Court clarifies law regarding royalties as interests in land and common law priority rules

January 12, 2023

In *PrairieSky Royalty Ltd v Yangarra Resources Ltd*, 2023 ABKB 11, the Alberta Court of King's Bench (ABKB) clarified the law governing royalties as interests in land in a contentious priority dispute between the holder of a gross overriding royalty in a Crown Lease and the current working interest holder of the Crown Lease who alleged that it had acquired its interest free and clear of the Plaintiff's royalty.

What you need to know

- The ABKB affirmed that royalties carved out of oil and gas leases can constitute interests in land if they meet the two-part test adopted by the Supreme Court of Canada (SCC) in *Dynex,*[1] which requires that:
  - 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
  - the interest, out of which the royalty is carved, is itself an interest in land (the *Dynex* Test);
- In assessing the parties' intentions, where a royalty agreement expressly states that the royalty in question constitutes an interest in land, such language creates a strong, but rebuttable presumption that the royalty is indeed an interest in land;
- To rebut the presumption of an interest in land arising from the plain wording of a royalty agreement in circumstances where the royalty lasts for the duration of the underlying estate, the remaining indicia and surrounding circumstances must "significantly contradict" those factors;
- If a priority dispute arises between the holder of an overriding royalty and the working interest owner of a Crown Lease in unpatented Crown lands, priority will be determined by common law and equitable rules of priority – the rules of priority under the *Land Titles Act*[2](LTA) do not apply; and
- Royalties that constitute interests in land and comply with all formal common law requirements for a valid conveyance of land will have priority over, and will be binding upon, any person who subsequently acquires an interest in the underlying estate, even if that person had no notice of the royalty at the time of acquisition – the principles of *bona fide* purchaser for value without notice do not apply.

Background

1. Facts

In April 2011, Range Royalty Limited Partnership (Range) and Home Quarter Resources Ltd (Home Quarter) entered into a Royalty Agreement (the Royalty Agreement), pursuant to which Home Quarter granted Range an eight per cent overriding royalty (the 8% Royalty) reserved out of Home Quarter's working interest in a Crown lease (the Crown Lease). The Crown Lease granted Home Quarter, as the lessee, the exclusive right to explore for, work, win, and recover petroleum and natural gas within and under certain lands in Alberta (the Lands). Notably, the Lands are unpatented Crown lands and no certificate of title was ever issued pursuant to the LTA.

Home Quarter sold its 100 per cent working interest in the Crown Lease to Relentless Resources Ltd (Relentless), and the Plaintiff, PrairieSky Royalty Ltd (PrairieSky) became the successor to Range in the Royalty Agreement and the holder of the 8% Royalty.

In 2016, Relentless sold its 100 per cent working interest in the Crown Lease to the Defendant, Yangarra Resources Ltd (Yangarra). In the course of that transaction, the Royalty Agreement was never formally contractually assigned by Relentless to Yangarra.

Yangarra subsequently drilled a horizontal well in the Lands (the Horizontal Well), and PrairieSky discovered that Yangarra was not paying PrairieSky its 8% Royalty. When PrairieSky demanded that Yangarra pay the 8% Royalty, Yangarra took the position that:

- the 8% Royalty did not constitute an interest in the Lands, and since the Royalty Agreement was never contractually assigned to Yangarra, Yangarra was not bound by it; or
- Yangarra was not bound by the 8% Royalty because it had acquired its interest in the Lands as a *bona fide* purchaser for value without notice of the 8% Royalty.

PrairieSky commenced an Action seeking, among other things:

- a declaration that the 8% Royalty constituted an interest in the Lands, which is binding on Yangarra, and all subsequent working interest owners of the Lands; and
- judgment for the outstanding royalties due and owing under the Royalty Agreement in relation to production from the Horizontal Well.

2. Issues

To determine whether Yangarra was bound by the 8% Royalty, the Court was required to determine the following issues:

1. Does the 8% Royalty arising from the Royalty Agreement constitute an interest in land?

2. If the 8% Royalty does constitute an interest in land, does it have priority over Yangarra's interest in the Crown Lease?
3. What remedy is appropriate?

Decision

The Court ultimately issued a declaration that PrairieSky's 8% Royalty constitutes an interest in the Lands, which attaches to the Lands, and is binding on Yangarra and all subsequent working interest owners of the Lands, and issued judgment against Yangarra for the outstanding royalties.

The 8% Royalty constituted an interest in land

In determining whether the 8% Royalty constituted an interest in land, the Court applied the *Dynex* Test. The second part of the *Dynex* Test was easily met in this case, as the 8% Royalty was carved from the working interest in the Crown Lease, which the common law unquestionably recognizes as an interest in land. Thus, the Court focused its analysis on the first branch of the *Dynex* Test and examined the parties' intentions from the agreement as a whole and the surrounding circumstances.

The Court identified two "core indicia" which, together, may be sufficient to satisfy the *Dynex* Test: (i) the presence of a clause that expressly states that the royalty in question constitutes an interest in land (an Interest in Land Clause); and (ii) whether the royalty in question is capable of lasting for the duration of the underlying estate. The Court must still analyze the whole of the contract and the surrounding circumstances to determine whether the parties intended the royalty to constitute an interest in land, but if these two core indicia are present, the remaining indicia and surrounding circumstances must "significantly contradict" these factors in order to find that the royalty is not an interest in land.

In this case, the Royalty Agreement contained an Interest in Land Clause, and witnesses from each of the original counterparties to the Royalty Agreement confirmed that the purpose of that clause was to ensure that the 8% Royalty would constitute an interest in land. The Royalty Agreement was also clear that the 8% Royalty would last for the duration of the underlying Crown Lease.

Notwithstanding that these two core indicia were present, the Court considered the remaining terms of the agreement, but ultimately found that these terms either aligned with the parties' intention to create an interest in land, or were neutral. Accordingly, the remaining indicia did not significantly contradict the two core indicia that were present, and the Court found that the 8% Royalty constitutes an interest in Land that runs with the Lands subject to the Crown Lease.

The common law rules of priority

Although the Court found that the 8% Royalty constitutes an interest in the Lands that runs with the Lands and binds all working interests of the Crown Lease, the Court considered Yangarra's alternative defence that it was not bound by the 8% Royalty because it was a *bona fide* purchaser for value without notice of the 8% Royalty.

Given that the Lands are unpatented Crown Lands for which no certificate of title has ever been issued, the rules of priority under the LTA did not apply. Instead, the Court was required to apply common law and equitable rules of priority that were largely developed before the Torrens system of land registration was introduced, and which depend on whether the competing interests are legal or equitable. Thus, the Court first needed to characterize PrairieSky's and Yangarra's interests as either legal or equitable.

The Court outlined two main distinctions between legal and equitable interests: (i) legal interests are rights "*in rem*" whereas equitable interests are "*in personam*"; and (ii) legal interests must be created or transferred in the manner prescribed either by the common law or by statute, whereas equitable interests may be created or transferred informally, without perfecting the interest pursuant to the requirements of common law or statute.

In applying these distinctions, the Court held that PrairieSky's 8% Royalty interest was a legal interest, given that as per the *Dynex* Test, it was an *in rem* interest in land and met all of the formal common law requirements for a valid conveyance of same: there was an offer, acceptance, consideration, and a written agreement signed by the parties. The Court held that Yangarra's interest was also a legal interest, given that a working interest in a Crown lease is a proprietary *in rem* right in land.

The Court applied the common law priority rule that governs when there are two competing legal interests in the same property. In those circumstances, priority is determined based on chronology and the maxim "*nemo dat quad non habet*", or, a seller cannot confer a greater title than that which they hold, applies. In this case, at the time Relentless sold its interest in the Crown Lease to Yangarra, the Crown Lease was already encumbered by the 8% Royalty, and therefore Yangarra could only acquire its interest subject to PrairieSky's 8% Royalty. The defence of *bona fide* purchaser for value without notice was not available to Yangarra, as that defence only applies where there is a dispute between a prior equitable interest and a subsequent legal interest.

The appropriate remedy

The Court granted the relief sought by PrairieSky, which included:

- a declaration that the 8% Royalty constitutes an interest in the Lands, which attaches to the Lands, and is binding on Yangarra and all subsequent working interest owners of the Lands; and
- a monetary judgment for the outstanding royalties due and owing under the Royalty Agreement in relation to production from the Horizontal Well.

Takeaways

Royalties play a significant role in the oil as gas industry in Alberta, and as such, it is common for a Crown lease to be encumbered by one or more overriding royalties. This decision serves as critical reminder for companies to conduct fulsome due diligence when acquiring an interest in a Crown lease. Given that there is no public registry where Crown lease royalty-holders can register public notice of their interest, it is incumbent upon a purchaser to fully investigate the vendor's files and all other publically available information to identify any royalties encumbering the Crown lease. If the purchaser fails to do so, this case makes clear that, in most cases, they will not be able to rely on the defence of *bona fide* purchaser for value without notice, and will be liable to pay the royalty, even if they purportedly had no notice of it at the time of acquisition.

This decision also demonstrates that oil and gas companies must take care when drafting royalty agreements to ensure that the terms carry out their intention to create an interest in land. At a minimum, drafters should include an Interest in Land Clause, and ensure that the royalty is capable of lasting for the duration of the underlying estate. The Court's reasons also provide a useful guide on other clauses drafters should pay close attention to, and which clauses tend to favour, or detract from, a finding that the royalty constitutes an interest in land.

[1] *Bank of Montreal v Dynex Petroleum Ltd*, 2002 SCC 7 (*Dynex*).

[2] *Land Titles Act,* RSA 2000, c L-4.

By

Laura Poppel, Emma Morgan, Aidan Paul

Expertise

Disputes, Energy - Oil & Gas
