

FIDUCIARY DUTIES, RESPONSIBILITIES,
LIABILITIES AND INDEMNITIES
OF OPERATORS UNDER THE
1990 CAPL OPERATING PROCEDURE

A paper prepared for the Conference on
Oil & Gas Operating Agreements:
Conventional, Frontier and International

Sponsored by

The Legal Education Society of Alberta
February 28, 1991

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I. The Role of the Operator

Of necessity, the CAPL Operating Procedure gives the Operator significant authority and responsibility for operation of the joint lands. Specifically, the second sentence of paragraph 301(a) provides that:

"Subject to the provision hereof, the Operator is hereby delegated the management of the exploration, development and operation of the joint lands and the construction, installation and operation of any production facilities for the joint account on behalf of the Joint Operators."

This broad authority has traditionally, of necessity, been delegated to the Operator in respect of conventional operations in the Western sedimentary basin because of the infeasibility of applying a management committee concept in the context of conventional drilling. It would impose an extreme administrative burden on industry participants to impose tax on extensive formalized consultative mechanisms where typical participants are participating in a multitude of properties with varying co-venturers, interests, tenure, prospectivity, maturity and activity. Moreover, in many instances, a management committee structure would be irrelevant in any event given the extensive consolidation of producing properties that has occurred as a result of the property rationalizations and the fact that, in more and more cases, a single party now holds more than a 50% interest in a well.

At the same time, however, the structure of the CAPL Operating Procedure does, in fact, give non-operators significant control respecting the setting of exploration strategy respecting the exploration of the joint lands. In

particular, the independent operations mechanism and the expenditure approval process in fact give the non-operators significant control respecting the exploration of joint lands. There are numerous provisions in the CAPL Operating Agreement which impose an accountability on the Operator for joint operations:

1. Subclause 301(a) imposes a duty on the Operator to consult from time to time with respect to exploration, development and operational decisions and decisions respecting the construction, installation and operation of production facilities.
2. Subclause 301(a) also imposes an obligation on the Operator to keep the joint operators informed with respect to operations planned or conducted for the joint account.
3. Clause 304 imposes a general obligation on the Operator to conduct operations in accordance with good oilfield practice.
4. Subclause 301(b) limits the Operator's freedom to commit monies for the joint account by requiring the Operator to obtain the authorization of the non-operators pursuant to an Authority for Expenditure ("AFE") for any operation on the joint lands for the joint account in excess of \$25,000. Pursuant to the definition of AFE in subclause 101(3)(i), the AFE must be sufficiently detailed "to enable a party to understand the nature, scope and consequence of" the operation. This requires the Operator to provide all the material information reasonably required to make an informed decision or risk that a non-operator's election could be voidable.

5. Paragraph 202(b)(i) enables the non-operators to remove an Operator without cause and against its will by an affirmative vote of two or more non-operators representing a majority of the working interests or by notice of a single non-operator holding at least 66% of the working interests. This mechanism is similar to the voting procedures/no-cause challenge mechanism used in conventional unit agreements, the CAPL Frontier Operating Procedure and U.K. joint operating agreements and should serve to reinforce the Operator's accountability for its performance. In practice, the general experience has been that it has proven to be extremely difficult to remove Operators who become insolvent because of the difficulty in obtaining the information about a Operator's business affairs required to establish that it is legally insolvent, particularly given that an Operator is unlikely to co-operate and is likely to challenge the allegation. Similarly, the limitation in the challenge mechanism requiring a challenger to give notice that it is ready, willing and able to conduct operations for the joint account "on more favourable terms and conditions" has proven less flexible than desirable since it is effectively limited to financial terms (essentially, overhead rates) because of the difficulty in quantifying more qualitative aspects of the Operator's performance, such as the Operator's technical, as opposed to cost, performance. Also, the challenge mechanism can take up to six months to effect, given that the Operator has an initial 60 days to respond to the challenge notice and, if it chooses to resign, may set an effective date as far into the future as 90 days following the end of the 60 day response period.

6. Clause 504 gives a non-operator the right to require the Operator to provide a forecast for informational purposes of the anticipated operations to be conducted for the joint account over the succeeding 3 to 12 month period. There is no requirement, however, for regular meetings or a formal mechanism for calling special meetings.
7. As revised, Clause 507 still permits an Operator to commingle funds received for the non-operators with its own funds but now provides that "the moneys of a Joint-Operator advanced or paid to the Operator, whether for the conduct of operations hereunder or as proceeds from the sale of production under this Operating Procedure, shall be deemed to be trust moneys, and shall be applied only to their intended use and shall in no way be deemed to be funds belonging to the Operator, other than in its capacity as the Joint-Operator's Trustee".
8. The independent operations provisions accommodate different exploration strategies by permitting differences in opinion as to the desirability or timing of a drilling program.

II. Relationship Between the Parties

Clause 303 establishes the Operator as an independent operator with respect to joint operations. The usual result of this characterization would impose on the Operator full responsibility for its own negligence, but this general legal principal is overridden by the provisions of Article VI dealing with liability and indemnity.

Clause 401 limits the Operator's general liability to gross negligence or willful misconduct.

The wording of the exemption clause has been cautiously worded to take into account the impact on its interpretation of the numerous legal decisions in this area:

1. The exclusion applies to all loss and expense, whether "contractual or tortious". In the absence of an express exclusion of contractual liabilities, a court could limit the provision solely to tortious liabilities. Dominion Bridge Company Limited v. Toronto General Insurance Company (1963), 45 W.W.R. 125 (s.c.c.) and Canadian Indemnity Co. v. Andrews and George Co., [1953] 1 S.C.R. 19 (S.C.C.).
2. Operator liability for its own negligence is expressly excluded since the general legal rule is that one has to contract out of responsibility for one's own negligence specifically.
3. The wording provides a distinct treatment between liability and indemnity since, if this distinction is blurred, the parties face the risk that the provision could be held to be solely an obligation to indemnify, with the effect that non-operators would not be able to rely on the Clause to provide a remedy with respect to direct damage to their property. Mobil Oil Canada Ltd. v. Beta Well Services Ltd. (1974), 43 D.L.R. (3rd) 745 (Alta S.C., App.Div.). Care must be taken to distinguish between the purposes of exclusion clauses and indemnities. An exclusion clause protects the Operator from any liability to the non-operators themselves. An indemnity, on the other hand, ensures recovery by the Operator from the non-operators (provided the non-operators are financially solvent or that sufficient security has been given) in respect of any Operator's liabilities to persons other than the non-owners.

From the point of view of the Operator, the indemnification provisions of the CAPL Operating Procedure leave the Operator exposed on at least four counts:

1. There is no general exemption for consequential or indirect damages. There is an express exclusion, however, for liability respecting "the loss or delay of production from the joint lands", including "loss of profits and other consequential or indirect losses applicable to such loss or delay of production". Also, the normal common law rules of causation and reasonable foreseeability continue to apply.
2. There is no general exception for exemplary or punitive damages. Presumably, therefore, a court would impose such damages on an Operator where its conduct is high-handed, oppressive or willfully reckless.
3. Operator's gross negligence.
4. Losses to be covered by insurance required to be held for the joint account.

In the event that a non-operator defaults on its contractual obligations to indemnify an Operator or its obligations to a third party for a loss suffered by that person as a result of joint operations, Clause 506 provides for a reimbursement of the Operator.

III. Canadian Case Law on the Fiduciary Duties of Operators

In general, it is clearly established law in Canada that an Operator under the standard oil and gas industry operating agreements is subject to a fiduciary duty to the non-operators; ie., the duties and obligations devolving upon the Operator are not limited to those outlined within the four corners of the agreement, but extend beyond the agreement, at least with respect to matters which are the subject of the agreement.

The leading Canadian judicial authority remains the 1958 decision of the Supreme Court of Canada in Midcon Oil & Gas Co. v. New Brunswick Dominion Oil Co. [1958] S.C.R. 314, 12 D.L.R. (2d) 705, affirming 21 W.W.R. 228, 8 D.L.R. (2d) 369, which affirmed 19 W.W.R. 317 [Alta]. In Midcon, the Operator of a gas field was permitted under the operating agreement to take all production in kind and make arrangements for its disposal and was obliged to account to the non-operators for their share of proceeds after deducting royalties and expenses.

As part of its marketing efforts, the Operator acquired a block of shares in a fertilizer company which was also a buyer of the gas.

The plaintiff non-operator claimed that the defendant operator held a portion of the fertilizer company's shares in trust for it, but a majority of the Supreme Court of Canada rejected this claim on the grounds that the Operator's profit in the shares arose in its capacity as a promoter, rather than as operator and co-owner of the gas field.

Similarly, in Pine Pass Oil & Gas. v. Pacific Petroleum Ltd. (1968), 70 D.L.R. (2d) 196, the Supreme Court of British Columbia rejected a claim of carried interest owners of an entitlement to participate in the proceeds of production from wells acquired by an Operator on lands adjoining the properties which were subject to the carried interest. The Court limited the trust imposed on the Operator to the proceeds from the wells subject expressly to the agreement and refused to extend it to adjoining properties and held that after-acquired leases were acquired outside the trust relationship.

In Act Oils Ltd. v. Pacific Petroleum Ltd., the Alberta Supreme Court similarly held that an Operator's fiduciary duty to the owner of a carried interest extended only to the proceeds of production from the lands governed by an agreement and not to the financial benefits which the Operator derived from its involvement in the promotion and establishment of a gas transmission company to which it sold joint venture gas.

IV. Is it Possible to Draft an All Encompassing Operator Indemnity?

Is it possible to draft a legally effective exclusion and indemnity provision which will be legally effective in insulating an operator from any liability whatsoever (other than its proportional responsibility as a joint interest owner for all costs and expenses of the joint operation) resulting directly or indirectly from the operation of a project?

More specifically, would Canadian courts enforce broadly drafted exclusion and indemnity clauses?

In my view, there is no significant possibility that the courts would not enforce such an exclusion clause. The only circumstance in which such an exclusion clause would not be enforced is if a court holds, directly or by speaking in terms of what is just and reasonable in the circumstances or in similar terms, that to do so would be contrary to public policy either because of something in the exclusion clause itself or in the circumstances surrounding its negotiation.

In Karsales (Harrow) Ltd. v. Wallis, [1956] 1 W.L.R. 936 (C.A.), Lord Denning set forth the doctrine of fundamental breach. This doctrine held that, as a matter of law, an exclusion of liability clause did not operate in face of a breach depriving the victim of substantially the whole benefit for which he had contracted. Denning's approach was rejected, in favour of one based upon construction of the clause in question (albeit contra preferentem) by the House of Lords in Suisse Atlantique Societe d'Armement Maritime S.A. v. N.V. Rotterdamsche Kolen Centrale, [1967] 1 A.C. 361, and again in Photo Production Ltd. v. Securicor Transport Ltd., [1980] A.C. 827. The Supreme Court of Canada approved the Suisse Atlantique formulation in B.G. Linton Construction Ltd. v. Canadian National Railway Co., [1975] 2 S.C.R. 678, and appeared to take a view similar to that of Securicor in Beaufort Realties (1964) Inc. et al v. Chomedev Aluminum Co. Ltd., [1980] 2 S.C.R. 718.

Most recently, in the 1989 Supreme Court of Canada case of Hunter Engineering Company Inc. v. Syncrude Canada Ltd., (1989), 57 D.L.R. (4th) 321, the Chief Justice, speaking for himself and La Forest, J., summarized his views on exclusion clauses in this way:

"It is preferable to interpret the terms of the contract, in an attempt to determine exactly what the parties agreed. If on its

true construction the contract excludes liability for the kind of breach that occurred, the party in breach will generally be saved from liability. Only where the contract is unconscionable, as might arise from situations of unequal bargaining power between the parties, should the courts interfere with agreements the parties have freely concluded."

In the Hunter case, Madam Justice Wilson, speaking for herself and L'Heureaux-Dube, J., took a somewhat different approach to the matter of exclusion clauses. Her comments on fundamental breach should be regarded as obligater dicta, since she determined that no fundamental breach had occurred. Wilson, J. said:

"Exclusion clauses do not automatically lose their validity in the event of a fundamental breach by virtue of some hard and fast rule of law. They should be given their natural and true construction so that the meaning and effect of the exclusion clause the parties agreed to at the time the contract was entered into is fully understood and appreciated. But, in my view, the court must still decide, having ascertained the parties' intention at the time the contract was made, whether or not to give effect to it in the context of subsequent events such as a fundamental breach committed by the party seeking its enforcement through the courts. Whether the courts address this narrowly in terms of fairness as between the parties (and I believe this has been a source of confusion, the parties being, in the absence of inequality of bargaining power, the best judges of what is fair as between themselves) or on the broader policy basis of the need for the courts (apart from the interests of the parties) to balance conflicting values inherent in our contract law (the approach which I prefer), I believe the result will be the same since the

question essentially is: In the circumstances that have happened should the court lend its aid to A to hold to this clause?"

Wilson, J. then mentions that fundamental breach has its origins in that aspect of the doctrine of unconscionability which deals with inequality of bargaining power. She states that "the equitable principles on which the doctrine [of unconscionability] is based are broad enough to cover many of the factual situations which have perhaps deservedly attracted the application of the "fair and reasonable" approach in cases of fundamental breach". She states that "[w[here ... there is no such inequality of bargaining power ... the courts should, as a general rule, give effect to the bargain freely negotiated by the parties". However, Wilson, J. does clearly contemplate that even in the case of equal bargaining power, an exclusion clause might be struck down on policy grounds if it is not fair and reasonable to allow reliance on that clause in light of subsequent events. Unfortunately, McIntyre J., the fifth member of the Court in Hunter, although agreeing with the result, did not endorse the theoretical approach to fundamental breach of either the Chief Justice or Madam Justice Wilson.

Even a very broadly drafted operator indemnity would clearly be enforceable according to the view of Chief Justice Dickson in Hunter. In my view it would likely also be enforceable on the analysis of Madam Justice Wilson. The theory and result of Wilson J.'s judgment, including her emphasis on such considerations as relative bargaining power and the parties' experience in the type of contract in question, suggest she has little interest in refusing to enforce exclusion clauses despite fundamental breach, absent unconscionability (it is also clearly relevant that, as is typical in oil industry joint ventures, the Operator receives no fee for its services).

Furthermore, Wilson J.'s view of fundamental breach is such that any breach by the Operator within the context of continuing execution by the Operator of its responsibilities under an operating agreement would not be characterized as a fundamental breach. The only possibly difficult case would be where unknown policy considerations come into play, and it is largely to guard against this possibility that it might make sense to incorporate structural as well as contractual protection for the Operator. I have been unable, however, to find any reported case in Canada, England or Australia in which parties of equal bargaining power who had excluded contractual and tortious liability were not allowed by a court, for public policy reasons, to rely on that exclusion.

In my view, the analysis would be the same in considering a limitation of liability clause rather than an exclusion of liability clause - that is, an appropriately drafted limitation of liability clause would be enforced by the courts, absent public policy reasons not to do so. Given my view of the efficacy of exclusion clauses, it is not necessary to use a limitation clause as a substitute for or in addition to an exclusion clause in order to achieve the required protection. Nor in our circumstances is it necessary to use a limitation clause to ensure that the Operator retains some contractual obligations, thereby providing consideration in support of the promises of the Owners. This is because, as we understand the agreement, even in the presence of the exemption clause and the indemnities, there would remain a residue of obligation on the part of the Operator that is not cancelled by concurrent exemption. For example, failure of the Operator to fulfill certain contractual obligations could lead to the Operator's removal.

In my view, the exclusion clause and use of Subco as Operator would adequately protect Esso Resources from claims by Owners against the Operator. A clause such as the indemnities is required to protect the Operator against third party claims (Subco also offers protection against third party claims, but it is protection Esso Resources may be reluctant to use).

We understand, for business reasons, there may be some reluctance to include a provision in the Agreement requiring remaining Owners, in respect of the indemnities, to contribute proportionately to the Operator any defaulting Owner's share. Without such a provision, the Operator has the "collection risk" of an Owner's insolvency, or refusal to honour his indemnity. Some protection against this collection risk can be found in security for the indemnities, particularly security unrelated to the Oil Sands Project (such as a performance bond), and in restrictions on the assignability by an Owner of his Participating Interest and on change of control of an Owner. In the absence of a contribution provision, however, the Operator should seek such other safeguards.

In my view, it is desirable to use Subco as operator. The incorporation of a separate subsidiary will insulate Esso Resources from liabilities attributable to the Operator.

It is only in the most exceptional circumstances that a court will pierce the corporate veil and hold a controlling shareholder liable for the obligations of a subsidiary corporation: see Amdue Holdings Ltd. v. Calgary (1980), 12 Alta. L.R. (2d) 76 (C.A.). Generally, there are only three such circumstances: (i) fraud; (ii) where a corporation is used as a means of circumventing an obligation (e.g., where the shareholder has agreed not to compete with a third party and endeavors to circumvent the non-competition covenant by

competing through a corporation controlled by it); and (iii) where a corporation is found to be agent of the shareholder (see Salomon v. Salomon & Co. Ltd., [1985-99] ALL E.R. Rep. 33; Jodrey's Estate v. Province of Nova Scotia et al., (1980), 32 N.R. 275 (S.C.C.) per Dickson J.; and Garbutt Business College Limited v. Henderson et al., [1939] 3 W.W.R. 257 (Alta. C.A.)). In the cases considering agency, the courts have examined as indicia of agency leading to a piercing of the corporate veil: the degree of control or domination exerted by the parent over the business of the subsidiary; the degree of interdependence between the business of the parent and that of the subsidiary; the capitalization of the subsidiary; and the degree of observance by the subsidiary of corporate formalities.

Case law suggests that lack of observance by the subsidiary of corporate formalities may be a determinative factor: see Canada Safeway Ltd. v. Canadian Food and Allied Workers et al., [1974] 4 W.W.R. 453 (B.C.S.C.). Esso Resources should therefore ensure that Subco is operated as a separate entity with proper directors' and shareholders' meetings, its own letterhead and employees, and a separate bank account.

There is no substantial legal advantage to inserting as operator, between the joint venture and Subco, another corporation ("Opco") owned proportionately by the Owners (although it may be thought desirable for other reasons that the operator be a company owned in this way). The concept is that Opco, as independent contractor, would act as operator, entering into a contract with Subco for Subco's services as Opco's agent. All contracts with third parties would be signed by Subco as agent for Opco, with the result that Subco would not be exposed to claims by third parties for breach of contract. Subco would have joint and several liability with Opco for

tortious actions committed by Subco, but this liability would be borne exclusively by Opco through the use of an exclusion clause and indemnities in favour of Subco.

Alternatively, pursuant to a unanimous shareholders agreement with an exclusion clause and indemnities in favour of Operator, Esso Resources could be given power to manage and control Opco which would itself provide the operatorship services to the joint venture as independent contractor.

In both Opco proposals, the Operator would still be relying on either or both of Subco's limited liability and the enforceability of an exclusion clause and indemnities. If there can be limited liability through interposition of a corporation, and an appropriate exclusion clause and indemnities are enforceable, then Opco is not necessary (Subco, together with the exclusion clause and indemnities, is sufficient); if not, then in any event, the Opco options fail.

Another structure which has been considered from time to time is the concept of "intermittent sale" of the operator. The suggestion is that periodically, as phases of the Project come to an end, and upon the exercise of a "put" by the Operator, the Owners purchase all the shares of Subco in proportion to their Participating Interests and release Subco from all liability arising from work performed as operator. The technology developed by Subco would be sold to the Owners in the same proportion, and Subco would be wound up. At the option of the Operator, a new Subco would then be created for the next phase of the Project, eventually to be subject to the same process as the first Subco. As in any share sale, contingent liabilities would be found in the entity bought by the purchaser.

Although intermittent sale may offer an operator additional structural protection from liability, in our view that additional protection is not necessary.

VI. Legal Liability for Well Abandonment

Section 18 of the Oil and Gas Conservation Act requires that the Energy Resources Conservation Board (the "ERCB") consent to transfers of well licences in the province. In cases where the proposed transferee has a proven operating record in the Province of Alberta, the transfer application will normally be approved in a routine manner. However, where the transferee is a party or company that is unknown to the ERCB or whose operating performance raises serious doubts as to the appropriateness of transferring additional wells into its custody, this will not be the case.

In these situations, pursuant to ERCB Information Letter IL 89-22 issued on December 21, 1989, the ERCB will seek information to fully satisfy itself that the transferee is aware of and capable of fulfilling all of its obligations and responsibilities under the Oil and Gas Conservation Act and the Oil and Gas Conservation Regulations, AR 151/71 as amended.

Specifically, the ERCB will require the transferee to provide documentation additional to its regular requirements respecting its ability to carry out the financial, technical and operational responsibilities that it will assume as the holder of a well license, including the subsurface abandonment of the well and reclamation of the well site. Documentation respecting the well abandonment requirement may include a written commitment to abandon the well or a commitment to a specific plan to ensure that adequate funds are in place to cover the

surface and subsurface abandonment and reclamation costs when they are required in the future. These requirements will be in addition to the ERCB's normal requirements for a well license transfer.

Until the ERCB approves the well license transfer, the new owner or prospective owner will not have the right to produce the well or wells in question and the ERCB may require that the well or wells be shut in pending the resolution of the transfer question.

If a transferee fails to satisfy the ERCB with respect to its ability to assume the full responsibilities of a licensee, the ERCB may deny the transfer, even if a sale transaction has been completed, and will instruct the existing licensee to continue its normal responsibilities for the well.

Under the Land Surface Conservation and Reclamation Act, stop and control orders are used to prevent activities in contravention of the Act or the regulations. Such orders are directed to the "person" who has contravened the regulations or an order or direction made under the Act. A person failing to comply with the order may be liable to a fine of up to \$10,000 for each day of the offense, or up to 12 months imprisonment, or both. A second type of order available is a reclamation order, which may require that work be done to condition, maintain or reclaim the land. Reclamation orders are directed to the "operator concerned". Operator is broadly defined and includes a person in whose favour a surface lease is or has been held and a person that has used the land for any of a number of operations including the drilling, operation or abandonment of a well. A failure to comply with such an order gives the government wide powers to do the requisite work and collect the expenses from the Operator.

In view of the current social and economic concern with environmental issues, we expect that environmental representations, warranties and indemnities will continue to be vigorously and extensively negotiated. In addition, parties to purchase and sale agreements should beware of common law and statutory liabilities for environmental matters which may accrue in the context of oil and gas property acquisition and divestiture programs.

VII. Abandonment Procedures under the 1990 CAPL Operating Procedure and the 1988 CAPL Frontier Operating Procedure

B. Abandonment Provisions

In several respects, the standard provisions of the Operating Procedure governing abandonment are deficient in circumstances where environmental issues make abandonment a matter of particular concern to the parties.

1. CAPL Abandonment Provisions

The abandonment procedure is set out in Article XII of the Operator Procedure. A party proposing abandonment serves the appropriate notice and, if all concur, the abandonment is for the joint account. Parties who do not concur in the proposal to abandon may either elect to take over the well or are assigned the other parties' interests "without consideration or warranty" and must pay the other parties their share of the salvage value of existing materials and equipment. Subsequently, when the well is no longer maintained as a producing well, the interests are re-assigned to the original owners; however, the responsibility for well abandonment remains with the parties that took over the well.

There are corresponding provisions dealing with the abandonment of wells drilled pursuant to independent operations which ensure that, as between the parties, the responsibility for abandonment is borne by the joint operators participating in the independent operations.

The allocation of costs for abandonment of wells which are not completed is dealt with by the inclusion of such costs in the definition of "drilling costs". Drilling costs, in the case of a well which is completed for the taking of production, include "the costs of abandoning the well pursuant to the regulations and costs of restoring the drilling site".

2. Drilling Costs

Two concerns arise from the definition of "drilling costs" used in the Operating Procedure.

Firstly, the definition of "drilling costs" included only costs of abandoning the well pursuant to the Regulations, as defined. If, because of unusual circumstances, the abandonment procedure varies from that prescribed by the Regulations, such costs are arguably not included.

Secondly, the definition of "drilling costs" include costs associated with abandonment of uncompleted wells but does not include other costs associated with environmental protection such as those included in Clause 216 of the standard form PASWC 1983 Accounting Procedure (the "Accounting Procedure") which provides that expenses chargeable by the operator to the joint account include the cost of "requirements, whether statutory or otherwise, relating to the ecology or environment of the Joint

Property". The Accounting Procedure goes on to provide that costs of related studies will be subject to the approval of the parties.

3. AFE Procedure

Where costs of abandonment are expected to exceed \$25,000. the Operating Procedure contemplates that the Operator will send out an authority for expenditure ("AFE") but the agreement does not specify what happens if one of the parties refuses to execute the AFE. More generally, the AFE mechanism may be inappropriate to costs such as those which are associated with abandonment and site restoration which may be mandatory rather than elective.

If the standardized AFE procedure is retained in drafting a customized operating procedure, then it may be appropriate to deem parties who refuse, without reasonable cause, to execute the AFE, to have executed the applicable AFE. In addition, in certain circumstances, it may be prudent to have joint operators provide operations with security for reclamation costs in much the same way as the government in certain circumstances now requires the operator or licensee to provide a bond or other form of security.

4. Standard of Care

Another matter which may require further clarification in a customized operating procedure is the standard to which the operator may be held in its abandonment procedure. On the one hand, the Operating Procedure specifies that abandonment is to be done in accordance with the Regulations. On the other hand, the overall standard of care imposed by Section 304 of the Operating Procedure on the operator in its

conduct of all operations is that they be conducted in a good and workmanlike manner and in accordance with good oilfield practices. Since compliance with a statutory standard of conduct is generally evidence that one has not been negligent, if the operator complies with the standard set by the Regulations, it should avoid tortious liability. However, it does not necessarily follow that, in exceptional circumstances, such compliance will satisfy the operator's obligation under Section 304 of the Operating Procedure.

The standard by which the operator will be held accountable should be clarified. Either compliance with the Regulations should be deemed satisfaction of the obligations under Section 304 or the Operating Procedure should specify that compliance with the Regulations only sets the minimum requirement, in which case the drilling costs definition should be amended to include all abandonment costs (not only those in accordance with the Regulations).

5. Re-Assignment

The last aspect of the abandonment provisions which should be re-evaluated in drafting an operating procedure for use in a situation in which environmental issues are of particular concern is that relating to the re-assignment of interests. As the Operating Procedure is currently drafted, with the exception of title preservation wells, when as a consequence of one joint operator's unwillingness to participate in an operation there is an assignment of an interest, there is provision for the re-assignment of the interest in the relevant zone upon the happening of certain events. The Operating Procedure stipulates that notwithstanding the re-assignment, the responsibility for

abandonment remains with the parties that took over the well. However, vis-a-vis third parties, the owner of the re-assigned lands may be responsible for abandonment and reclamation. For example, a holder of a re-assigned interest may be held responsible to the lessor for site clean up. In particular circumstances, this potential source of liability should be considered and, if necessary, addressed.

6. Frontier Abandonment Provisions

The Frontier Operating Procedure alleviates many of the problems associated with the Operating Procedure provisions relating to abandonment by the inclusion of the following definitions:

"Abandonment" means the proper plugging and abandonment of a well in compliance with the Regulations [definition provided below], including the salvage of the salvageable material and equipment respecting such well and the restoration of the well-site."

"Regulations" means all statutes, laws, rules, orders and regulations in effect from time to time and made by governments or governmental boards or agencies having jurisdiction over the Agreement Lands or over the operations to be conducted thereon."

By the inclusion of a definition of abandonment, the standard of every abandonment is addressed. Each abandonment must meet a double-barrelled standard: it must be proper and in compliance with the Regulations. If proper abandonment entails a procedure which exceeds the standard set by the Regulations, then so be it. The joint operators are liable for their proportionate share of the costs

associated with the proper abandonment. There is no scope for argument that their liability is limited to only those costs associated with compliance with the standard set by the Regulations. Similarly, in the Frontier Operating Procedure, the potential for conflict between the general standard of care imposed on the operator and the specific standard imposed with respect to its conduct of abandonment is avoided by the imposition of the double-barrelled test.

Moreover, since the definition includes well-site restoration, under the Frontier Operating Procedure it is clear that obligations relating to well-site restoration are part of the joint obligations of all parties. The definition of well costs in the Frontier Operating Procedure includes not only those costs associated with abandonment but also many other costs associated with reclamation and environmental studies and thereby ensures that these additional costs are accounted for.

Subclause 9.08(G)(a) of the Frontier Operating Procedure deals with the problem of allocation of well costs where participation in various operations has differed. Specific mention is made of abandonment costs:

"... the costs of the logging and Abandonment of such well shall be allocated to the respective portions of such well in the ratio that the meterage of a portion of such well bears to the total depth of such well."

The above provisions for allocation of costs associated with well abandonment is subject to the general provisions in subclause 9.08(G) which provide for equitable allocation by agreement, and failing agreement, by arbitration.

The problem created by the unsuitability of dealing with the mandatory costs associated with abandonment by the use of the AFE procedure is also avoided under the Frontier Operating Procedure, the operator may charge the Joint Account (without AFE) costs or expenses arising when the "Operator is required to conduct an operation respecting the Agreement Lands by the Regulations, where failure to conduct such operation should be inconsistent with good oil field practice or could result in the prosecution of the Operator thereunder, in which case the Operator shall conduct such operation for the Joint Account, unless the Parties make arrangements whereby such operation shall be conducted other than for the Joint Account".

C. Termination of the Operating Procedure

When environmental issues are in the forefront, the termination provision in Article XXVIII of the Operating Procedure creates a concern. Pursuant to this provision, the Operating Procedure terminates when all documents of title have terminated, all wells have been abandoned and a final settlement of accounts has been made among the parties. Unfortunately, contingent tortious and statutory liabilities may continue after such events.

By way of illustration, consider the following situation. The well is abandoned and the Operating Procedure terminates. (In fact, according to its terms, the Operating Procedure terminates upon abandonment even if the abandonment is not done in accordance with the Regulations.) The well is on land in respect of which the operator holds the surface lease. The surface restoration was inadequate and, consequently, the surface owner suffers damages for which he sues the operator. In addition, the regulatory authorities intervene imposing

additional clean-up obligations. In such a scenario, the operator's contractual right to indemnification from the joint operators may no longer exist since the Operating Procedure has terminated.

To rectify this potential problem, the termination provision of the Operating Procedure should include a survival clause preserving the operator's right to contribution and indemnification from the joint operators where liabilities contingent at the time of termination of the Operating Procedure become actual liabilities.

In the Frontier Operating Procedure, this issue is addressed by Clause 23.11 which deals with the term of the agreement and stipulates that indemnities are to survive. It reads:

"... all Documents of Title have terminated and all wells on the Agreement Lands have been Abandoned, all equipment relating thereto has been salvaged and a final settlement of accounts has been made among the Parties provided that those provisions related to audit, liability, indemnity, disposal and salvage of material and enforcement on default shall survive for six (6) years thereafter."

D. Replacement of Operators

Under the Operating Procedure, upon replacement of an operator, the replaced operator is released and discharged of its duties and obligations and the successor operator assumes all duties and obligations of the operator except the unsatisfied duties and obligations of the operator accrued prior to the effective date of the change of the operator.

Accordingly, the replaced operator remains liable for the unsatisfied duties and obligations accrued prior to the effective date of the change of operator.

With respect to tortious liability, in particular, it may be years before the contingent liability actualizes and becomes an accrued liability. Since at the date of change of operatorship the liability has not accrued, the replaced operator may be relieved of such liability even in circumstances where the liability is as a result of the replaced operator's gross negligence. Under the terms of the Operating Procedure, the obligation to satisfy those claims which have not accrued as of the effective date are assumed by the new operator; however, if they arise because of the gross negligence of the replaced operator, the joint operators may object to any indemnification because of the exclusion for gross negligence. Similarly, any insurance that may otherwise have covered the situation may not be available because of an exclusion for gross negligence.

To rectify this problem, an appropriately worded exclusion to the replaced operator's release should be inserted in the Operating Procedure.

E. Insurance

The dollar amounts of coverage required by Section 311 of the Operating Procedure with alternative (A) are too low in circumstances where there are unusual dangers involved in operations because of the existence of toxic substances or because operations are being conducted in environmentally sensitive areas. In addition to the insurance coverage mandated by Section 311 of the Operating Procedure, many prudent

operators now also carry umbrella liability insurance which covers bodily injury, death and property damage to a limit of \$10-15 million and "well control" to a limit of \$5-10 million.

Generally, coverage for long term environmental damage and sudden and accidental spills is excluded from comprehensive general liability policies and environmental impairment liability insurance is difficult to obtain. There are, however, a few underwriters writing this insurance on a claims made basis (ie., the claim must be made during the policy period). Generally, the coverage limits are low (\$1-2 million both per claim and annual aggregate). Minimum deductibles of \$10-50,000 are not unusual. Typically, all insured locations must be scheduled and clean-up costs are often not covered. Usually, claims are excluded from coverage where the insured know about or could reasonably have foreseen the environmental impairment prior to the inception of the policy or where the environmental impairment is attributable to the insured's intentional, willful or deliberate non-compliance with applicable statutes and regulations. Also, payment of fines and penalties is often not covered.

Operators and joint operators may also want to reconsider the Operating Procedure requirements relating to insurance coverage of contractors and subcontractors. Under the Operating Procedure, the only obligation of the operator with respect to contractors or subcontractors is to use reasonable effort to ensure that the contractor or subcontractor carries adequate insurance. What happens if the operator uses reasonable effort but the contractor nonetheless does not carry adequate insurance? Both under tort law and under many applicable statutes, the operators and joint operators may be liable for damages caused by contractors and subcontractors. Moreover, if the operator and joint operators have assumed that

the contractors and subcontractors are carrying adequate insurance, then they themselves may not have procured the amount of insurance which they would have otherwise.

Similarly, under some of the insurance provisions now used, the joint operators are responsible for carrying their own insurance but may not have the right to be informed of whether the other joint operators are carrying adequate insurance. Given the frequency of joint and several liability, the inadequacy of one joint operator's insurance may negligently impact on the other joint operators.

F. Indemnification

Pursuant to the indemnification provisions of Section 402 of the Operating Procedure, operators are entitled to indemnification for operations carried on pursuant to the Operating Procedure provided that they have not been grossly negligent. Difficulties may arise in situations where an operation is not carried out strictly pursuant to the Operating Procedure because of some irregularity in procedure. In addition, and perhaps more importantly, there is a lack of judicial interpretation of the term gross negligence in the area of oil and gas operations and it is extremely difficult to know where the line will be drawn between gross negligence and negligence.

The Frontier Operating Procedure recognizes the difficulty surrounding the interpretation of gross negligence and addresses it by the inclusion of the following definition:

"Gross Negligence" means such willful misconduct or such willful omissions or such wanton and reckless conduct or omissions, as

constitutes in effect a willful or utter disregard for harmful, foreseeable and avoidable consequences."

G. Surrender and Quit Claim of Joint Lands

Article XI of the Operating Procedure provides for the surrender and quit claim of a party's interest to the other parties. It appears that in drafting the surrender provision, the liabilities which were foremost in the drafter's minds were those that related to rentals and accordingly the provision deals adequately with such liabilities by providing that surrender may only occur if "there is not then existing with respect to those joint lands an obligation which cannot be avoided by surrender or quit claim to the grantor of the title documents".

The provision is silent, however, on the matter of contingent liabilities and therefore parties may surrender interests in the joint lands in respect of which there are not existing liabilities but for which there are contingent liabilities and thereby shift the ultimate burden for liabilities relating to environmental matters. Accordingly, if contingent liabilities are a concern, the responsibility for them should be addressed in the surrender provisions.

As a practical matter, in circumstances where there are legitimate concerns about contingent liabilities, when a party receives a surrender notice it should consider whether it appears that the surrendering party is trying to avoid liabilities other than those associated with the payment of rentals. If there is reason to suspect that there are other

contingent liabilities which parties are attempting to avoid, then the recipient of the surrender notice may consider doing likewise.

Under the Frontier Operating Procedure, liability for the Abandonment (which by definition includes site restoration) cannot be shifted by surrender. Prior to surrender, the salvage value of the surrendering party's interest is estimated, as is its share of abandonment costs, and the payment by the appropriate party is required.

H. Concerns Relating to Facilities

1. Facilities Not Covered by Operating Procedure

The Operating Procedure governs only operations on the joint lands such as the drilling of wells, and not the ownership and operation of joint facilities constructed or operated in connection with the joint lands. Specifically, the definition of "equipping costs" establishes the extent to which downstream operations are covered by the Operating Procedure; ie., it includes initial treatment costs, but specifically excludes costs incurred beyond the point of entry into a gathering system, plant or common facility. A separate construction, ownership and operation agreement covering these facilities should be executed by the owners; however, persons frequently neglect to enter into such agreements erroneously believing that the Operating Procedure extends to all related facilities.

In instances where there is no agreement governing the operation of a facility and an operator finds itself liable for either environmental damage associated with the operation of a facility or reclamation costs associated with

a facility site, the operator will not have the benefit of a contractual right of indemnification and contribution from the other joint venture participants. To guard against such an eventuality, operators should ensure that there are subsisting agreements governing the operation of all facilities used by the joint venture participants.

2. Assignments of Interests

In drafting operating agreements governing facilities, drafters are confronted with many of the same issues as are encountered in the drafting of agreements relating to well operations. While a general discussion of the specific provisions of agreements for the construction, ownership and operation of facilities is outside the scope of this paper, there is one issue we wish to point out. This issue relates to assignability of interests. In our discussion of abandonment of wells, we indicated that interest owners should be aware that other owners may use surrender of interest as a method of avoiding reclamation liability. The other obvious method which interest owners should guard against is the use of assignment.

For example, once a well has been depleted past a certain point, the administrative costs associated with the well may make it uneconomic for a major company to retain its interest; however, a junior company, with lower overhead expenses, may find continued operation of the property economic, provided that it can purchase the property for an attractive price. With the expectation of avoiding abandonment costs, the major company may be willing to sell the property at an extremely low price. Until recently, whether or not the junior company which purchased the property conducted the abandonment and site reclamation in

accordance with the applicable government regulations, the company which sold was relieved of liability for these operations; however, in the future this may not be the case. Many new-generation environmental statutes expressly fix liability on prior owners; thus, in the future assignment may not relieve past owners of obligations relating to environmental damage. Moreover, it appears that as a matter of policy, the Energy Resources Conservation Board is now pursuing past owners of "orphaned" wells.

An analogous problem is occurring, and may be expected to occur with increasing frequency, with respect to facilities. Under typical construction, ownership and operation agreements, an owner may avoid obligations for site reclamation by simply transferring its interest to another entity. Under most of these agreements, the transfer is effective upon the assignee executing a copy of the construction, ownership and operation agreement; the other owners of the facilities do not have even a right to withhold consent, provided that the requisite documentation has been executed. When it is time to conduct the reclamation operations, those other owners may find that their proportionate costs are increased because prior owner's have assigned their interests to either financially distressed entities or shell companies.

This potential problem should be addressed in the drafting of these agreements by:

- (a) either requiring bonds or other forms of security, or requiring the establishment of a reserve fund from which the costs of reclamation may be paid;

- (b) providing that interest owners have the right to withhold consent to the assignment by another interest owner based on an assessment of the financial capabilities of the proposed assignee; or
- (c) providing that notwithstanding any assignment, assignors are not relieved of their obligations under the agreement.

VIII. The Northern Badger Decision - Can the ERCB Order the Cost of Abandoned Wells to be Paid Out of Funds Held by a Receiver for the Benefit of Secured Creditors?

1. Recourse to a Creditor's Security Interests to Pay for Environmental Clean-Up Costs

The decision in Panamerican de Bienes Y Servicios, S.A. v. Northern Badger Oil & Gas Ltd. (1989), 75 Alta L.R. (2d) 185 (Q.B.) is of interest to secured creditors who take security from borrowers whose operations are subject to environmental regulation.

In Panamerican the issue was whether the cost of abandoning wells (approximately \$200,000) could be ordered by the Alberta Energy Resources Conservation Board (ERCB) to be paid out of funds held by a receiver for the benefit of secured creditors or out of any residual funds payable to a trustee under federal bankruptcy legislation, or whether the province which regulates the activity of the bankrupt would have to pay the abandonment costs. The Chambers Judge found that abandonment orders under the Alberta Oil & Gas Conservation Act, which are intended to prevent pollutants being released from abandoned wells, are subject to the

scheme of distribution set forth in Section 136 of the Bankruptcy Act. This means that the costs of provincial environmental regulation are to be borne by the provincial government in instances in which a debtor subject to an abandonment order has become bankrupt.

Canadian legislation is developing which purports to hold lenders and receivers liable as owners or operators. Such risks to secured creditors are not substantially diminished with the Panamerican decision particularly where federal environmental legislation is concerned. However, if the Panamerican case is upheld on appeal, creditors may find it will be useful, when possible, to rely on the provisions of the Bankruptcy Act in order to argue that the proceeds of any security realized upon go to benefit the secured creditor as opposed to being used to pay for compliance under provincial environmental clean-up or site abandonment regulations.

2. The Bankruptcy Act and Orders of the ERCB

The ranking of the ERCB abandonment order in priority behind that of secured creditors was related solely to an analysis of bankruptcy law and how it affects the claim the ERCB creates for itself with abandonment orders.

Because the ERCB was seen as having been within its authority, the issue essentially became whether an order of this sort affects the law as to distribution by a receiver charged with the distribution of debtors' assets among its secured and unsecured creditors. The claim of the ERCB was seen to be provable in bankruptcy under Section 121 of the Bankruptcy Act. The ERCB was delegated to the status of a

creditor seeking to have its claim preferred to that of a secured creditor and to the scheme of distribution set forth in Section 136 of the Bankruptcy Act.

By adopting this approach, the court deferred to Parliament to decide the issue of whether the public purse or the secured creditors would pay for the ERCB order. As MacPherson, J. stated:

"The Bankruptcy Act has not been amended to deal with modern social problems of abandonment of contaminated property. Here the abandonment and the securing of potentially dangerous well sites is at the expense of the secured creditors' entitlement if the ERCB were to succeed."

2. Implications of this Decision

This decision is currently being appealed by the ERCB and the Attorney General of Alberta, as Intervenor. If this decision is upheld at the appeal level, it will leave the issue of who pays the costs in these situations squarely in the hands of the federal government. Essentially, amendments to the Bankruptcy Act may have to be made in order for the costs imposed by site abandonment and clean-up orders under similar provincial legislation, to be borne by secured creditors.

3. Legislative Intervention

Secured creditors, however, are beginning to face clear legislative statements which affect their security interests.

In Ontario, recent amendments to the Environmental Protection Act and the Water Resources Act permit provincial authorities to recover clean-up costs by creating a statutory lien on the property which may be collected by local municipalities with the same priority as municipal taxes. Secured creditors will be faced with the payment of these costs in realizing on their security.

Proposed new Alberta environmental legislation varies with respect to how it affects the interests of secured creditors. Costs incurred in carrying out general "environmental protection orders" and "emergency environmental protection orders" will be recoverable by an action in debt against the persons to whom such orders are directed. Recovery in this manner should have no effect upon a creditor's security. However, costs of "environmental protection orders" may also be recovered by the Minister from a subsequent purchaser of the property which, as a practical matter, would likely diminish the value of a creditor's security.

In collecting expenses incurred by a local authority under an order to clean up "unsightly property", the proposed legislation provides that such expenses are recoverable as a municipal tax. This provision would seem to have a similar effect as the recent Ontario amendments. The draft Alberta legislation does not expressly refer to the creation of a statutory lien which could pose problems for collection by the government where bankruptcy has intervened. If such environmental costs are to be imposed as taxes after the date that bankruptcy intervenes, it will likely be left to the courts to decide whether secured creditors may side step the proposed legislation by relying upon a distribution scheme which favours them under the Bankruptcy Act.

4. Recommendations

Depending upon the method of collection of expenses incurred in complying with provincial environmental legislation, there will be a significant impact upon secured creditors. Where costs of environmental policing and clean-up are recoverable as municipal taxes, secured creditors will see the amount to be realized under their security on such property diminished. The decision in Panamerican will provide a serious incentive for provinces to follow the Ontario lead in order to include responsibility for the costs of environmental enforcement and clean-up on secured creditors rather than the government. The best protection for secured creditors will, as a result, be to investigate environmental risks before lending and to monitor environmental performance thereafter.

VIII. Proposal to Limit the Public Risk from Corporate Insolvencies Involving Inactive Wells

In December, 1989, the ERCB released a position paper entitled "Recommendations to Limit the Public Risk from Corporate Insolvencies Involving Inactive Wells" (the "ERCB Position Paper").

As a result of ERC-Industry-Government discussions subsequent to the release of the ERCB Position Paper, a joint industry task force comprised of representatives from CPA, IPAC and SEPAC was formed to develop an industry response to the ERCB Position Paper and to the social problem of orphaned wells. On December 13, 1990 this Joint Committee Task Force released its "Recommendations to Limit the Public Risk from Corporate Insolvencies Involving Inactive Wells" (the "Industry

Recommendations"). The recommendations contained in the Industry Recommendations have been approved by the respective governing boards of the three industry associations.

In particular, the Joint Committee Task Force objected to two suggestions of the ERCB Position Paper.

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