Mesa Operating Ltd. v. Amoco Canada Resources Ltd. (Alta. C.A.), [1994] A.J. No. 201

Alberta Judgments

Alberta Court of Appeal
Calgary, Alberta
Kerans, Irving JJ.A. and Moore J.
March 15, 1994.
1994 CarswelAlta 89
Appeal No. 13606

[1994] A.J. No. 201 | 19 Alta. L.R. (3d) 38 | 149 A.R. 187 | 13 B.L.R. (2d) 310 | 46 A.C.W.S. (3d) 644

Between Mesa Operating Limited Partnership, Plaintiff, (Respondent/Appellant by Cross-Appeal), and Amoco Canada Resources Limited, Defendant, (Appellant/Respondent by Cross-Appeal)

(24 pp.)

Case Summary

STATUTES, REGULATIONS AND RULES CITED

Oil and Gas Conservation Act, s. 72(4)(c).
Oil and Gas Conservation Regulations, Alberta Reg. 151/71 as am., s. 4.020(2).

[Ed. note: A Corrigendum was released by the Court April 8, 1994; the correction has been made to the text and the corrigendum is appended to the judgment.]

Mines and Minerals — Unitization agreements, general — Exercise of operator's unilateral power to pool royalty properties — Validity — Operation and production agreements — Revenue distribution — Entitlement of joint venture partner electing not to contribute to development costs.

Appeal and cross-appeal. In 1979, the plaintiff respondent sold its mineral interests in several parcels to the appellant. However, it retained an overriding royalty of 12.5 per cent of the proceeds received by the appellant from the properties. The agreement between the parties gave the appellant the right to pool or unitize any portion of the properties. In 1980, the appellant built a successful gas well on one of the royalty properties. It later claimed that it then had pooled that property with another property owned exclusively by it. Because the two parcels were of identical size, the respondent, by reason of the pooling, received only half of the royalty it would have received. The plaintiff subsequently commenced these proceedings seeking unpaid royalties. According to the evidence adduced at trial, one of the well-established practices of the oil and gas exploration and

development industry was that an operator pools on a reserve basis if the geographical data clearly show the boundaries of the reservoir and those boundaries were significantly at variance with the size of the corresponding surface parcels. Finding that 98 per cent of the well was located on the royalty property and that the appellant breached its contractual duty of good faith in deciding upon pooling on an aerial basis, he held the respondent entitled to unpaid royalties. The respondent had also retained the overriding gross-royalty in several properties in which the appellant held only a working interest and was not the operator. When the appellant received demands from the operators to contribute toward development, it refused. However, development proceeded resulting in producing wells on 18 properties where the appellant had elected "non-consent". While permitting the appellant to refuse to contribute, the agreement between the parties deprived the appellant of any participation in the fruits of the success during a "penalty period" until the operator recovered all development costs and a substantial penalty. At first instance, the appellant had unsuccessfully claimed a share of the revenues received during the penalty period. Accordingly, while the appeal involved the interpretation of the appellant's unilateral power to pool or unitize portions of the properties sold to it by the respondent, the cross-appeal involved the question of the appellant's entitlement during the penalty period.

HELD: Appeal dismissed.

Cross-appeal dismissed. The trial judge's findings of fact were amply supported by the evidence. Also, he was correct in the conclusions that he arrived at. Accordingly, there was no reason to interfere with his disposition of the matter. With respect to the act of aerial pooling by the defendant, the plaintiff respondent, had, at a minimum, the reasonable expectation at the time it made the agreement that the appellant would consider both aerial and reserves-based pooling, and follow whichever route the facts justified. That expectation might also have been that the operator would advise the holder of the gross royalty of all the facts of the matter in a case where the decision was anything but completely straightforward and, as here, there happened to be a conflict of interest. Given that the appellant was required, at law to perform the contract in accordance with the reasonable expectations created thereunder, it fell short of its obligations when it decided on aerial pooling in the manner it did. Also, with respect to the issue comprised in the cross-appeal, the agreements between the parties did not provide that revenues during the penalty period were in any sense received for the appellant, hence the correctness of the trial judge's conclusion on that issue.

D.J. McDonald Q.C. and A.S. Harvie, for the Respondent. C.D. O'Brien Q.C. and E.B. Mellett, for the Appellant.

REASONS FOR JUDGMENT

The judgment of the Court was delivered by

KERANS J.A.

1 This is an appeal and cross-appeal from findings about the interpretation and performance of a contract.

2 In 1979, the plaintiff Mesa sold its mineral interests in several parcels to the defendant Dome, now Amoco. It retained "... an overriding royalty ..." of 12.5% of the " ... proceeds received by

(Dome) ... " of the "... petroleum (and) natural gas ... produced and marketed from or allocated to ..." the properties.

3 In 1990, Mesa sued Amoco for, among other relief, what it claimed were unpaid royalties. It was successful in part at trial, and recovered a judgment. Amoco appeals that award. Mesa cross-appeals for those royalty claims denied by the trial judge.

4 These two appeals raise issues about two provisions in the original agreement. The first granted Amoco " ... the right to pool or unitize any portion ..." of the properties. The other permitted Amoco, where it was not the operator of a property, to refuse to contribute money to the development of a property. While I do not entirely agree with all the analysis by the learned trial judge of the several issues between the parties, I am of the view that his conclusion in this case was the correct one, or, at least, not one with which this court ought to interfere. I would therefore dismiss both the appeal and the cross-appeal.

5 As they raise quite separate issues, I will deal with each in turn.

I

6 The appeal by Amoco turns on the power, or "discretion", granted to it by the agreement by Mesa to pool properties.

7 In 1980, Amoco drilled a successful gas well on one of the royalty properties, the south half of a section of land in the Caroline field. Amoco later claimed that it then had pooled that property with the northern half-section, respecting which Mesa had no royalty, and which, curiously, Amoco owned outright. The pooling was said to be areal, which means that the production is shared by those in the pool in the proportion the surface acreage of each parcel bears to the entire section. The two parcels being of identical size, Mesa by reason of the pooling received only half of the royalty it would have received had there been no pool. The trial judge said that this was wrong, and ordered Amoco to pay the full royalty. His reasons, and an exhaustive review of facts, are reported at (1992) 129 A.R. 177.

8 The trial judge did not find that pooling was unjustified. On the contrary, the law requires a pooling in these circumstances. The normal spacing unit for a gas well in Alberta is an entire section of land. See s. 4.020(2) of Oil and Gas Conservation Regulations (alta. Reg. 151/71, as amended). Nor, Mesa conceded, did he accept its trial argument that there was in fact no pooling. Nor did he accept Mesa's claims of fraud. He did, however, find that the agreement obliged Amoco to pool on the basis of the actual location of the gas reservoir, and also found that the reservoir in fact did not extend into the northern half-section. (Before us, counsel called this "reserves" pooling.)

9 The learned trial judge concluded that the pooling arrangement should have left all the revenue for the holders of interests in the southern half. He ordered an account, and return of all monies taken by Amoco on the basis of the areal pooling.

10 The appeal of Amoco had three branches. It first said that it had, in the circumstances of this case, breached no contractual duty in selecting areal pooling over reserves pooling. It next said that, even if the contract imposed consideration of reserves-based pooling here, an equitable division would not leave all the fruits for the owners of the southern half and deprive the northern

half of any benefit, not even the power to drill on their own lands. The third branch, abandoned during oral argument, raised a limitations period.

11 The first ground engages the question what if anything is the limit on the power to pool granted Amoco in the contract. Amoco does not claim that power is absolute; it acknowledged before us that the power must be exercised in good faith, as it would interpret that phrase. Mr. O'Brien, for Amoco, contended that we should say that Amoco's duty to act in good faith simply means that it cannot act from bad motives, as, for example, he conceded it would have done had it deliberately chosen areal pooling to advance its own position over that of Mesa. He insisted that the state of mind of the party said to have breached the contract was "particularly important" in an inquiry about a breach of a duty to act in good faith by a party who has been granted a "discretion" by the contract. [Factum p. 17] And liability would only flow if the exercise of the discretion was "motivated by bad faith reasons, such as dishonesty or a deliberate attempt to harm the legitimate interests of the other contracting party."

12 He emphasized that the trial judge had found only that the Amoco employees who chose areal pooling ought to have been more careful. The actual finding was that Dome/Amoco "... knew or must have suspected that the reservoir was located entirely or substantially under the south half of the section." Mr O'Brien said this was the highest the trial findings, and the Mesa case, could be put. He said that the most that could be said of Amoco here is that it was less than diligent when it chose areal pooling. He argued that the duty to act in good faith does not include a duty of care.

13 Mr. McDonald during oral argument sought to step past this legal issue by contending that Amoco pooled on an areal basis for no reason other than to dilute the interest of Mesa, and thus breached the duty even as Amoco described it. The learned trial judge, in my view, took care not to go that far in his finding. He said only:

> "... I find that the knowledge that they possessed at the time of pooling as to the most likely reservoir dimensions and geographical markers should have alerted them to their good faith obligation to consult with Mesa."

He did not say that any Amoco employee had deliberately fudged the matter in order to dilute the Mesa interest, and did not clearly make a finding of bad motives or of bad faith in that sense. On the contrary, he seemed to accept the evidence of the Amoco landman and geologist about their intentions when the decision to pool was first made. I mention this in more detail later, but the burden of that evidence was that they simply failed even to consider the possibility of reserves-based pooling. His finding is a reasonable one and available on a fair assessment of the evidence, notwithstanding the many troubling facts pointed to by Mesa that, it said, suggested darker forces at work. The case thus unavoidably engages the issue whether liability can exist in the absence of bad motives.

14 The second answer of Mr. McDonald was that the duty to act in good faith extends beyond the duty to avoid acting for bad motives. He argued, and the trial judge accepted, that:

> In Canada, the test ... does not include the need for the plaintiff to show that the defendant intentionally acted in bad faith.
>
> ... the common law duty to perform in good faith is breached when a party acts in bad faith, that is, when a party acts in a manner that substantially nullifies the contractual

> objectives or causes significant harm to the other, contrary to the original purposes or expectations of the parties.

15 I agree with the learned trial judge. My only hesitation is whether one need, in this discussion, employ the term "good faith". In my view, we should hold carefully to the distinction between the two sources of rules about contracts, the law and the contract. Sometimes a rule of law imposes a duty or a constraint upon the parties to a contract despite their agreement, as is the case of the rules about illegal contracts and unconscionable contracts. On other occasions, however, the courts impose a rule upon the parties because we conclude that this fulfils the agreement. In other words, the duty arises as a matter of interpretation of the agreement. The source of the rule is not the law but the parties. I worry that the term "good faith" in this case might blur that distinction.

16 A general obligation expressed in terms of good faith is not an obvious part of contract law in England and Canada, although Professor E. P. Belobaba advocates otherwise. See Belobaba, "Good Faith in Canadian Contract Law", 1985 Special Lectures of the Law Society of Upper Canada, 73. It is part of the civil law. See National Bank of Canada v. Soucisse et al, [1981] 2 S.C.R. 339. And it has become part of the general law of contract in the United States. See the Restatement of the Law, Contracts 2d (St. Paul: American Law Institute Publishers, 1981). The restatement also offers the vocabulary for the American approach to pooling clauses, and the exercise of a unilateral power to pool. See, for example, Boone v. Kerr-McGee Oil Industries Inc. (10 Cir 1954), 217 F (2d) 63 at 65, where the Court said:

> Where discretion is lodged in one of two parties to a contract or a transaction, such discretion must, of course, be exercised in good faith. That simply means that what is done must be done honestly to effectuate the object and purpose the parties had in mind in providing for an exercise of such power.

17 Kelly, J., in Gateway Realty Ltd. v. Arton Holdings Ltd. and La Have Developments Ltd. (No. 3) (1991) 106 N.S.R. (2d) 180 expressed a strong preference for this approach. The decision was affirmed on appeal without explicit approval of all his views on this point. See (1992) 112 N.S.R. (2d) 180. And it is true that there are some casual references to "bad faith" in cases collected by Professor Belobaba.

18 The argument the other way is that "good faith" is too vague a term. It might be said that it would encourage judges to wander unnecessarily far into the thicket of extra-contractual rules of conduct. This is the point made by the redoubtable Professor Clark. See D. Clark, "Some Recent Developments in the Canadian Law of Contracts" (1993) 14 Advocates' Q. 435. See also S. J. Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith" [1980] 94 Harvard L.Rev. 369 at 389.

19 In any event, it is not necessary for this case that I go further into this difficult area. This is because this case turns on a rule founded in the agreement of the parties, not in the law. In my view, as a matter of fact, this contract created certain expectations between the parties about its meaning, and about performance standards. If those expectations are reasonable, they should be enforced because that is what the parties had in mind. They are reasonable if they were shared. Of course, those expectations must also, to be reasonable, be consistent with the express terms agreed upon. This contract should be performed in accordance with the reasonable expectations created by it.

20 The assessment of those expectations should include regard to the commercial context. That context, of course, here included the traditions and practices of the oil and gas exploration and development industry. One of those practices, well established in the evidence, is that an operator pools on a reserves basis if the geographical data clearly shows the boundaries of the reservoir, and those boundaries are significantly at variance with the size of the corresponding surface parcels. Indeed, that practice is reflected in the law of Alberta The Energy Resources Conservation Board, who have jurisdiction to order pooling if the parties cannot agree, is directed by statute to order reserves-based pooling if that is "equitable". See Oil and Gas Conservation Act s.72(4)(c). Its practice, established by many decisions in pooling controversies, confirms what I have said.

21 I therefore conclude that, at a minimum, the reasonable expectation of Mesa and Dome/Amoco, at the time they made their agreement, was that Amoco would consider both areal and reserves-based pooling, and follow whichever route the facts justified. That expectation might also have been that the operator would advise the holder of the gross royalty of all the facts of the matter in a case where the decision was anything but completely straightforward and, as here, there happened to be a conflict of interest.

22 The rule that governs here can, therefore, be expressed much more narrowly than to speak of good faith, although I suspect it is in reality the sort of thing some judges have in mind when they speak of good faith. As the trial judge said, a party cannot exercise a power granted in a contract in a way that "substantially nullifies the contractual objectives or causes significant harm to the other contrary to the original purposes or expectations of the parties."

23 So stated, the governing rule is analogous to the rule that would arise in other cases. It is, for example, not unlike the duty owed to a principal by a gratuitous agent. See Fridman, The Law of Agency, 6th ed. (Toronto, Butterworth, 1990) at 144. The rule would also be analogous to the rule in cases where one party has been granted the right to judge whether a contractual obligation of the other has been performed. In that event, the modern view is to look for, and if found, enforce an expectation that the "judge's party" will act reasonably and responsibly. See Greenberg v. Meffert et al (1985), 18 D.L.R. (4th) 548, 50 O.R. (2d) 755 (C.A.) [leave to appeal to S.C.C. refused, 64 N.R. 156 (note), 14 O.A.C. 240 (note) (S.C.C.)]. See also Jack Wookey Hldg. Ltd. v. Tanizul Timber Ltd. (1988), 27 B.C.L.R. (2d) 221 (B.C.C.A.) and Shibamoto & Co. v. Western Fish Producers, Inc. (Trustee of) (22 May 1992), Vancouver 480/A-343-91 (Fed. C.A.). But see Truman v. Ford Motor Co. of Canada Ltd., [1926] 1 D.L.R. 960. The duty to act in accord with settled expectations about pooling is also not unlike the duty to use reasonable efforts to satisfy a condition subsequent. See Dynamic Transport v. O K Detailing Ltd. [1978] 2 S.C.R. 1072.

24 Mr. O'Brien also argued that an industry practice of reserves pooling was not yet well established in 1981, when this matter came before Amoco employees for action. Unfortunately for that view, there is considerable evidence, including from Amoco employees, to indicate otherwise. While the judge made no explicit finding on this point, it was implicit in his approach to the case. In any event, were I wrong in that, I would make that finding on the basis of my own assessment of the evidence of the Amoco employees. Both the landman and the geologist involved were aware of the practice, although they said they understood that reserves-based pooling was rare. What happened here is that the landman said he thought it was up to the geologist to warn him if the facts warranted any special consideration, and the geologist said he

did not consider the question what form of pooling should occur. Between them, they simply failed to consider the matter. That was a breach of contract.

25 That breach would be a trifling matter if the facts did not warrant serious attention to at least the possibility of reserves pooling. Mr. O'Brien argued that the geologist testified he had no sense of certitude at the time about the boundaries of the reservoir. With respect, that is not the point. He, by his own admission, at the time knew that there was a good chance that the reservoir boundary did not extend into the north half. That knowledge imposed upon him a duty to take further steps, and he did not do anything. That was the point made by the learned trial judge, and he was right.

26 What remained, then, was merely to decide what would have occurred had Amoco performed its contract correctly. That takes us to the second ground of appeal.

II

27 The second ground of appeal is that the learned trial judge erred in his assessment of damages in failing to place the complaining party in no better position than it would have enjoyed had there been no breach. The argument supposes that, even if Amoco had consulted Mesa about the pooling at the time of the drilling, the likelihood is that it would nonetheless have occurred on an areal basis. I agree that a court does not offer much relief for a breach of contract that had no unhappy consequences.

28 The principal argument in support is that, even if Amoco had consulted Mesa, and even if the pooling question had gone before the Energy Resources Conservation Board, the likely result would have been that the Board would have ordered areal pooling. The error of the trial judge, it was said, was in failing to ask what the Board would have done. Had he asked that question, he would have concluded that the Board would not order reserves pooling unless it could say to a near certainty what were the boundaries of the reserve. In this case, it is common ground that the reservoir Amoco discovered lay inside the sandy shores of an old river-course, which seems to have meandered not unlike a modern prairie river. While it had wandered about the southern half more than it did the northern half, it was impossible precisely to say what were its boundaries. Therefore, it was argued, the Board would refuse to order reserves pooling. The pooling done by Amoco would be left to stand.

29 The argument about non-direction has merit only in that the learned trial judge did not explicitly ask what the Board would have done. He did, however, observe that, if Amoco had consulted Mesa, Mesa could "... urge that an application be made to the E.R.C.B. to resolve the matter." He had heard and noted the evidence of many witnesses, including Amoco witnesses, about the need for "... an abundance of control to provide a delineation of a pool that would indicate the fairness of pooling on a reserves basis..." (at 129 A.R. 177 at 211) And at 209 he had heard and noted the evidence of a Board employee that an applicant who complained that areal pooling was inequitable must produce "...geological, engineering, and seismic data...". In my view, he must be taken as having accepted that, had the matter gone before the Board, that tribunal would have ordered reserves pooling only if the evidence in support was persuasive. I infer that he simply reduced the question "What would the Board have done?" to the question "Is the reservoir boundary proven?" And he made this answer at 221:

> I find, on the balance of probabilities, that the producing reservoir underlies the south 1/2 of section 4. That is the opinion expressed in the reports of Davis, Hughes, and Janbaz.

> Murison and Coles did not say that they were wrong. They contended that the data was insufficient to establish the location and size of the reservoir with certainty and likely insufficient to justify consideration of a reserves based method of pooling. However, in the case of Murison, it is worth noting that his early 1982 map placed the reservoir substantially under the S1/2 section ...

30 The argument is that this reduction stepped past several issues. The first is about burden of proof. Does the Board decide the question on the balance of probabilities? It is said, on the contrary, that it requires the evidence establishing the boundaries of the reservoir to meet a more stringent test. Mr O'Brien suggested the burden was "a high degree of certainty." I have read several Board decisions. Unsurprisingly, they do not articulate a burden of proof, and adjectives and adverbs are loosely used. On my reading of the decisions, the Board examiners give relief only when persuaded about the facts of the matter. Understandably, because they analyze evidence about conditions about two miles below the surface of the earth, they sometimes find the theories un-persuasive, and sometimes deny relief because the theories before them are not convincing. But I do not agree that the Board denies relief unless the matter is entirely free from doubt. I suspect some degree of doubt is inevitably present in these assessments. I therefore conclude that the burden of proof required by the Board is the balance of probabilities, with the onus on he who suggests areal pooling is inequitable. The learned trial judge employed the same burden of proof as that accepted by the Board, and his failure to ask what burden the Board employed did no harm.

31 It was said also that the learned trial judge failed to address the question on the basis of what the Board might have heard in 1980. It is true that he heard the evidence 12 years later, and that some witnesses said that less was known in 1980. This is a weak argument. The issues were not before the Board in 1980 because of Amoco's default. At the very least, it was for Amoco to show that there would have been a different result in the previous decade. The evidence is not at all convincing that this is so.

32 It was also said that the learned trial judge failed to consider that "... but for the contribution of the north half ... the ... well could not have produced any revenues." [Factum par. 68] This is a reference to the statutory rule that effectively forbids further drilling after the first well in a section. Again, Amoco is the author of that situation. As the owner of the north half it could have, even before drilling, asked for a pooling or indeed a drilling permit. It did not. It might be that, if it had made a request for areal pooling from Mesa before drilling, Mesa or indeed the Board would have agreed. But can it now turn its failure to advantage by speculating about what might have been? At the very least, it would need to demonstrate the alternative convincingly. Again, it has failed to do so. Nor has it shown from analysis of Board decisions that the Board awards compensation for deprivation of the loss of the right to drill.

33 It was also said that the learned trial judge failed to consider that reserves pooling was rare. In the last decade or so, it has been ordered by the Board on only 17 occasions. I see no great weight to this fact. The real issue is whether this case is one of the rare ones. It is if the judge is persuaded, as he was, that the reservoir lies under only the southern half.

34 It was also said that it would have been impossible for Amoco at the time to take this case before the Board. This is because Amoco at the time owned both tracts and, of course, supported areal-based pooling. The Board, we were told, would not deal with a dispute between the owner of a tract and the holder of a gross royalty trust. In my view, the Board would have heard Amoco's application if Amoco had explained that it owned both tracts, and favoured areal

pooling, but that a royalty interest challenged this view. After all, the purpose of the statute is to expedite useful drilling as well as discourage useless exploration. Indeed, it is not clear to me that the Board ever lost jurisdiction in this case, although that option was not fully explored because the parties were content to let the trial judge decide the case.

35 Lastly, it is said that the evidence indicated that at least some small portion of the reservoir likely is under the north half. It is correct that some witnesses conceded that this was a possibility. One calculated, however, that even the Murchison 1981 estimate for Amoco, which the trial judge preferred over Murchison's later estimate, put 98 per cent of the gas in the reservoir under the south half. Most of the experts, moreover, said that the likelihood was that the reservoir was entirely under the south half. This supported the finding of the trial judge, which of course refused to concede even a small percentage to the north half. Nor does the existence of that evidence assist Amoco in its argument that the trial judge failed to ask what the Board would have done, for the reasons already noted.

36 In the end, I reject this ground of appeal also, and would dismiss the Amoco appeal.

III

37 The cross-appeal turns on another term in the contract, and different events. The details are in the trial decision, but the essence is that Mesa also retained the overriding gross royalty in several properties in which Amoco held a working interest but was not the operator. Moreover, when it received demands from the operators for a financial contribution toward development, Amoco refused to contribute. Development nevertheless proceeded, and producing wells were drilled on 18 properties where Amoco had elected "non-consent". The agreement with the operator in each case indisputably permits Amoco to refuse to contribute, but deprive Amoco of any participation in the fruits of this success during a "penalty period" until the operator recovers all development costs plus a substantial penalty. The dispute in the suit is about the consequence of Amoco's non-consent for the calculation of the gross royalty. Mesa contended that the royalty was payable by Amoco on all the earnings of the well during the penalty period; Amoco said that the royalty was suspended while its revenue was suspended.

38 The starting-point of the Mesa argument was that the royalty was explicitly a gross royalty. In other words, it was calculated on the basis of the gross revenue from the well, without any deduction for development or other expense. It was common ground before us that, had Amoco consented to the contribution, and began at once after production to receive revenue, it would have been obliged to pay the royalty and it could not have deducted development costs.

39 The learned trial judge accepted that the contract with Mesa indeed obliged Amoco to pay a royalty on "gross proceeds". He stepped past the Mesa argument, however, by relying on the contractual definition of that term, which was that it meant gross proceeds "received" by Amoco. He then adopted the argument for Amoco that gross proceeds "received" means gross proceeds to Amoco. In the case of a non-consent well, Amoco would get no proceeds until the penalty period ended. This he described as the literal and plain meaning of the term.

40 Mesa suggested before us that he accepted a narrow meaning for the word "received". He seems to have required receipt in a physical sense, an actual transfer of funds. Mesa protested that this meaning is neither plain nor literal, because the word "receive" can and often does describe receipt for a person, not just by a person. A simple example is receipt by an assignee or agent, or by a creditor who then sets the amount received off against a debt.

41 I agree that the term "received" means receipt for as well as by a recipient. I have the greatest difficulty offering a reason why one would not accept the broader sense. It is indeed hard to credit that Amoco could deprive Mesa of a royalty by the simple technique of assigning its right to receive it to, say, a creditor. I am in no way assisted in this position by talk about meaning being plain. But I would adopt the wider meaning because otherwise there would be an absurd result.

42 In fairness, I should add that I am also not entirely persuaded that the learned trial judge adopted the narrow view. Unfortunately, however, his meaning is not plain.

43 The broader view, in any event, necessarily requires one to rule on the legal status of the well earnings during the penalty period as between the operators and Amoco, which raises a matter of interpretation of the agreements between them. This the learned trial judge did not do, which gave rise to the attack by Mesa.

44 Much of the argument before us turned on the question whether, under those agreements, the production revenues during the penalty period were in any realistic sense received for Amoco even though they were admittedly not received by Amoco. For example, those agreements might have acknowledged an entitlement of Amoco for the revenues, but placed a charge against them for a debt-charge owing by Amoco's for production costs. In that case, it might be said that the operator paid the revenues to the credit of Amoco and a royalty was payable.

45 After a review of those agreements, I am of the view that they do not provide that revenues during the penalty period in any sense are received for Amoco. I therefore am of the view that the learned trial judge came to the correct conclusion.

46 My agreement comes in part from a broader perspective. I agree with Mesa that one should look at the commercial context. I agree that the gross royalty here does not share the right or cost of exploration but does share in the fruits of exploration. But that context also answers the Mesa complaint that one should start from the assumption that a royalty, because it is a gross royalty, would be payable even on revenues earned by a third party without deduction of the expenses incurred by the third party. In my view, the commanding fact is that the royalty agreement does not in any way oblige Amoco to work the interest. And it leaves the choice whether to go non-consent with Amoco exclusively. Whether Mesa gets a penny from even the most promising property depends on the decision of Amoco, wholly independent from Mesa, whether to make the huge and uncertain investment that is the hallmark of the industry. If Amoco decides not to participate, Mesa then is in the hands of a similarly independent investment decision by strangers to the contract. I adopt this argument for Amoco:

> An overriding royalty is carved out of the working interest. Thus the fortunes of that royalty holder track those of the working interest holder. If Dome chooses not to expend funds for drilling costs on a non-producing property, there will be no production and Mesa receives no royalty. Similarly if Dome chooses to go non-consent there will be no proceeds from the working interest until such time as the penalty period is over. ...

47 The significance of the lack of any commitment to invest is that Amoco has no risk of royalty except from production revenue. From this perspective, it is not surprising to see that the royalty agreement provides for a gross royalty on "proceeds received by the Purchaser" as opposed to

"earnings of the well". There would be no need for this except to affirm that Amoco is never at risk of payment of a royalty from its own pocket.

48 The non-consent clause, in turn, can be seen as a sort of rental of the working interest accompanied by a right of first refusal. It is common in the oil and gas industry, as are shared working interests, and this permits each player to establish its own development plans and budgets. The benefit to working interests and royalty-holders alike is to encourage more investment generally in the industry, much more than the amount planned by or within the means of the firm with which the royalty-holder has its agreement.

49 From this perspective, it is not surprising to see that the model agreement of the Canadian Association of Petroleum Landmen, used for some of the operating agreements under review, refers to the non-participating interest as though ownership has changed hands, albeit temporarily. Clause 1008 provides that "... the participating parties shall be entitled to retain possession of the well and to all production therefrom." The other agreements contain similar terms. Some deem an alteration in ownership by reference to an assignment. The effect is the same. During the penalty period, the interest of Amoco is deemed to cease, and the interest is held by those who participate. I see nothing suspicious in this.

50 In the case of the agreements that use the assignment terminology, Mesa contended that they cannot be said to assign the right to proceeds in any way that impairs the Mesa claim because, if that were the case, the operating agreements were in breach of the covenant against assignment in the royalty agreement. The answer is that another covenant in the royalty agreement permits that sort of thing, and is necessarily paramount. I refer to the term permitting Amoco to decide not to participate in development. That implies, in the light of all that I have just said, that it may also execute operating agreements that provide that, in doing so, it will lose any claim to any sort of interest in revenue during the penalty period.

51 I therefore agree that, while "proceeds received" in the royalty agreement means proceeds received for as well as by Amoco, both the royalty agreement and the other agreements mean to say that production revenue during a penalty period are not received for, let alone by, Amoco.

52 It was contended for Mesa that subsequent conduct of Amoco offers a different view. Reliance was placed also on internal memoranda by staff landmen and lawyers arguably asserting the existence of an obligation. I see no error on the part of the learned trial judge in putting no emphasis on these matters, although he should indeed have discussed them. In any event, they are not determinative. I agree with Lambert J.A. that subsequent conduct by individual employees in a large corporation are not always reliable indicators of corporate policy, intention, or understanding. See Re Canadian National Railways and Canadian Pacific Ltd. 95 D.L.R. (3d) 242 (B.C.C.A.) at 262 (aff'd. [1979] 2 S.C.R.668). Indeed, in this case, the learned trial judge heard many examples of confusion in the offices of what was then Dome, and heard the explanation that Dome was in the middle of a huge expansion program.

53 I would, for these reasons, dismiss the cross-appeal.

IV

54 In the result, I would dismiss both appeal and cross-appeal. In my view, the parties should bear an equal obligation for costs. The simplest way to achieve this is to provide that each party bear their own costs, except that Mesa must pay Amoco one-half the cost of production of the

appeal books. No other costs issues having been raised in the factums or during oral argument, I would make this a final order.

KERANS J.A.

IRVING J.A.:-- I concur.

MOORE J.:-- I concur.

* * * * *

Corrigendum

Released April 8, 1994

Attached is corrected page 7. The correction made is as follows:

PAGE 7:
First sentence, Line 1, 2 & 3:
"The argument the other way is that "good faith" is
too vague a term. It might be said that it would
encourage judges to unnecessarily far into the thicket
of extra-contractual rules of conduct."

has been corrected to read:

"The argument the other way is that "good faith" is
too vague a term. It might be said that it would
encourage judges to wander unnecessarily far into the
thicket of extra-contractual rules of conduct."

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