Operators' remedies in uncertain economic times

April 21, 2020

The current oil and gas pricing environment, exacerbated by the COVID-19 pandemic, will inevitably result in disputes amongst operators and non-operators arising from defaults on payments and disagreements about shut-ins. Accordingly, it is imperative for operators to be aware of their rights, obligations and available remedies.

What you need to know

- Like its predecessors, the 2015 CAPL Operating Procedure includes a number of remedies for an operator when a non-operator does not pay its share of costs and expenses incurred by the operator. Pertinent amongst these are the operator's lien, the right of set-off, and the right to treat a default as an assignment of the non-operator's share of produced substances.
- These remedies are not likely to be enforceable once the non-operator becomes the subject of bankruptcy or receivership proceedings, or makes a proposal under the *Companies Creditors Arrangements Act.*
- Operators contemplating shutting-in a well should carefully review the specific terms of the governing lease to ensure that the conditions of any shut-in clause have been and remain satisfied, failing which claims by non-operators may be available for failing to preserve title documents. The force majeure provisions in the CAPL Operating Procedures and most leases may provide a further answer to such claims given the current COVID-19 pandemic.
- Operators should also be aware that there is a risk that a court may find that shutting-in a well to the detriment of non-operators constitutes a breach of fiduciary duty. This risk is reduced under the 2007 and 2015 CAPL Operating Procedures, which expressly stipulate that obligations other than those related to the commingling of funds, the distribution of proceeds and the maintenance of confidential information are not intended to be fiduciary obligations.

Remedies for non-operators' defaults on payment

Operator's lien

An operator has a lien under the 2015 CAPL Operating Procedure[1] against each non-operator's interest in the joint lands, the wells and equipment thereon, the produced substances, and any other joint property to secure payment of that non-operator's share of costs and expenses incurred for the joint account.

Practically, to enforce the operator's lien against the non-operator's working interest in the joint lands, the operator will require a court order confirming the sale of the non-operator's interest. Such an order will:

- confirm the operator's right to sell if the defaulting non-operator challenges the validity and extent of the operator's lien;
- provide assurance to the purchaser that it is acquiring the non-operator's interest, free of any adverse claims or prior security, and;
- ensure that the defaulting non-operator's freehold interest can be transferred at Land Titles.

Notably, an operator cannot enforce its operator's lien until 60 days after it has given notice to the defaulting non-operator (copying all others) of the default and requirement to remedy.

Right of set-off

An operator has a right under the 2015 CAPL Operating Procedure[2] to set-off any unpaid amount against funds owed to it by the non-operator under the governing operating agreement or any other agreement, without a corresponding set-off right for the non-operator. This can be an important self-help remedy for operators that have dealings with non-operators outside the scope of the joint operations because it enables them to apply unrelated funds payable to non-operators against amounts owing by them. Caution should be exercised when setting off against a potentially insolvent non-operator. Other creditors may obtain a court order to reverse the set-off transaction on the basis that it constitutes an improper or fraudulent preference, with potentially significant cost consequences.

The set-off remedy cannot be exercised until the expiration of a 30-day cure period following a default notice.

Right to assignment of produced substances

An operator under the 2015 CAPL Operating Procedure[3] may treat a non-operator's default in the reimbursement of costs and expenses as an immediate and automatic assignment of the non-operator's share of produced substances. An operator may then dispose of those substances at a market price on whatever terms the operator can reasonably arrange, and apply the proceeds against amounts owing, including interest. Assuming there is on-going production, this is likely the simplest and most efficient method of recovering a defaulting non-operator's share of costs and expenses incurred for the joint account.

The assignment remedy cannot be exercised until the expiration of a 30-day cure period following a default notice.

Effects of the non-operator's insolvency

Operators should be aware that there will be a stay of proceedings against the non-operator in the event that it becomes the subject of proceedings under the *Bankruptcy and Insolvency Act,* RSC 1985, c.B-3 (BIA), including a receivership order, or makes a proposal to creditors under the *Companies' Creditors Arrangements Act* (CCAA). It is unlikely that the default remedies for a party's failure to pay amounts owing under an oil and gas operating contract are enforceable during the stay of proceedings.

Under the BIA, once a debtor files a notice of intention with the official receiver or files a proposal with the Office of the Superintendent of Bankruptcy, there is a stay of proceedings whereby no creditor has any remedy against the debtor or its property, and no creditor shall commence or continue any proceeding.[4]

The Alberta template receivership order includes a provision that stipulates that all rights and remedies, including, without limitation, set-off rights, are stayed and suspended except with the written consent of the receiver or leave of the court.[5]

The Alberta CCAA template order similarly provides that during the stay of proceedings, all creditors' rights and remedies, whether judicial or extra-judicial, against the applicant debtor, the monitor, or affecting the debtor's property or business, are stayed and suspended.[6] Courts have been clear that the term "proceeding" in this context is not confined to legal proceedings.

Operators' rights to shut-in

Many operators will be motivated to shut-in wells due to current pricing and the shortage of available storage. Shutting-in, however, may give rise to disputes with non-operators that require continued production.

Shutting-in a well may result in termination of the lease and thereby give rise to claims by non-operators for breach of its obligation to maintain title documents. Pursuant to Clause 3.04[7], an operator has an obligation to conduct all joint operations diligently, in a good and workmanlike manner, in compliance with the title documents and regulations, and in accordance with good oilfield practice. An operator is liable to non-operators where it breaches those obligations to a degree amounting to gross negligence or wilful misconduct. Failure to maintain title documents may reach this degree. Whether shutting-in will result in termination will depend on the specific terms of the lease, and accordingly it is incumbent upon every operator contemplating a shut-in to review the specific governing lease(s).

Under many leases, unless the conditions of a shut-in clause in the lease have been and remain satisfied, shutting-in a well will result in a cessation of operations which, if it persists beyond any permitted cessation period, will result in the expiration of the primary term and may terminate the lease. Many leases contain an express shut-in clause that permits the lease to continue as long as there is a shut-in well that is capable of resuming production when conditions permit. For example, the CAPL 1999 Petroleum and Natural Gas Lease and Grant provides that the lease will continue insofar as there is a shut-in well that is "completed for and capable of production of the Leased Substances". This has been interpreted by the courts to mean "capable of producing in meaningful quantities", which contains an element of commercial viability.

Courts have held that failure to produce, when economical and profitable to do so, results in termination of the lease. The test for whether production would be economical and profitable is whether, based on information available at the time, a prudent lessee would have foreseen profitability.

Given the current COVID-19 pandemic, an operator shutting-in a well may also rely upon the force majeure provisions in the applicable lease(s) and the 2015 CAPL to preserve the lease(s) and respond to any claims by non-operators.

Under Article 16 of the 2015 CAPL[8], a party's obligations are suspended insofar as they are prevented from performing them by force majeure, which is defined as an event beyond the reasonable control of the applicable party that has not been caused by its negligence and could not have been prevented by reasonable diligence. Notably, however, "lack of finances, changes in a party's economic circumstances and changes that affect the economic attributes of investments hereunder" are specifically excluded from the definition of force majeure.

Most oil and gas leases also contain a force majeure clause whereby the lease is preserved for the duration of any suspension or interruption of operations due to an event of force majeure, defined as any cause beyond the lessee's reasonable control, but does not include a lack of finances.

To the extent that the current COVID-19 pandemic has resulted in the interruption or suspension of operations, the force majeure provisions of the 2015 CAPL and the governing lease may result in the preservation of the lease and suspension of any obligations that the operator is prevented from performing.

Operators should be aware that shutting-in a well because it is in their own best interests, but not the best interests of non-operators, may result in claims for breach of fiduciary duties.

Fiduciary duties are obligations to act selflessly and with undivided loyalty to another party. A party may be found to owe fiduciary obligations if it has the ability to unilaterally exercise some discretion or power so as to affect the legal or practical interests of another party that is peculiarly vulnerable to it, and to whom it has provided an undertaking of loyalty.

Courts will give significant weight to contractual provisions that expressly define the parties' relationship, including fiduciary obligations, however despite such provisions they may nonetheless find that additional fiduciary obligations exist. Unlike earlier versions, the 2007 and 2015 CAPL Operating Procedures expressly limit the operator's fiduciary duties to the handling of commingled funds, distribution of production proceeds, and the obligation to maintain confidential information. The risk that a court will find that shutting-in a well constitutes a breach of fiduciary duty is therefore higher for operations governed by the 1990 or earlier versions of the CAPL Operating Procedure.

[1] Clause 5.05(A), 2015 CAPL Operating Procedure. Similar provisions exist in the 2007, 1990, 1981, 1974 and 1971 CAPL Operating Procedures. However, the language regarding the priority of the lien over other liens, charges, mortgages and security interests was not incorporated until 1990.

[2] Clause 5.05(B)(c), 2015 CAPL Operating Procedure. Similar provisions exist in the 2007 and 1990 CAPL Operating Procedures. An explicit contractual right to set-off is not contained in the 1981, 1974 and 1971 CAPL Operating Procedures.

[3] Clause 505(B)(e), 2015 CAPL Operating Procedure. Similar provisions exist in the 2007, 1990, 1981, 1974 and 1971 CAPL Operating Procedures.

[4] *Bankruptcy and Insolvency Act,* RSC 1985, c.B-3, *s. 69*

[5] https://www.albertacourts.ca/docs/default-source/qb/template-receivership-order-redwater-scc-edits-feb-14-19.pdf?sfvrsn=c686ad80_6

[6] https://www.albertacourts.ca/docs/default-source/qb/cal01---2470918-v2-ccaa-order-(alberta)---jakr-markup65b9d3391b316d6b9fc9ff00001037d2.pdf?sfvrsn=e986ad80_4

[7] Clause 3.04, 2015 CAPL Operating Procedure. Similar provisions exist in the 2007, 1990, 1981, 1974 and 1971 CAPL Operating Procedures. However, the standard of care expected of an Operator varies depending on which CAPL Operating Procedure applies.

[8] Article 16, Force Majeure, 2015 CAPL Operating Procedure. Similar provisions exist in the 2007, 1990, 1981, 1974 and 1971 CAPL Operating Procedures.

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