Canadian oil and gas: Non-operators' remedies

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Claims by non-operators can be expected to arise more frequently when operators are in financial distress. This article outlines the rights and remedies of non-operators in the event of a dispute over funds held or payable by the operator, or well shut-ins.

What you need to know

There are at least three instances in which a non-operator may have a claim for compensation as a result of joint operation conducted under the 2015 CAPL Operating Procedure[1] (the 2015 CAPL):

1. Where an operator has marketed a non-operator's share of production pursuant to Clause 6.02[2] and has not remitted the entire proceeds to the non-operator.
2. Where a non-operator has advanced its share of costs to pay for joint operations pursuant to an authorization for expenditure (AFE) issued under Clause 5.02[3], yet the operator has not spent the money on the capital or incurred the costs. The non-operator will have a claim for the return of these funds.
3. Where an operator has shut-in a well resulting the termination of the lease.

In addition to claims for compensation, non-operators concerned with the actions or financial viability of the operator should be aware of the provisions of the 2015 CAPL that call for the replacement of the operator.

Should the operator become the subject of bankruptcy, CCAA or receivership proceedings, there will be a stay of proceedings against the operator and its properties. In these circumstances, the non-operators' options will include applying to lift the stay, claiming against the operator's estate, claiming against funds held in trust, or focusing on claims against third parties such as the operator's directors or the recipients of production revenue from the operator.[4]

Remedies for non-operators

Claims against the operator

A non-operator securing a judgment for debt against an operator will be subordinate to secured creditors and will have to share in any ultimate distribution *pro rata* with other

unsecured creditors. Fortunately, cash advances and production proceeds held by an operator are deemed to be held in trust.[5] Pursuant to Clause 5.07(B)[6] of the 2015 CAPL, notwithstanding the operator's rights to commingle funds, any funds paid to, received by or held on behalf of a non-operator, are deemed to be held in trust on behalf of that non-operator, and do not belong to the operator.

The implications of the imposition of a trust are significant. The funds will be deemed to be owned beneficially by the non-operator, and the non-operator will be able to step out from the line of creditors and make a claim directly against the trust funds themselves.

A non-operator dealing with an operator withholding trust funds will want to act quickly to advance its claim to the funds. Although the non-operator will also have a personal claim against the operator, that will be of little benefit against an insolvent operator. In the event the funds are dissipated, the operator's viable recourse will be against other parties, as discussed below.

Claims against directors or officers of the operator

Directors and officers of an operator may be personally liable to a non-operator under the doctrine of knowing assistance in the event of dissipation of trust funds. To establish liability, the non-operator must prove, in essence, that the operator took a knowing risk resulting in the prejudice to the non-operator, that the director or officer knew (or was reckless or wilfully blind) of the misconduct, and assisted in the fraudulent or dishonest design.[7]

If the directors or officers of a nearly insolvent operator expose AFE funds or production revenue to risk of dissipation by commingling them in the general account, or if they are otherwise involved in the dissipation of the trust funds, then the non-operators may be successful in suing these individuals in their personal capacity.

Claims against recipients of funds

In addition to potential claims against directors and officers, non-operators may have a claim against companies that have received the funds on the basis of the doctrine of "knowing receipt"[8]. To prove this, a non-operator must demonstrate that:

1. The defendant received the funds held by the operator in trust;
2. The property was taken from the plaintiff in simple breach of trust;
3. The recipient of the funds had knowledge of facts sufficient to put a reasonable person on notice or inquiry of the breach of trust; and
4. The defendant applied the property for its own use and benefit.

Non-operators awaiting the return of funds advanced under AFEs or production revenue, and who believe that those funds have been delivered to other parties, including the operator's bank, service providers, or other creditors, may obtain recovery against the recipient of those funds.

Rights on shut-in

There will be instances where operators will shut-in wells due to the current pricing environment despite the protests of non-operators requiring continuous cash flow.

Clause 3.04 of the 2015 CAPL[9] imposes a duty on the operator to manage the joint property and conduct all joint operations "diligently, in a good and workmanlike manner, in compliance with all title documents and in accordance with good oilfield practice". Depending primarily on the specific terms of the governing lease, a non-operator may have recourse against an operator in the event of a shut-in. If continuation of the lease is dependent on production, and there is no provision expressly permitting shut-ins due to current market conditions, shutting-in will terminate the lease, potentially in breach of the operator's obligations. The 2015 CAPL generally limits an operator's liability to conduct amounting to "gross negligence or wilful misconduct". The courts have held that permitting a lease to terminate can, in certain circumstances, meet this standard.[10]

Replacing the operator

A non-operator concerned with the actions or financial viability of the operator should also be mindful of the prospect of replacing the operator. The 2015 CAPL stipulates that the operator shall be immediately replaced in certain circumstances, most notably the insolvency of the operator, by the largest working interest holder unless there is another replacement operator appointed. However, the courts have determined that this clause is not enforceable in an insolvency proceeding.[11]

The operator may also be replaced upon appointment by non-operators holding at least a 60 per cent working interest or upon default of its obligations without adequately curing the default commencing within 30 days of the default notice.

Conclusion

Non-operators that do not immediately receive funds payable from operators are not without recourse. The first and most efficient remedy is to advance an immediate claim against the withheld funds. In the event those funds are dissipated, there are viable options to pursue compensation from directors or officers of the operator, or from the recipient of the withheld trust funds. Depending on the terms of the lease, disputed well shut-ins may also give rise to a valid claim against the operator. Non-operators concerned with the actions or financial viability of the operator should also be aware of the provisions in the 2015 CAPL calling for the replacement of the operator, in particular their options to replace the operator by appointment as the courts have held that the automatic, immediate replacement provisions of the CAPL due to the operator's insolvency are unenforceable.

[1] This bulletin focuses on the 2015 CAPL Operating Procedure. Companion provisions in earlier versions are addressed in the footnotes.

[2] Clause 6.02, 2015 CAPL Operating Procedure; see also Clause 6.02, 2007 CAPL Operating Procedure; Clause 602, 1990 CAPL Operating Procedure; Clause 602, 1981 CAPL Operating Procedure; Clause 602, 1974 CAPL Operating Procedure; Clause 602, 1971 CAPL Operating Procedure.

[3] Clause 5.02, 2015 CAPL Operating Procedure; see also Clause 5.02, 2007 CAPL Operating Procedure; Clause 502, 1990 CAPL Operating Procedure; Clause 502, 1981 CAPL Operating Procedure; Clause 502, 1974 CAPL Operating Procedure; Clause 502, 1971 CAPL Operating Procedure.

[4] There is recent authority in Alberta that says that Non-Operators may not rely on the 'insolvency' clause in an operating agreement as a basis to issue a notice to assume operatorship. Thus, insolvency alone may not be a sufficient basis to lift the stay. If, however, there are provisions in the operating agreement which permit a Non-Operator to assume operatorship if the Non-Operator owns more than a specified percentage working interest, the Court may, in limited circumstances, authorize a transfer of operatorship. See *Alberta Energy Regulator v. Lexin Resources Ltd*, 2019 ABQB 23 (Lexin) and *Firenze Energy Ltd v. Scollard Energy Ltd*, 2018 ABQB 126. If in doubt, contact legal counsel with questions about when a Court may be willing to transfer operatorship when an Operator is the subject of an insolvency proceeding.

[5] The 1981 and earlier CAPL Operating Procedures do not expressly deem these funds to be held in trust. Where these earlier versions govern operations, Non-Operators may rely upon the Alberta Court of Appeal Decision in *Bank of Nova Scotia v. Societe General (Canada),* [1988] 4 W.W.R. 232, where the Court held that an Operator is a trustee of funds received from and on behalf of Non-Operators.

[6] Clause 5.07(B), 2015 CAPL Operating Procedure; see also Clause 5.07(B), 2007 CAPL Operating Procedure; Clause 507, 1990 CAPL Operating Procedure; Clause 507, 1981 CAPL Operating Procedure; Clause 507, 1974 CAPL Operating Procedure; Clause 507, 1971 CAPL Operating Procedure. Notably, the corresponding provisions in the 1981, 1974 and 1971 CAPL Operating Provisions do not contain this deemed trust language.

[7] *Indutech Canada Limited v. Gibbs Pipe Distributors Ltd.,* 2011 ABQB 38 (CanLII) at paras 399 - 410

[8] It is also possible to claim against recipients of funds under the *Fraudulent Preferences Act* if the funds have been transferred for the purpose of preferring one creditor over another.

[9] Clause 3.04, 2015 CAPL Operating Procedure. The standard of care expected of an Operator varies depending on which CAPL Operating Procedure applies. See Clause 3.04, 2007 CAPL Operating Procedure; Clause 304, 1990 CAPL Operating Procedure; Clause 304, 1981 CAPL Operating Procedure; Clause 303, 1974 CAPL Operating Procedure; Clause 304, 1971 CAPL Operating Procedure.

[10] *Adeco Exploration Company Ltd. v. Hunt Oil Co. of Canada,* 2008 ABCA 214

[11] *Lexin* at para 35.

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