power of the Crown or the Minister under this Act or the regulations or the agreement, and

(b) does not derogate from the proprietary rights of the Crown in the minerals in respect of which rights are granted by the agreement.

(10) If a security notice is registered against an agreement and the Minister, as a consequence of the exercise by the lessee of a right of lease selection conferred on the lessee, issues one or more leases for all or part of the location of the agreement, the registration of the security notice shall be continued in respect of the lease or leases as though the security notice referred to them and as though they had been issued prior to the registration of the security notice.

(11) If a security notice is registered against an agreement and

(a) a transfer of part of the location of the agreement is registered and a new agreement is issued for the part of the location so transferred,

(b) the agreement is divided into 2 or more agreements and one or more new agreements are issued to effect the division, or

(c) the agreement and one or more other agreements are consolidated into one agreement,

the registration of the security notice shall be continued in respect of each of the new agreements or the consolidated agreement, as the case may be, as though the security notice referred to it and as though the issuance of the agreement or the consolidation had occurred prior to the registration of the security notice.

(12) When an agreement is reinstated pursuant to section 8(1)(e), the agreement is subject to all the security notices registered against the agreement when it was surrendered or cancelled, as though the agreement had not been surrendered or cancelled.

(13) When the term of an agreement is extended pursuant to section 8(1)(h) after the expiration of the term, the agreement is subject to all security notices registered against the agreement

immediately before the expiration of the term so extended as though the term had not expired.

1981 c55 s7;1990 c28 s8;1992 c21 s28;1997 c17 s32

Discharges

96(1) There may be submitted to the Minister for registration

(a) a notice of the discharge or partial discharge of the security interest that is the subject of a registered security notice,

(b) a notice of the assignment of all or part of the security interest that is the subject of a registered security notice,

(c) a notice of the postponement of a registered security notice, or

(d) a notice of the discharge or partial discharge of a postponement that is the subject of a registered notice of postponement.

(2) The Minister shall register a notice submitted for registration under subsection (1) unless the regulations are not complied with.

(3) A notice of assignment shall provide for an address for service for the assignee named in it for the purposes of this Division.

1981 c55 s7;1997 c17 s33

Demand for information

97(1) A person may serve a demand under this section if the person is

(a) the lessee or one of the lessees of an agreement against which a security notice is registered,

(b) the person named in a security notice as the person who gave the security instrument,

(c) the secured party under another security notice registered against the same agreement,

(d) a person who has obtained the permission of the Court of Queen's Bench to do so, or

(e) a person who is a member of a class of persons designated by the regulations for the purposes of this clause.

(2) A person within any of the classes enumerated in subsection (1) may serve on the secured party under a registered security notice a written demand requiring the secured party

TAB 13

2018 ABCA 41
Alberta Court of Appeal

Cormack v. Indergaard

2018 CarswellAlta 146, 2018 ABCA 41, [2018] A.W.L.D. 816, [2018] A.W.L.D. 817, [2018] A.W.L.D. 818, [2018] A.W.L.D. 819, 288 A.C.W.S. (3d) 197, 33 E.T.R. (4th) 255

Reverend David Alastair Cormack (Appellant) and Roxana Indergaard (Respondent)

Ronald Berger, Peter Martin, J.D. Bruce McDonald JJ.A.

Heard: December 5, 2017
Judgment: January 31, 2018
Docket: Calgary Appeal 1601-0289-AC

Proceedings: affirming *Cormack v. Indergaard* (2016), 25 E.T.R. (4th) 142, 2016 ABQB 544, 2016 CarswellAlta 1917, G.H. Poelman J. (Alta. Q.B.)

Counsel: G.A. Kirk, for Appellant
G.P. Vanderleek, for Respondent

Subject: Estates and Trusts
Related Abridgment Classifications
Estates and trusts
I Estates
I.13 Passing of accounts
I.13.c Accounting
I.13.c.i Inventory
I.13.c.i.B Account of money disbursed
Estates and trusts
I Estates
I.13 Passing of accounts
I.13.c Accounting
I.13.c.ii Miscellaneous
Estates and trusts
I Estates
I.14 Remuneration of personal representatives
I.14.c Entitlement to compensation
I.14.c.iii Effect of conduct
Headnote
Estates and trusts --- Estates — Passing of accounts — Accounting — Miscellaneous
Testator had three children, including C and D, from first marriage as well as daughter H from second marriage — Apart from certain specific bequests, testator's will left 70 per cent of residue of his estate to H and 10 per cent each to other three children — Estate's main asset was residential property where H lived with testator until his death — H and C remained in home, with H's boyfriend J, initially paying rent and utilities — Two years after they all stopped making such payments, executrix transferred home to H and J for payment to estate of 30 per cent of its appraised value — D's application for formal accounting of executrix's administration of estate was granted — Trial judge found executrix failed to act in timely manner in administering estate as administration was only now nearing completion, more than eight years

after testator's death — Trial judge found estate, essentially made up of home, insurance policies, modest investments and few items of personal property, was relatively simple — Trial judge found that while executrix acted with good faith and proper motives throughout, her handling of some matters was inadequate as, for many years, executrix failed to liquidate assets, list property for sale, make distributions or report to beneficiaries — Trial judge found executrix did not breach duties by disposing of firearm bequeathed to testator's brother, as she could not have reasonably been expected to go to trouble and expense of finding replacement parts for inoperable restricted weapon that she was advised by retired police officer had to be destroyed — Trial judge found executrix's arrangement with H and J, that rent was offset by benefits they provided in occupying, maintaining and repairing house, was within reasonable discretion but estate should have been reimbursed by H and J for utilities charges that it paid — Trial judge found executrix failed to invest estate's cash in interest-bearing account but proper approach, given minor amounts involved, was to credit executrix's foregone compensation against D's claim for interest — D appealed — Appeal dismissed — Trial judge made reasonable determination regarding witness testimony and accounting process — Trial judge properly exercised discretion in not calling accountant as witness — There was no error regarding Surrogate Rules, and trial judge was entitled to exercise discretion on basis of difficult evidentiary record to arrive at reasonable conclusion regarding losses.

Estates and trusts --- Estates — Passing of accounts — Accounting — Inventory — Account of money disbursed

Testator had three children, including C and D, from first marriage as well as daughter H from second marriage — Testator's will left 70 per cent of residue of his estate to H and 10 per cent each to other three children — Estate's main asset was residential property where H had lived with testator until his death — H and C remained in home, with H's boyfriend J, on agreement to pay rent and utilities — Two years after they had all stopped making such payments, executrix transferred home to H and J for payment to estate of 30 per cent of its appraised value — D's for formal accounting of executrix's administration of estate was granted — Amount that C owed for her occupancy after ceasing to pay rent was deducted from her distribution — Trial judge found it was not unreasonable exercise of executrix's discretion to give credit to H and J for lawn, maintenance, and snow removal at rate of one half of what was charged by contractor who used to do such work — Trial judge found while it was regrettable that documentation of repairs and maintenance carried out by H and J was incomplete, executrix reasonably determined that she was receiving services of sufficient value to offset rental obligations — Trial judge found occupation was best means to end of keeping property secure while executrix was working toward sale of property to H and J and beneficiaries shared view that testator's children should have ability to occupy property — Trial judge found rental arrangement that executrix used her discretion to implement was to credit H and J value of their services in exchange for rent but to require them to pay all utilities — Trial judge found accounting showed that utility charges continued to be incurred by estate and there was no indication that they were reimbursed by H and J — Trial judge found if executrix did not demonstrate that estate had already been reimbursed, then she must reimburse estate for utilities in amount of $6,608 — Trial judge found executrix would be responsible for reimbursing amount of newspaper subscription that she failed to cancel and any interest or penalties charged by CRA for late filing of returns — D appealed — Appeal dismissed — Trial judge made reasonable determination regarding witness testimony and accounting process — Trial judge properly exercised discretion in not calling accountant as witness — There was no error regarding Surrogate Rules, and trial judge was entitled to exercise discretion on basis of difficult evidentiary record to arrive at reasonable conclusion regarding losses.

Estates and trusts --- Estates — Remuneration of personal representatives — Entitlement to compensation — Effect of conduct

Testator had three children, including C and D, from first marriage as well as daughter H from second marriage — Testator's will left 70 per cent of residue of his estate to H and 10 per cent each to other three children — Estate's main asset was residential property where H had lived with testator until his death — H and C remained in home, with H's boyfriend J, on agreement to pay rent and utilities — Two years after they had all stopped making such payments, executrix transferred home to H and J for payment to estate of 30 per cent of its appraised value — D applied for formal accounting of executrix's administration of estate — Application granted — Trial judge found administration of this relatively simple estate took far too long but executrix spent considerable time on her duties — Trial judge found executrix probably spent about 250 hours on her work which, at $20 per hour set by testator in will, would lead to fees in range of $5,000 — Trial judge found executrix's foregoing of compensation was adequate recompense for loss of interest arising from failure to invest estate's cash in interest-bearing account — D appealed — Appeal dismissed — Trial judge

made reasonable determination regarding witness testimony and accounting process — Trial judge properly exercised discretion in not calling accountant as witness — There was no error regarding Surrogate Rules, and trial judge was entitled to exercise discretion on basis of difficult evidentiary record to arrive at reasonable conclusion regarding losses — Decision of executor to forego executor compensation properly played role in not awarding lost interest.

Table of Authorities

Cases considered:

Tatum v. Tatum (2011), 2011 ABQB 253, 2011 CarswellAlta 677, 68 E.T.R. (3d) 65 (Alta. Q.B.) — referred to

Statutes considered:

Trustee Act, R.S.A. 2000, c. T-8

Generally — referred to

Rules considered:

Surrogate Rules, Alta. Reg. 130/95

R. 2 — considered

R. 113 — considered

R. 117(2) — considered

Tariffs considered:

Alberta Rules of Court, Alta. Reg. 124/2010

Sched. C, Tariff of Costs, column 2 — referred to

APPEAL by beneficiary from judgment reported at *Cormack v. Indergaard* (2016), 2016 ABQB 544, 2016 CarswellAlta 1917, 25 E.T.R. (4th) 142 (Alta. Q.B.), granting beneficiary's application for accounting of estate.

***Per curiam*:**

1 The respondent is the executrix of the Estate of the late Stanley George Cormack who passed away on August 11, 2008. The appellant is the son of the testator. He and two of his co-beneficiaries were each to receive 10% of the Estate. Another, Heather Cormack was to receive 70%. The main asset of the Estate was a home which, together with other assets, left a net value of $260,189.00.

2 The respondent entered into a "Rental Agreement" whereby the home was to be rented to Heather Cormack, her boyfriend John Ross, and Christina Cormack, under an arrangement for the payment of rent by each of them in the amount of $300 per month and one third each of the monthly utilities. In August 2010, Christina Cormack ceased paying any rent but remained in the home.

3 Two difficulties ensued. The first, in November 2012, the respondent transferred the home to Heather Cormack and her boyfriend as a distribution in kind without consulting the appellant. The other beneficiaries were also kept in the dark. Heather Cormack and her boyfriend paid 30% of the value to the Estate to reflect her 70% share of the residue of the Estate. The second problem was delay in the administration of the Estate. An interim distribution was not made until September 2014; a formal accounting, not until July 18, 2013.

4 The appellant was not satisfied with the respondent's accounting and filed an application for a formal passing of the accounts. The December, 2013 Order provided the appellant with further documents including income tax returns and an Estate accounting report updated to December 2013.

5 A court appointed accountant identified a number of shortfalls in rent, in utilities, a failure to collect interest income on cash balances, a failure to deposit dividends and invest them, and an alleged diminution in the administration of certain investments as a consequence of a failure to liquidate them in a timely fashion.

6 The appellant also brought an application for advice and direction because of the delay and the respondent's alleged failings in dealing with several assets.

7 There can be no question that the respondent dragged her feet, failed to provide court ordered responses to undertakings and delayed matters until a consent order provided directions on December 8, 2015. Even then, it was difficult to get the matter beyond the courtroom door.

8 The appellant asserts that the trial judge erred in quantifying the loss caused by the respondent's administration of the Estate, erred in accepting her oral testimony, erred in failing to call the accountant as a witness, failed to recognize concerns in the accountant's report, and erred in failing to award costs payable by the respondent personally on a solicitor-client-basis instead, he awarded costs payable by the Estate.

9 The appellant also asserts that the testimony of the respondent was unworthy of belief. In fact, the trial judge spoke of the "difficulties" with the credibility of some of the testimony given by both the appellant, his witness, and the respondent. The judge was of the view that both the beneficiary Christina Cormack and David Cormack "bore strong animosity" to the respondent which coloured their testimony.

10 Not mentioned by the appellant is the finding by the judge of the close relationship that the deceased enjoyed with the respondent over her entire life. It was to use the words of the trial judge "a close and enduring relationship between the two of them."

11 Notwithstanding certain misgivings, the judge accepted the "forthright and dispassionate testimony" of the respondent as personal representative of the Estate. He found her testimony "on the whole . . . to be honest and reliable." Importantly, he accepted that she assumed her role from purely disinterested motives. Put another way, the judge was obviously of the view that the respondent had conducted herself in good faith and had neither an "axe to grind" nor "any skin in the game."

12 In addition to the foregoing, the trial judge found that Heather Cormack and her boyfriend ceased paying rent in August, 2010, but that in the period of time preceding the transfer of the home, they effected repairs for which they assumed the cost and, in addition, attended out of their own pockets for maintenance, taxes and utilities.

13 Regarding losses to the Estate, the appellant relied on the report from the accountant. The trial judge, however, observed that the author did not testify and that the report was based upon incomplete information. He was of the view that the failure to receive rental payments from August, 2010 to November, 2012 was "more than offset by benefits"(set out above) that Heather Cormack and her boyfriend provided. He found no evidence, however, that the utilities paid by the Estate were being reimbursed and therefore found a loss of $6,608.00 to the Estate which in default of an acceptable accounting, the respondent would have to pay the Estate.

14 He found the Estate lost interest because cash was not kept in an interest bearing account. The deceased kept it in the police credit union, which does not pay interest on Estate accounts, and the respondent left the money there. The potential loss was $3,300 assuming 1.8 percent interest. However, the trial judge found that was an overestimation because some cash was needed to be kept readily available and the interest to each beneficiary with a 10% interest would be too minor for second guessing detailed calculations. Instead, he credited the respondent's foregone compensation against those claims.

15 He also required the respondent to pay interest or penalties for late filing of tax returns, and the cost for failing to cancel a newspaper subscription. He found no losses had been incurred in the sale of the house as it was never listed and hence there were no real estate fees to be paid; there was no evidence a higher price would have been received if the house sold earlier.

16 In an oral decision on costs, the trial judge noted the starting point in Estate cases is that they are in the discretion of the judge. Usually an executor is entitled to legal costs incurred on behalf of the Estate. He noted the strict test for solicitor-client costs, which requires misconduct, *mala fides* or unreasonable conduct.

17 He appreciated that the appellant had some modest success in his application.

18 He found no basis for solicitor-client costs. While there was unjustified delay, the negligent administration was minimal. He also noted the size of the Estate and that most of the expense would be borne by the 70% beneficiary who was not involved in the litigation. He found no misconduct. His main concerns were the deleterious effect of holding negligent executors to account to a partially successful party, and the encouragement of litigation that made no economic sense.

19 He set costs to the appellant on a party and party basis on Schedule C, column 2, but awarded no costs for the hearing or any applications where costs had already been ruled on.

20 The trial judge held that costs of the proceedings should be paid out of the Estate because the respondent had already borne significant costs with administering the Estate, has foregone compensation, and acted in good faith with proper motives throughout.

21 He also approved payment to the respondent of $3,500 for legal expenses as personal representative.

22 Three grounds of appeal are advanced:

a) by accepting the respondent's oral evidence, which contradicted her formal accounting and in quantifying the loss caused by the respondent's administration of the Estate;

b) failing to raise concerns with the accountant's report during the oral hearing and failing to call the accountant as a witness pursuant to *Surrogate Rule* 117(2); and

c) awarding costs payable by the Estate and failing to award costs payable by the respondent personally on a solicitor client basis.

ANALYSIS

23 The trial judge was alive to the shortcomings of the testimony of the witnesses that came before the Court. He appreciated full well the deficiencies of the respondent's formal accounting and took great pains to carefully consider the Court-ordered Accountant's Report. As we see, it he properly addressed all factors pertinent to the quantification of the alleged loss caused by the respondent's administration of the Estate and made a reasonable determination well within his discretion.

24 As to the complaint regarding *Surrogate Rule* 117(2), we are unable to conclude that the trial judge erred. The concerns he mentioned about various aspects of the Report during the oral hearing pointedly put the parties on notice of his concerns and afforded to them an opportunity to address whether or not the Accountant would and/or should be called. The accounting records were carefully evaluated as was the respondent's testimony. Indeed, the question of reimbursement of the Estate for missing utility payments not collected from the tenants was clearly a live issue before the Court and, as we see it, was addressed in a manner to ensure that the Estate "was receiving services of sufficient value to offset rental obligations for the period after the three tenants discontinued paying cash rent" (AR F11). In our view, it was not an error in the circumstances of this case to take account of both the accounting records and the testimony of the respondent to so conclude (*Tatum v. Tatum*, 2011 ABQB 253 (Alta. Q.B.) at para. 11).

25 *Rules* 2 and 113 of the *Surrogate Rules*, Alta Reg 130/1995 makes clear that the trial judge was entitled to exercise a sound discretion on the basis of a difficult evidentiary record to arrive at a reasonable conclusion regarding losses. We see no evidence on this record of overriding palpable error that would warrant appellate intervention. Moreover, even if we had been persuaded that there was a compensable rental loss, we agree with the respondent that the trial judge had the discretion to alleviate such a claim against the respondent wholly or partially pursuant to s. 41 of the *Trustee Act*, RSA 2000 cT-8.

26 The executor here did her best. Although this was not a complicated matter, the respondent administered the estate in an adversarial context while experiencing significant personal challenges. She was not intentionally negligent.

27 As to the claim for lost interest of $3,300.00 sought by the appellant, the trial judge had in mind the respondent's decision to forego executor compensation which, mindful of the compensation set in the Will, was calculated to be approximately $5,000.00. In the view of the trial judge that was adequate compensation for any interest lost by the Estate. We see no error in that regard.

28 As to the alleged failure of the trial judge to call the Accountant as a witness pursuant to *Surrogate Rule* 117(2) we note that the *rule* is permissive. It reads, in part:

> The court may require the accountant to appear at any hearing and give any further explanations the court needs in order to pass the accounts.
>
> We see no error in the trial judge's exercise of discretion, given the complexities of the case and counsel's advice to the Court that the author would not be called. Indeed, all counsel agreed that they would simply "examine the numbers and see if intuitively or practically there [were] some adjustments [to] be made." (Transcript pgs. 10/l - 1 1/l). This ground of appeal fails.

29 We turn to the issue regarding the costs award in the Court below. On the whole of the record, an award of solicitor-client costs will not generally be made absent evidence of misconduct, *mala fides* or unreasonable conduct. Solicitor-client costs may be ordered in circumstances where the misconduct of a party occurs during an action that is adjudged to be, *inter alia*, reprehensible, scandalous or outrageous.

30 In our opinion, the finding of fact by the trial judge that the respondent acted with good faith and proper motives throughout is unassailable and, we would add, has substantial support in the evidentiary record of the trial.

31 It follows that this ground of appeal must also be dismissed.

32 None of the remaining complaints impugning the disposition below (including the ruling regarding the vintage firearm) warrant appellate intervention. The appeal is dismissed. No order of costs of the appeal is warranted in this case.

Appeal dismissed.

TAB 14

2008 BCSC 38
British Columbia Supreme Court [In Chambers]

Cox v. Crystal Graphite Corp.

2008 CarswellBC 29, 2008 BCSC 38, [2008] B.C.W.L.D. 1788, 163 A.C.W.S. (3d) 530, 38 C.B.R. (5th) 254

Alexander W. Cox, also known as Alexander William Cox (Plaintiff) and Crystal Graphite Corporation, Canada Pumice Corporation, James T. Deith and Lisa J. Stephens-Deith (Defendants)

Parrett J.

Heard: December 7, 14, 2007
Judgment: January 10, 2008
Docket: Vancouver S060335

Counsel: J.F. Grieve for Receiver
R.D. Holmes, J.W. Bilawich for Defendants, Deith, Stephens-Deith

Subject: Corporate and Commercial; Civil Practice and Procedure; Insolvency

Related Abridgment Classifications

Civil practice and procedure
XXIV Costs
XXIV.8 Scale and quantum of costs
XXIV.8.d Quantum of costs
XXIV.8.d.iii Special costs
Debtors and creditors
VII Receivers
VII.7 Actions involving receiver
VII.7.e Practice and procedure
VII.7.e.iii Costs

Headnote

Debtors and creditors --- Receivers — Actions by and against receiver — Practice and procedure — Costs

Receiver was appointed as administrator of debtor assets — Receiver pursued several claims against defendants on behalf of debtor — Defendants alleged that such claims were frivolous attempts to deny defendants rightful benefits under agreements with debtor — Receiver's claims were uniformly unsuccessful — Defendants brought application for order awarding special costs against receiver — Application dismissed — Award of special costs was discretionary and generally made only where there had been reprehensible conduct either in circumstances giving rise to litigation or during course of proceeding — Receiver's conduct was not scandalous, outrageous or deserving of rebuke — Receiver's claim had arguable basis — Receiver's duty as court appointed officer required honest action and pursuit of litigation if necessary — Receiver was not obligated to avoid legitimate commercial disputes — Fiduciary obligations often required that receiver take positions and seek court determinations in difficult circumstances where outcomes could affect multiplicity of interest.

Table of Authorities

Cases considered by *Parrett J.*:

Garcia v. Crestbrook Forest Industries Ltd. (1994), 119 D.L.R. (4th) 740, 9 B.C.L.R. (3d) 242, 14 C.C.E.L. (2d) 84, 41 C.P.C. (3d) 298, (sub nom. *Garcia v. Crestbrook Forest Industries Ltd. (No. 2)*) 45 B.C.A.C. 222, (sub nom. *Garcia v. Crestbrook Forest Industries Ltd. (No. 2)*) 72 W.A.C. 222, 1994 CarswellBC 1184 (B.C. C.A.) — considered

Leung v. Leung (1993), 77 B.C.L.R. (2d) 314, 15 C.P.C. (3d) 42, 1993 CarswellBC 71 (B.C. S.C.) — considered
Royal Bank v. Harrison Airways Ltd. (1979), 30 C.B.R. (N.S.) 310, 1979 CarswellBC 564 (B.C. S.C.) — referred to
Royal Bank v. Vista Homes Ltd. (1984), 54 C.B.R. (N.S.) 124, 1984 CarswellBC 590, 58 B.C.L.R. 354 (B.C. S.C.) — referred to
Sylvan Lake Golf & Tennis Club Ltd. v. Performance Industries Ltd. (2002), 98 Alta. L.R. (3d) 1, 283 N.R. 233, [2002] 5 W.W.R. 193, *(*sub nom. *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd.)* [2002] 1 S.C.R. 678, 2002 SCC 19, 2002 CarswellAlta 186, 2002 CarswellAlta 187, 50 R.P.R. (3d) 212, 299 A.R. 201, 266 W.A.C. 201, 20 B.L.R. (3d) 1, 209 D.L.R. (4th) 318 (S.C.C.) — considered

Rules considered:

Rules of Court, 1990, B.C. Reg. 221/90
App. B, s. 2(2)(b) — referred to

APPLICATION by defendants for order awarding special costs against receiver.

***Parrett J.*:**

Introduction

1 The present application seeks an order awarding special costs against the Receiver. A second application seeking an order and declaration with respect to a second GIC was resolved and did not proceed.

2 At the close of the applicant's submissions on this application, counsel for the Receiver was afforded additional time to respond to those submissions.

Submissions

3 Counsel for the Deiths seeks an award of special costs of his applications of December 5, 2006 and March 26, 2007 and the Receiver's motion of January 8, 2007, on the basis that the Receiver's conduct falls within the category of "reprehensible conduct" as defined in *Garcia v. Crestbrook Forest Industries Ltd.* (1994), 9 B.C.L.R. (3d) 242 (B.C. C.A.).

4 The Deiths' submission is founded on the proposition that the Receiver is an officer of the court and as such is expected to meet a substantially higher standard than that of an ordinary litigant.

5 They submit that the Receiver failed to meet that standard by —

(a) repeated frivolous attempts to deprive Mr. Deith of the fruits of the Deith agreement;

(b) undermining the integrity of the court sale process;

(c) bringing a frivolous application for rectification of the Deith agreement;

(e) bringing a frivolous application for rescission of the Deith agreement;

(f) failing to make full and candid disclosure to the court and Mr. Deith.

6 In essence the applicant submits that the Receiver's actions, taken at a time when Mr. Cox and his company were advancing separate claims against them, has the appearance of either trying to appease Mr. Cox or to protect its own interests.

7 The Receiver opposes the relief sought on the basis that throughout they acted in accordance with its professional duties and its rights as a party to litigation. The Receiver submits that the Deiths criticism of its actions is founded more on speculation than fact and lacks any evidentiary foundation.

Discussion

8 The award of costs is discretionary and an award of special costs is generally made only where there has been "reprehensible" conduct either in the circumstances giving rise to the litigation or during the course of the proceeding. These elevated levels of costs are awarded in circumstances generally where the court concludes such an award is necessary as a form of chastisement.

9 In *Garcia v. Crestbrook Forest Industries Ltd.*, *supra*, our Court of Appeal adopted the reasoning of Esson, C.J.S.C. (as he then was) in *Leung v. Leung* (1993), 77 B.C.L.R. (2d) 314 (B.C. S.C.) at p. 305, where he writes that:

> The concept of special costs was introduced to our rules in the 1990 amendments. It has been held that entitlement to special costs is to be determined on the same principles formerly applied to awarding solicitor-client costs. The test for awarding such costs was stated thus by Lambert J.A. in ***Stiles v. British Columbia (Workers' Compensation Board)*** (1989), 38 B.C.L.R. (2d) 307 (C.A.), at p. 311:
>
> > . . . solicitor-and-client costs should not be awarded unless there is some form of reprehensible conduct, either in the circumstances giving rise to the cause of action, or in the proceedings, which makes such costs desirable as a form of chastisement. The words "scandalous" and "outrageous" have also been used.
>
> There is nothing in the conduct of Mr. Leung in relation to this matter which I would call "scandalous" or "outrageous". But "reprehensible" is a word of wide meaning. It can include conduct which is scandalous, outrageous or constitutes misbehaviour; but it also includes milder forms of misconduct. It means simply "deserving of reproof or rebuke".
>
> [Emphasis added]

10 In *Garcia*, Lambert J.A., after reviewing the authorities, concluded at para. 17 that:

> Having regard to the terminology adopted by Madam Justice McLachlin in ***Young v. Young***, to the terminology adopted by Mr. Justice Cumming in ***Fullerton v. Matsqui (District)***, and to the application of the standard of "reprehensible conduct" by Chief Justice Esson in ***Leung v. Leung*** in awarding special costs in circumstances where he had explicitly found that the conduct in question was neither scandalous nor outrageous, but could simply be said to be "deserving of reproof or rebuke", it is my opinion that the single standard for awarding of special costs is that the conduct in question properly be categorized as "reprehensible". As Chief Justice Esson said in ***Leung v. Leung***, the word reprehensible is a word of wide meaning. It encompasses scandalous or outrageous conduct but it also encompasses milder forms of misconduct deserving of reproof or rebuke. Accordingly, the standard represented by the word reprehensible, taken in that sense, must represent a general and all-encompassing expression of the applicable standard for the award of special costs.
>
> [Emphasis added]

11 Mr. Holmes, in his submissions, asserts that the Receiver, as an officer of the court, ". . . is expected to meet a substantially higher standard than would an ordinary litigant".

12 I am uncomfortable with this submission. While there is an element of truth to this assertion, as is evident from the decisions in *Royal Bank v. Vista Homes Ltd.*, [1984] B.C.J. No. 2713 (B.C. S.C.), and *Royal Bank v. Harrison Airways Ltd.*, [1979] B.C.J. No. 1141 (B.C. S.C.), the submission largely ignores the Receiver's obligation to act both in a fiduciary capacity and with the utmost fairness to all.

13 This obligation may require the Receiver to take positions and seek court determinations in difficult circumstances where the outcomes may affect a multiplicity of interest.

The Relevant Conduct in the Present Case

14 With respect, the applicants seem, in their submissions, to confuse the outcome of the applications in their favour with a conclusion that the Receiver's position lacked "even an arguable basis". Much may seem clearer after the final outcome is known and in this case that seems to be particularly so.

15 The documents and the discussions, particularly those that passed between the Receiver and Cox, may have been unclear but they were documents from which an arguable but, in my view at least, incorrect position could be advanced. This position was factually complicated further for the Receiver by the litigation commenced against him and inaccurate information apparently being provided by the Ministry of Energy and Mines.

16 The Receiver did not advance a claim of fraud against the applicant; but rather an allegation of equitable fraud (or unconscionability) within the context of the claim for rectification.

17 The distinction was expressly recognized by the Supreme Court of Canada in *Sylvan Lake Golf & Tennis Club Ltd. v. Performance Industries Ltd.*, 2002 SCC 19 (S.C.C.) at para. 39.

18 In my view, the circumstances here do not meet the test for an award of special costs and do not support a conclusion that the Receiver's conduct was "scandalous", "outrageous" or "deserving of rebuke".

19 The present assertions by the applicant are, in my view, an unfortunate result of advocacy enthusiasm perhaps seasoned with a liberal dose of litigation success. Perhaps, if counsel had brought to bear the same clear-sighted reason they urge on the part of the Receiver the present dispute would have been avoided as well.

20 At its simplest, there was, in the end, a dispute between Mr. Deith and the Receiver over whether or not the reclamation bond was included within the purchase. The Receiver's decisions are consistent with that dispute. The Receiver's duty as a court appointed receiver requires him to act honestly and bona fide. It does not require him to avoid legitimate commercial disputes; indeed, he is expected to analyze such situations and litigate when necessary.

21 The applicant's claim for special costs has not been made out. The applicant will recover his costs with respect to the three applications set out above on Scale B.

Application dismissed.

End of Document