THE OIL AND GAS ROFR: UNDERSTANDING CURRENT ROFR ISSUES FROM THE POINT OF VIEW OF THE TRANSACTIONAL LAWYER, THE LITIGATOR, AND IN-HOUSE COUNSEL

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Rights of first refusal and other preferential or pre-emptive rights (together, ROFRs, and individually a ROFR) routinely find their way into oil and gas industry agreements. Disputes often arise because of the complex nature and significant economic consequences of ROFRs. In recent years, a number of reported cases, either relating directly to ROFRs or more generally relating to contractual interpretation, have clarified (or at times muddied) the waters surrounding the use, application, and interpretation of ROFRs. However, most ROFR disputes never result in a reported decision because the parties typically negotiate solutions long before trial.

The authors consider current trends involving ROFRs in oil and gas agreements, and how they believe the law and legal practice surrounding ROFRs might continue to evolve in the years to come. The authors do not attempt to rehash the fundamentals of the law surrounding ROFRs; instead, they focus on how the courts have dealt with ROFRs in recent cases as well as how corporate lawyers and in-house counsel grapple with ROFRs day-to-day. The authors utilize the ROFR provisions found in industry standard contracts to analyze outstanding areas of uncertainty as well as what lawyers should contemplate prior to including a ROFR in an agreement. Additionally, the article examines the implications of recent rulings on the duty of good faith that may affect ROFRs. Finally, the article considers selected subjects of topical interest, including ROFRs in the context of busted butterfly transactions, insolvency proceedings, and package deals.

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I. INTRODUCTION

The scope and application of contractual provisions that create ROFRs[1] are limited only by the drafter's creativity.[2] Historically, parties have negotiated all aspects of a ROFR's function, including specific triggering events, notice procedures, and exceptions. In tandem with the growth and evolution of the oil and gas industry in Canada, a series of standardized ROFR provisions have emerged and evolved as the starting point for parties considering the inclusion of a ROFR.

However, many of the early ROFR provisions remain in effect. Some of these early ROFR provisions contain archaic clauses that are ambiguous in their application and implication or have lost relevance or meaning over time. As a result, many ROFR disputes still involve these early ROFR provisions.

Since these early days, the industry has largely moved to standard form agreements (including ROFR provisions) that have been tested by negotiators and the courts. The use of industry operating procedures began with the form developed by the American Association of Professional Landmen.[3] The Canadian Association of Petroleum Landmen (CAPL) subsequently developed a form of agreement to suit the unique characteristics of oil and gas exploration and development in Canada (the CAPL Operating Procedure).[4]

Many Head Agreements[5] append the CAPL Operating Procedure, which contains an optional ROFR provision. This ROFR provision evolved in response to disputes or challenges as the industry developed.[6] Further, the iterations of the CAPL Operating Procedure were tested in each instance by the particular circumstances that arose throughout

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1 Note that the ROFR discussion in this article is limited to rights to match a bargain agreed to by a seller and a buyer. It is not intended to include, and is distinct from, rights of first negotiation and rights of first offer (together ROFOs). Such ROFOs typically give the seller's co-owners a right to negotiate to acquire the sale asset *before* the seller is permitted to market the sale asset to a third party buyer. ROFOs are seen as less burdensome to sellers and less valuable to co-owners than ROFRs for several reasons, based primarily on the difference in the administrative burdens and the deal dynamics amongst the seller and its co-owners. It is arguable that a ROFO may provide greater certainty in its application than a ROFR, but there are issues with ROFOs that are similar to some of the ROFR issues we discuss herein. A full analysis of ROFO provisions is outside the scope of this article.

2 The reasons for granting a ROFR are generally twofold: (1) to give the ROFR holder a degree of control over the identity of any new co-owners by allowing the ROFR holder to acquire the seller's interest in preference to and in place of any proposed buyer; and (2) to give the ROFR holder the ability to increase its interest in a particular asset. See Robert Flannigan, "The Legal Construction of Rights of First Refusal" (1997) 76:1 Can Bar Rev 1 at 5–6.

3 Nicholas P Laurent, "A Day in the Life of a JOA – Selected Daily Operational Issues" (Paper delivered at the 2011 Energy Law Institute at the South Texas College of Law, 1 September 2011), [unpublished] at P-1, online: <www.mcginnislochridge.com/images/uploads/news/11-09-01_Laurent_A_Day_in_the_Life.pdf>.

4 Canadian Association of Petroleum Landmen, *2015 CAPL Operating Procedure* (Calgary: CAPL, 2015), online: <www.landman.ca/resources/forms-store/2015-capl-operating-procedure/>. There are several versions of the CAPL Operating Procedure that will be discussed in this article. For simplification, unless specified otherwise, references to a particular clause in this article refer to the provision as set out in the *2015 CAPL Operating Procedure*.

5 Agreements that may include a ROFR, including joint operating agreements, operating procedures, pooling agreements, farmout or earning agreements, and other types of arrangements where the parties may share the same property by each having a working interest, will be referred to collectively as Head Agreements throughout.

6 See e.g. *Canadian Long Island Petroleums Ltd v Irving Industries Ltd*, [1975] 2 SCR 715 [*Long Island Petroleums*].

business and asset life cycles. However, ROFRs are becoming narrower in focus.[7] Increasingly, owners recognize that they will probably seek to sell an asset at some point during their tenure of ownership. Given the different characteristics and approaches of different owners,[8] few owners hold an asset from cradle to grave. When parties negotiate new agreements, they must weigh the relative benefits and burdens of including a ROFR, not only for themselves, but also implicitly for all of their successors.[9] Successor owners take the benefits and the burdens of the ROFR choices made by their predecessors. In the authors' experience, it is uncommon for the successor owners to renegotiate an agreement to either add or remove a ROFR.

This article considers some of the recent trends and legal issues related to the interpretation and application of ROFRs in the Canadian oil and gas context, in particular the ROFR provisions in the CAPL Operating Procedure and some alternative contractual forms. The authors have not attempted to restate the fundaments of ROFRs that have already been well-documented and discussed by other commentators.[10] Nevertheless, to aid the understanding of the current ROFR issues discussed in this article, a brief review of the common forms of ROFR provisions and the related procedures may be useful. This article also considers the implications of the Supreme Court of Canada's decision in *Bhasin v. Hrynew* as to the increased focus on good faith and the duty of honest performance in all commercial disputes, including ROFR-related disputes.[11] This article concludes by looking at selected ROFR issues facing the industry today, including ROFRs in busted butterfly transactions, implications of insolvency proceedings, and recent decisions involving package sales.

II. CONTRACTUAL TRENDS

A. THE CAPL OPERATING PROCEDURE

The CAPL Operating Procedure is the most widely used operating procedure in the Canadian oil and gas industry. It has evolved as the standard form in Canada, facilitating faster deal-making, creating greater certainty through standardization, and curing identified

7 Canadian Association of Petroleum Landmen, *2015 CAPL Operating Procedure Annotated (Part III)* (Calgary: CAPL, 2015) at 56, online: <www.landman.ca/wp/wp-content/uploads/2015/11/2015-CAPL-Operating-Procedure-Annotated-Part-III.pdf> [*Annotated 2015 Procedure*].

8 For example, a wildcatter might always intend to sell out before incurring development costs, a developer may decide to sell out before primary production is completed, and an enhanced oil recovery specialist may be interested in extending the life of mature assets.

9 See the discussion in Part II.D, below.

10 See e.g. Gordon L Tarnowsky, Miles F Pittman & Carolyn Wilton, "Restrictions on Disposition in the Oil and Gas Industry: The Extinction of the Species?" (2007) 44:3 Alta L Rev 477; Keith T Smith & Shawn HT Denstedt, "Preemptive Rights and the Sale of Resource Properties: Practical Problems and Solutions" (1992) 30:1 Alta L Rev 57; Flannigan, *supra* note 2; Clifford D Johnson & David J Stanford, "Rights of First Refusal in Oil and Gas Transactions: A Progressive Analysis" (1999) 37:2 Alta L Rev 316; Douglas G Mills, Carolyn A Wright & Julie JM Inch, "Exploring the Balance of Power in the Operator/Non-Operator Relationship Under the CAPL Operating Procedure" (2010) 48:2 Alta L Rev 363; Paul M Perell, "Options, Rights of Repurchase and Rights of First Refusal as Contracts and as Interests in Land" (1991) 70:1 Can Bar Rev 1; Craig Spurn, Jana Prete & Melissa Zerebeski, "The 2007 CAPL Operating Procedure" (2009) 46:2 Alta L Rev 427.

11 2014 SCC 71, [2014] 3 SCR 494 [*Bhasin*]. See also *Styles v Alberta Investment Management Corporation*, 2017 ABCA 1, 408 DLR (4th) 725.

and anticipated contractual deficiencies. CAPL first published the document in 1971 and subsequently updated it in 1974, 1981, 1990, 2007, and 2015.[12]

The *2015 CAPL Operating Procedure* aims to balance the interests of all parties, reflects the lessons learned and legal developments predating its publication as well as evolving business practices, and includes updated considerations to address previous gaps that arose through the emergence of shale plays and horizontal drilling.[13] The *2015 CAPL Operating Procedure* is a refinement of the *2007 CAPL Operating Procedure*, which made broad changes to the widely adopted *1990 CAPL Operating Procedure*. Helpfully, CAPL compiled the changes within these three forms of agreement into a comprehensive table.[14] Specific to ROFRs, the primary enhancements built into the provisions after the *1990 CAPL Operating Procedure* relate to the handling of earning agreements, the ability to avoid perpetual ROFRs, and the increase in the scope of exceptions to limit the application of ROFRs.[15]

Historically, the CAPL Operating Procedure has not been subject to extensive customization by users. Instead, users would append the form of CAPL Operating Procedure to their Head Agreement and select from a series of options on a printed election sheet. The CAPL Operating Procedure requires that any amendments to the standard form must be made: (1) by underlining or strikethrough text on the printed form of CAPL Operating Procedure; (2) in the Head Agreement itself; or (3) in a separate schedule, or else those amendments are deemed inoperative.[16] However, this rigidity may be relaxing somewhat. The *2015 CAPL Operating Procedure* recognizes that users increasingly use custom provisions where no clear industry practices exist (for example, in respect of independent operations for resource plays). This might signal the start of a trend whereby CAPL users will make increasingly extensive modifications to the standard printed form.

1. ALTERNATE B — ROFR

On dispositions of working interests in jointly-owned assets, clause 24.01 of the CAPL Operating Procedure allows the parties to elect to include either Alternate A, the consent requirement,[17] or Alternate B, the ROFR requirement that is the focus of this article. The ROFR provision in Alternate B has evolved out of the industry's experience with asset

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12 Mills, Wright & Inch, *supra* note 10 at 365.

13 Jim MacLean, "Overview of Update: 2015 CAPL Operating Procedure" (24 November 2015), online: <www.landman.ca/wp/wp-content/uploads/2015/11/Overview-of-Update-2015-CAPL-Operating-Procedure.pdf>.

14 Jim MacLean, "Material Differences Between 1990 and 2007/2015 CAPL Operating Procedures" (24 November 2015), online: <www.landman.ca/wp/wp-content/uploads/2015/11/Material-Diff-between-1990-and-20072015-CAPL-Operating-Procedures.pdf>.

15 However, as to the ROFR exceptions, as discussed in Part II.A.2, below, the later forms of the provision also added a bona fide requirement to rely on such exceptions. For a larger discussion on the risks of continuing to use the *1990 CAPL Operating Procedure*, see Jim MacLean, "2007 CAPL Operating Procedure: Why You Should Be Much More Afraid of the 1990 CAPL Operating Procedure Than the 2007" (Lecture delivered at the Canadian Association of Petroleum Land Administration, 9 June 2011), online: <https://www.landman.ca/landman_support/Content/Why%20You%20Should%20Be%20Afraid%20Of%20The%201990%20than%20the%202007.pdf>.

16 *2015 CAPL Operating Procedure*, *supra* note 4, cl 1.15.

17 *Annotated 2015 Procedure*, *supra* note 7 at 57. A reasonable basis to withhold consent might include a reasonable belief that the proposed buyer would not be able to meet its financial obligations, or concerns that one's interest would be adversely affected. See *IFP Technologies (Canada) Inc v EnCana Midstream and Marketing*, 2017 ABCA 157, 53 Alta LR (6th) 96 at paras 202–203 [*IFP Technologies*]; *Exxonmobil Canada Energy v Novagas Canada Ltd*, 2002 ABQB 455, [2003] 3 WWR 657 at para 49; *1455202 Ontario Inc v Welbow Holdings Ltd* (2003), 33 BLR (3d) 163 (Ont Sup Ct J) at para 9.

rationalization programs, a greater understanding of when it is most appropriate for ROFRs to apply, and an appreciation that ROFR provisions have important implications that deserve consideration before any decision is made to include (or not include) them.[18]

Clause 24.01, Alternate B of the *2015 CAPL Operating Procedure* requires that the seller notify the ROFR holders of the proposed sale, and gives each ROFR holder 30 days from such notice to exercise its ROFR or be deemed to have waived its right.[19] Where there is such a waiver, the ROFR holder retains a consent right to the sale. The 2007 and 2015 CAPL Operating Procedures also contain an optional provision to provide an expiration date for the ROFR.[20]

Despite the significant value of the oil and gas assets involved, relatively few cases have gone before the courts that involve the ROFR provision of the CAPL Operating Procedure, or even ROFRs attaching to oil and gas assets generally.[21] There are at least three explanations for this. First, parties may prefer a negotiated compromise, because either the asset value does not justify the cost of litigation, or the parties determine that the certainty of a negotiated compromise is a preferred alternative to a possible "all or nothing" litigation outcome. Second, litigation timelines may prevent disputes from reaching a courthouse, given that litigation can take years and most parties are reluctant to hold up a deal and take market risks over this time. Third, many agreements provide for dispute resolution by private and confidential arbitration so that the disputes do not end up before the court.[22] In the following sections, the authors discuss some current issues and recent judicial considerations pertaining to the ROFR provision within the CAPL Operating Procedure.

a. Contents and Timing of ROFR Notices

Determining the content of the ROFR notice can be one of the more difficult procedural elements of applying the ROFR provision. Subclause 24.01B(b) specifies the information that the seller must provide to the ROFR holder for the ROFR notice to be valid. This information includes identifying the assigned working interest, the name of the proposed assignee, the price or other consideration, the proposed effective or closing date, and "any other information about the terms of that disposition it reasonably believes would be material to the exercise of [the ROFR holder's rights]."[23] It is this final requirement that may present some difficulty, as what is "reasonably material" is subjective and may not be clear.[24]

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18 *Annotated 2015 Procedure*, *ibid* at 56. See Part II.D, below.

19 *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.01B(f)–(g).

20 Wherein the provision reverts to the consent right found in Alternate A, see the *Annotated 2015 Procedure*, *supra* note 7 at 56–57. See also Spurn, Prete & Zerebeski, *supra* note 10 at 494.

21 Tarnowsky, Pittman & Wilton, *supra* note 10 at 480.

22 See e.g. the optional dispute resolution provision contained in the *2015 CAPL Operating Procedure*, *supra* note 4, cl 21.00.

23 *Ibid*, cl 24.01B(b)(v).

24 The wording of this requirement is less harsh than the older *1981 CAPL Operating Procedure*, for example, which required that the ROFR notice contain all "terms and conditions" of the disposition, which is arguably a higher standard. See *Online Constructors Ltd v Speers Construction Inc*, 2011 ABQB 43, 99 CLR (3d) 198 at para 26. See also *Theratechnologies inc v 121851 Canada Inc*, 2015 SCC 18, [2015] 2 SCR 106, Abella J (a material "fact" is anything "that may reasonably be expected to have a significant effect on the market price or value" at para 23); Smith & Denstedt, *supra* note 10 at 85–87.

The authors note that there is a variety of commercial practices regarding the inclusion of a copy of the sale agreement (with or without redactions) with the ROFR notice. Some sellers make the sale agreement available at their office for review, but otherwise attempt to maintain the confidentiality of the sale agreement. Other sellers and buyers are comfortable providing a copy of the sale agreement, with redactions of any information not relevant to the ROFR.[25] CAPL recommends attaching the finalized sale agreement to the ROFR notice, but this practice is not yet standard across the industry.[26] In the authors' experience, if a seller or buyer is required to make a public announcement or file the sale agreement with a stock exchange, they are usually more comfortable providing a copy of the sale agreement to the ROFR holder. Where a seller or buyer is particularly concerned that the ROFR holder will either challenge the validity of the ROFR notice or exercise its ROFR, those parties tend to provide a copy of the sale agreement. The intent in providing a copy of the sale agreement is to foreclose a ROFR holder's challenge to the adequacy of the ROFR notice (and avoid any consequential delays in the sale process), and to prevent any renegotiation of the sale agreement if the ROFR holder decides to exercise its right.

The seller and buyer should consider the risks of not providing a copy of the sale agreement with the ROFR notice. If the seller only provides a summary of the material terms, but fails to disclose all of the burdens on the buyer in the sale agreement, and the ROFR holder exercises its ROFR, the ROFR holder could argue that any burdens not disclosed in the summary are not part of the bargain struck by the exercise of the ROFR.[27] In this way, the seller's failure to disclose any terms can only create a better bargain for the exercising ROFR holder. Contrast this with the situation where the seller fails to include in the summary any material terms that benefit the buyer and the ROFR holder. In this case, the ROFR holder could argue that it is entitled to a new ROFR notice, because the seller is not permitted to complete its sale to the buyer on terms that are more favourable than the terms offered to the ROFR holder.[28]

Further, if there are amendments to the sale agreement after issuance of the ROFR notice, the seller should issue a new ROFR notice. If the seller does not issue a new ROFR notice and such amendments are material, then it is possible that the original ROFR notice could be invalid because the proposed transaction between the seller and the buyer proceeded on terms that are different from those offered to the ROFR holder.

There is some flexibility in the timing for issuing ROFR notices under the *2015 CAPL Operating Procedure*. It is clear that the seller and buyer cannot complete their sale before the seller has complied with the ROFR provisions.[29] For this reason, sellers and buyers

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25 See e.g. information on and provisions related to non-ROFR assets in the *2015 CAPL Operating Procedure*, *supra* note 4.

26 *Annotated 2015 Procedure*, *supra* note 7 at 57.

27 *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.01B(f): "A Notice of Acceptance creates a binding contractual obligation on the Disposing Party and an Offeree giving a Notice of Acceptance to proceed with the disposition and acquisition of that Working Interest on the terms and conditions described in that Disposition Notice and the agreement to which it pertains."

28 *Ibid*, cl 24.01B(h). This principle is set out in the seminal case of *Manchester Ship Canal Company v Manchester Racecourse Company*, [1901] 2 Ch 37 (Eng CA).

29 Sellers and buyers sometimes provide for a closing in escrow in their sale agreements to provide additional flexibility and to avoid delays related to ROFRs on assets that may not be critical to their transaction. In these cases, the assets subject to the ROFR are held in escrow, pending the expiration of the applicable time for exercise, and the resolution of any disputes initiated by the ROFR holders. If the ROFR is exercised, the assets subject to a ROFR are removed from escrow and conveyed to the ROFR

generally tend to provide ROFR notices promptly after execution of the sale agreement. However, in other cases, it may be more practical for the seller and the buyer to delay sending a ROFR notice.[30] For example, the seller and buyer may wish to delay sending the ROFR notice until after they have secured all required regulatory approvals[31] so that they can complete their transaction within the allotted grace period.[32] In addition, the seller may wish to delay sending the ROFR notice until the sale is unconditional, because if the ROFR notice is sent and the ROFR holder exercises its rights, there is a binding obligation to buy and sell between the ROFR holder and the seller.[33]

b. Non-Cash Consideration and Valuation

Sometimes the consideration for a sale cannot be matched in kind[34] or the ROFR assets are packaged with non-ROFR assets, meaning that a value must be attributed to the ROFR assets alone as well. In these cases, issues may arise regarding the seller's "bona fide estimate of the value (or allocated value), in cash, of that consideration as it applies to that [working interest]"[35] under clause 24.01B(e). In these cases, the ROFR holder may dispute the seller's valuation, and the dispute would then be resolved through the dispute resolution mechanism contained within the CAPL Operating Procedure.[36]

While the obligation to provide a valuation falls upon the seller under the CAPL Operating Procedure, the buyer often has the right under the sale agreement to reasonably allocate value. The buyer often has this right due to its greater interest in the allocation of value: (1) the allocation will impact the final price paid by the buyer for the final asset package it receives; and (2) the seller will be held whole in any event, as it will still sell the entire package of assets and receive the entire purchase price. In exchange for the buyer having the right to reasonably allocate the value, the buyer will often indemnify the seller against any challenge to the valuation by the ROFR holder.[37] The opposite case arises where the consideration cannot be matched in kind. In those cases, the seller has a greater interest in defining the value of the non-cash consideration, as the seller will not want to settle for a lesser bargain if the ROFR holder exercises its right. In any case, it remains ultimately the obligation of the seller to provide a bona fide allocation of value.[38]

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holder, and the sale agreement is amended to exclude such pre-empted assets from the assets sold to the buyer. If the ROFR is waived or expires, then the assets subject to the ROFR form part of the sale assets that are conveyed to the buyer, and the value thereof is reflected in the purchase price.

30 *Annotated 2015 Procedure*, *supra* note 7 at 58: "[A] Disposing Party should only issue its ROFR notice if it is confident that its transaction will proceed."

31 Such as any necessary approvals under the *Investment Canada Act*, RSC 1985, c 28 (1st Supp) and the *Competition Act*, RSC 1985, c C-34.

32 *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.01B(h)–(i). These provisions allow the parties 150 days after the ROFR notice to complete the sale. Because different agreements have different grace periods, it may be necessary to delay sending the ROFR notices so that the parties do not exceed the grace period while they are working to satisfy the conditions precedent to closing.

33 By reference to the Block A and Block B discussion in Part II.A.1.b.i, below, the seller, for example, might not wish to be obliged to sell Block B to the ROFR holder if it was not assured of also being able to sell Block A. See also *ibid*, cl 24.01(B)(f).

34 For example, a property swap, a royalty, shares in a public or private company, and so forth.

35 *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.01B(c).

36 *Ibid*, cl 21.00.

37 However, an indemnity might not provide the seller with complete protection if the ROFR holders seek an injunction to prevent the sale.

38 *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.01B(c).

i. Concerns Over Environmental Liabilities

The post-2014 downturn in the oil and gas industry, as well as some of the regulatory responses to the increased risk of owners being unable to fulfil their abandonment obligations, have created challenging circumstances for some sale agreements involving ROFRs. In Alberta, in response to the ruling in *Redwater Energy Corporation (Re)*,[39] the Alberta Energy Regulator (AER) issued Bulletin 2016-16 (as updated and clarified by Bulletin 2016-21, collectively referred to as the Redwater Bulletin).[40] The Redwater Bulletin included, *inter alia*, restrictions on transferring any AER-issued licences, approvals, or permits unless transferees could demonstrate that the transferee's Liability Management Ratio (LMR)[41] would be 2.0 or higher and the transferor could demonstrate that its LMR would be 1.0 or higher, each on a post-transfer basis.[42] The energy regulators in other provinces are also reviewing and revising their respective LMR programs to mitigate risks to the public.[43]

These enhanced regulatory thresholds are increasingly relevant. Consider the example where an asset package contains Block A, comprised of lands that are not subject to a ROFR and that have a negative value because of the future or net present value of their related abandonment and reclamation obligations (AROs), as well as Block B, which comprises a second group of lands that are subject to a ROFR and have a positive value. If, for example, the overall sale price for these packaged lands were $100 million, the value of Block B would be in excess of $100 million. In this circumstance, the value in the ROFR notice for Block B would be $100 million in addition to the estimated cash value associated with the assumption of the Block A unquantified AROs, representing non-cash consideration for the seller.

Such a scenario could create a number of questions for the seller, buyer, and ROFR holder:

- How would the unquantified Block A AROs be quantified? Sale agreements typically allocate past, present, and future environmental liabilities of sale assets (including AROs) to the buyer, but sale agreements typically do not try to quantify this liability.

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39 2016 ABQB 278, [2016] 11 WWR 716, aff'd 2017 ABCA 124, [2017] 6 WWR 301 [*Redwater*]. The AER plans to appeal the decision to the Supreme Court of Canada: see Alberta Energy Regulator, News Release, "AER to Appeal Redwater Decision to Supreme Court of Canada" (28 April 2017), online: <www.aer.ca/about-aer/media-centre/news-releases/news-release-2017-04-28>.

40 Alberta Energy Regulator, "Bulletin 2016-16" (Calgary: AER, 20 June 2016); Alberta Energy Regulator, "Bulletin 2016-21" (Calgary: AER, 8 July 2016).

41 Alberta Energy Regulator, "Directive 006" (Calgary: AER, 17 February 2016). The LMR is a formula derived from the ratio of an industry participant's deemed assets to its deemed liabilities, as set out in Directive 006. Subject to variance among asset classes and simplifying somewhat, "deemed assets" is calculated from the average production for each licenced asset multiplied by the average industry netback over the past three years, while "deemed liabilities" is an estimate of the costs to abandon and reclaim each well or facility.

42 Or otherwise provide evidence that the transferee would be able to meet its obligations throughout the life cycle of energy development with an LMR of less than 2.0. To achieve this required LMR before approving a transfer application, similar to a case where the licensee's LMR falls below 1.0 on its monthly assessments, the AER may require a security deposit from the licensee.

43 For example, British Columbia's regulator indicated that it will be conducting a review to determine how to respond effectively to *Redwater*, *supra* note 39: see British Columbia Oil and Gas Commission, "2017/18 — 2019/20 Service Plan" at 10, online: <https://www.bcogc.ca/node/13658/download>.

- Different parties may value the liabilities associated with the AROs differently. How would this affect the buyer and the ROFR holder, who may value such liabilities significantly differently?

- Will the buyer want to buy Block A if the ROFR is exercised on Block B? Buyers would likely not opt to complete a transaction for only the liability-laden Block A lands, meaning that the seller would be potentially stuck with these assets. Additionally, depending on the structure of the related sale agreement, the buyer's desire to terminate the agreement could lead to disputes or litigation.

- If the buyer can opt out of or cannot purchase Block A, can the seller complete a transaction for just Block B, even if it puts the seller offside of its LMR requirements?

- If it is possible to split the asset package between the buyer and the ROFR holder, how will the purchase price be split and adjusted, and how will the ROFR holder and seller compensate the buyer for the Block A AROs?

- If needed, would the ROFR holder, as the owner of Block B, post (or provide financial assistance to post) any applicable security deposit required by the AER to approve the transfers? Would the owner of Block A (the seller or the buyer) require additional security in excess of the statutory requirements from the ROFR holder as comfort that it be fully indemnified or compensated as set out in the original sale agreement?

Ultimately, it would appear that the seller would often be the party stuck holding the undesirable Block A lands. It is clear that there are several important live issues around AROs, other environmental liabilities, and the potential exercise of a ROFR.

ii. Facility Interests and Maintaining Service

Briefly moving away from land-related ROFRs, consider the example of a swap of facility interests, each subject to a ROFR, which may yield intriguingly complex valuation issues.[44] Assume two parties each own interests in two facilities in close proximity to each other in an area with constrained capacity in such facilities.

The Construction, Ownership and Operating Agreements (CO&Os) governing one or both facilities contain ROFRs. The parties wish to swap interests in the facilities so that each might increase its interest in one facility and reduce or eliminate its interest in the other.[45] The challenge is how to derive the cash value of each party's facility interest as its ROFR value for inclusion in a ROFR notice. One simple method would be to look at the replacement value of each facility interest being swapped. Given potential area capacity

44 Issues surrounding strategic valuations in ROFR situations, involving non-cash consideration specifically, are discussed in Tarnowsky, Pittman & Wilton, *supra* note 10 at 499–500, citing *Baggots Brass Beds Ltd v Neal Leasing Inc* (1989), 4 RPR (2d) 316 (Ont Sup Ct (H Ct J)).

45 A swapping party's rationale could relate to a desire to increase its interest in a facility where it is the facility operator, a plan to modify the facility or how it is operated, particular facility characteristics that it wants to exploit, or the pursuit of some other perceived operating efficiency.

constraints, however, this might leave a purchasing party who loses the asset by the exercise of a ROFR without the capacity it needs to process or transport its existing or planned production, unless and until this lost capacity can actually be replaced.

Arguably, the better valuation of each facility interest would be one that makes a party at risk of losing crucial capacity indifferent to that loss. In other words, the value of the interest being offered for swap is the replacement value of the swapped capacity plus the net present value of the delay in production that an exercise of the ROFR would cause. Then if one or both ROFRs are exercised, a party that ends up with a net loss of area facility capacity gives up its own facility interest in exchange for the cash value obtained from the exercised ROFR. Needless to say, a recipient of such a ROFR notice might be surprised by the ROFR valuation and want to better understand (and perhaps challenge) this rationale for determining the value of this non-cash consideration.

c. Earning Agreements

The *2015 CAPL Operating Procedure* clarified the status and procedure for the application of ROFRs in the case of earning agreements (such as farmout agreements).[46] Where there is an earning agreement, the farmor (seller) may choose to defer issuing a ROFR notice until it becomes certain that assets subject to a ROFR will form part of the earned interest through the conduct of a specific work program by the farmee (buyer), instead of issuing the ROFR notice upon mere execution of the earning agreement.[47]

Issues surrounding ROFRs and earning agreements came to a head in *Canadian Natural Resources Ltd. v. Encana Oil & Gas Partnership*.[48] In this case, a dispute arose as to the triggering date for the ROFR under a pooling agreement that included the *1990 CAPL Operating Procedure*. The defendant farmor farmed out its interest to a third party farmee under an earning agreement that included 15 blocks of land, two of which were pooled with the plaintiff ROFR holder's lands. The farmor did not provide a ROFR notice to the ROFR holder upon execution of the earning agreement. When the farmee indicated an intention to drill and earn on some of the pooled lands for the 2007 drilling season, the farmor notified the ROFR holder. The ROFR holder exercised its ROFR, but the parties disputed the location and timing for the drilling of the test wells, leading to the litigation. An application for summary judgment was made to the Court to resolve the issue, which initially ruled in favour of the defendant farmor.[49]

On appeal of the summary judgment, the ruling was vacated and sent back for a full trial. The Alberta Court of Appeal found that the agreement was ambiguous as to the triggering event for the ROFR and that, given the importance of the CAPL Operating Procedure to the oil and gas industry, a summary judgment application was not the appropriate method to resolve the dispute.[50] The Court further recognized that a ROFR is "an important contractual

46 Spurn, Prete & Zerebeski, *supra* note 10 at 492.
47 *Annotated 2015 Procedure*, *supra* note 7 at 57. See also *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.01B(a)(i)–(ii).
48 2008 ABCA 267, 440 AR 338 [*CNR*], rev'g 2007 ABQB 460, 33 BLR (4th) 163.
49 *CNR*, *ibid* at paras 5–15.
50 *Ibid* at paras 28–29.

right"[51] and that both parties' interpretations were reasonable. As such, the Court sent the case to trial so that there could be an analysis of the full evidentiary record, including evidence of industry practices.[52] The parties opted to negotiate a resolution of the dispute and the case never made it to trial. Although there was no judicial determination of the issue, the drafters of the *2015 CAPL Operating Procedure* resolved the ambiguities in the *1990 CAPL Operating Procedure* highlighted by this dispute.[53]

d. Royalty Interests

There is an increasing trend for oil and gas companies to finance their operations through the creation of a "manufactured" non-convertible gross overriding royalty (GOR) and the sale of that GOR to a royalty company or a financial investor. Clause 24.01 of the *2015 CAPL Operating Procedure* applies exclusively to a "Working Interest" and the definition of "Working Interest" excludes a GOR, so it seems reasonably clear that manufactured GOR transactions will not trigger a CAPL ROFR.[54] However, parties that are subject to non-CAPL ROFRs or parties drafting a custom ROFR provision ought to be cautious about the application or the potential application of their ROFR to a manufactured GOR transaction. In such circumstances, unless there is similar exclusionary language in the ROFR provision (such as is contained in the *2015 CAPL Operating Procedure*), the creation and sale of a manufactured GOR could trigger the ROFR. This is an important consideration, because many of the custom ROFR provisions apply to resource plays and oil sands projects, where manufactured GORs are becoming more popular.[55]

There are several potential future trends regarding royalties that could raise issues under the CAPL Operating Procedure. For example, in the past, while the "income trust" structure was popular for tax reasons, companies sometimes created and transferred 99 percent GORs within their own corporate groups. Today it is possible that a company might seek to create a large GOR and then sell that GOR to another party as a means of transferring a valuable interest in an asset or project, without having to be concerned about the LMR issues discussed in Part II.A.1.b.i, above, or a ROFR. If a seller undertook such a transaction, a ROFR holder might challenge that transaction on the basis that a party should not be able to do indirectly what it cannot do directly, as discussed in Part III.A, below.

In another example that presents multiple issues, consider a CO&O where an owner of oil- and gas-producing properties and facilities could, without triggering the ROFR on the

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51 *Ibid* at para 28.

52 *Ibid* at para 30.

53 *Annotated 2015 Procedure*, *supra* note 7 at 56–57.

54 See *2015 CAPL Operating Procedure*, *supra* note 4. Note that the 1971 and 1974 CAPL Operating Agreements are ambiguous in this regard as the provision purports to apply to the sale of "any interest in the joint lands." See e.g. *Husky Oil Operations Ltd v Forest Oil Corp* (1989), 68 Alta LR (2d) 206 at 211 (QB); *Best Pacific Resources Ltd v Eravista Energy Corp*, 2002 ABCA 286, 317 AR 308 at para 12 [*Eravista*].

55 See e.g. Athabasca Oil Corporation, News Release, "Athabasca Oil Corporation Upsizes Contingent Bitumen Royalty With Burgess Energy Holdings L.L.C. to $257 Million" (3 November 2016), online: <www.marketwired.com/press-release/athabasca-oil-corporation-upsizes-contingent-bitumen-royalty-with-burgess-energy-holdings-tsx-ath-2172762.htm>; Pengrowth Energy Corporation, News Release, "Pengrowth Announces the Sale of a 4.0% Gross Overriding Royalty Interest on Its Lindbergh Thermal Assets for $250 Million" (14 December 2016), online: <www.marketwired.com/press-release/pengrowth-announces-sale-40-gross-overriding-royalty-interest-on-its-lindbergh-thermal-tsx-pgf-2183330.htm>.

facility, dispose of its entire interest or any portion of it in the sale of all of its oil- and gas-producing properties in a defined area. Would either the seller's granting or reservation of the GOR to itself in respect of the producing properties trigger the ROFR on the facility, even if all of the producing properties are otherwise being sold? Several issues may come into play in making such a determination:

- whether the use of "producing" in the CO&O excludes a GOR, which is not a "producing property";[56]

- whether the structure of the GOR is an interest in land or an interest in the petroleum substances produced from the lands, as often a GOR is intentionally structured to be an interest in land;

- if the underlying purpose of the ROFR exception is to maintain alignment of the facility interest and the production interest, whether a GOR triggers the ROFR and would separate those interests and potentially lead to stranded production in the defined area; and

- the commercial context and the possibility of negotiations leading to better outcomes towards continued cooperation in the future.

2. CLAUSE 24.02 — EXCEPTIONS

Clause 24.02 provides several exceptions to the operation of the ROFR requirements of clause 24.01. The *2015 CAPL Operating Procedure* contains a requirement that all such exceptions are bona fide.[57] In reliance on the clause 24.02 exceptions, the seller must notify the ROFR holder of the disposition in a timely manner and provide reasons for its reliance on the particular exception. Depending on the exception relied upon, this information might include the total hectares being sold or farmed out, evidence that the seller is amalgamating or disposing of its interest to an affiliate, or evidence that the seller is selling all of its interest in the province. Such notices allow the ROFR holder to verify that the relevant exception applies and help to avoid disputes.[58]

Several of the exceptions found in the *2015 CAPL Operating Procedure* have been included in the CAPL Operating Procedures for many years. These exceptions include:

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56 To simplify for the purposes of this example, assume that the GOR holder does not produce and has no right under the CO&O to produce or to take its royalty in kind.

57 The term "bona fide" can be thought of as having a similar meaning to "honestly": see Neil Finkelstein et al, "Honour Among Businesspeople: The Duty of Good Faith and Contracts in the Energy Sector" (2015) 53:2 Alta L Rev 349 at 376, citing *The Queen v Holl* (1881), 7 QBD 575 (Eng CA). Generally, this requirement may exclude certain transactional structures, yet the case law demonstrates a degree of tension in the law: see *GATX Corp v Hawker Siddeley Canada Inc* (1996), 27 BLR (2d) 251 (Ont Ct J (Gen Div)) [*GATX*], as discussed in Part II.C, below, versus *Northrock Resources, a Partnership v ExxonMobil Canada Energy*, 2016 SKQB 188, 59 BLR (5th) 287 [*Northrock*], as discussed in Part III.A, below.

58 *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.02. Sellers often pay close attention to these exceptions when planning and structuring dispositions to reduce administrative burdens by limiting the situations where a ROFR may apply.

- *Security*: An assignment made by way of security for an assignor's present or future indebtedness, its issuance of debentures, or its performance as a guarantor under a guarantee (the exception does not apply if the security is enforced by sale or foreclosure to a party other than the secured creditor);

- *Affiliates or amalgamations*: An assignment to an affiliate or through an amalgamation (or other business combination), other than for a transaction that could limit the available remedies to the other party where the assigning party is subject to a notice of default;[59]

- *All or substantially all*: A disposition of all or substantially all (90 percent or more of its net hectares of working interest) of its oil and gas rights in the province, if the disposition is: (1) pursuant to a single transaction to two or more assignees or earned under an earning agreement; or (2) to the same proposed assignee in different transactions as of the same date;[60] and

- *Size threshold/de minimis*: A disposition, other than through an earning agreement where the net hectares of the joint lands being disposed of are less than 10 percent of the total net hectares of working interest in oil and gas rights being disposed of.[61]

With respect to the "all or substantially all" and the "size threshold or *de minimis*" exceptions, the authors can foresee a possible future trend where these amounts are calculated based on market value and not net hectares.[62] While market value, even where contractually defined, is arguably subjective, which could lead to more disputes than the mechanical and objective calculation of net hectares, net hectares might not be an appropriate measure in the era of resource plays and multiple stacked formations.

Consider a seller who acquires and packages 9,001 net hectares of "moose pasture" (nominally valued at $1) with 999 net hectares of prime resource play lands (valued at $20 million), and where the size threshold exception is applicable. The concentration of value in a relatively small area that occurs in a resource play might not align well with an area-based (as opposed to a value-based) threshold. In such highly concentrated areas with many stacked and productive formations, alternative approaches to this exception might be useful. For example, parties may wish to consider utilizing a value-based provision or some other mechanism to account for the high concentration in these types of areas. It may also be useful to have a dual threshold for the exception, that is, both area-based and value-based. This dual

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59 Note that this exception previously included a disposition in exchange for shares in a company or an interest in a partnership. Contrary to the trend of broadening the exceptions, the modernized version of this exception has been narrowed, with the rationale being to prevent its abuse. See Spurn, Prete & Zerebeski, *supra* note 10 at 497; Johnson & Stanford, *supra* note 10 at 325.

60 If a seller were interested in selling its assets in multiple provinces, it seems that the test would be applied on a province-by-province basis or the seller could establish separate asset packages for each province. This exception is not intended to apply to multiple transactions with multiple assignees: see the *Annotated 2015 Procedure*, *supra* note 7 at 59.

61 Prior to the *2007 CAPL Operating Agreement*, this percentage was 5 percent. See Jim MacLean, "Modifications to 1990 Operating Procedure" (16 August 2007) at 50, online: <www.landman.ca/>.

62 As is done in the Association of International Petroleum Negotiators (AIPN) Model International Joint Operating Agreement (JOA), which is discussed in Part II.B.2, below. See Association of International Petroleum Negotiators, *2012 Model International Joint Operating Agreement* (Houston: AIPN, 2012), online: <https://www.aipn.org/forms/store/ ProductFormPublic/joint-operating-agreement-2012> [*AIPN JOA (2012)*].

threshold would protect a ROFR holder's rights where the asset package involved a small but valuable producing area and a large undeveloped hot new play; under a value-based threshold alone, the hot new play might fall under the threshold and deprive the ROFR holder of an opportunity to exercise its rights.

In addition to these long-standing exceptions (as modified over time), additional exceptions were introduced in the *2007 CAPL Operating Procedure* and carried forward into the *2015 CAPL Operating Procedure*. These exceptions pertain to earning agreements specifically:

- *Size threshold for an earning agreement*: An arm's-length disposition pursuant to an earning agreement where the net hectares of the joint lands being disposed of are less than 35 percent of the total net hectares of working interest in oil and gas rights that can potentially be earned; and

- *Optional paragraph*: All bona fide earning agreements.[63]

The evolution of these exceptions demonstrates a desire to narrow the application of ROFRs, even where they would otherwise apply, especially in the case of earning agreements. Nevertheless, situations continue to develop, most interestingly for resource play areas, where some potential modifications could be desirable or even necessary.

B. ALTERNATIVE CONTRACTUAL FORMS

Sometimes, standard form agreements may not be useful. In these cases, parties must draft their own agreements to fit the circumstances. Such circumstances may include large joint ventures involving unique assets or projects (for example, oil sands mines or pipelines). Parties in these situations will still often use the standard forms as a starting point. In such cases, however, parties should be mindful of how courts have considered the provisions contained in standard form agreements as they make modifications to suit their needs.

One possible negative trend for custom agreements is that many oil and gas companies do not have the internal administrative structures needed to address the custom provisions of these agreements, and many administrators could incorrectly assume that the custom agreement is no different from the CAPL Operating Procedure. This has the potential to increase the costs of administration (through new or modified information technology systems), increase the time required for staff to administer the agreement, and lead to future disputes where parties assume and apply incorrect terms.

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[63] If only the optional provision in clause 24.02(f) is being relied upon as an exception, the other party still has a right of consent under clause 24.01A: see *2015 CAPL Operating Procedure*, *supra* note 4.

1. LANDS VERSUS FACILITIES

The CAPL Operating Procedure is used in joint ventures relating to the ownership and operation of oil and gas interests in land. However, a distinction must be drawn with the CO&Os that commonly govern joint ventures relating to the ownership and operation of major oil and gas facilities. The Petroleum Joint Venture Association (PJVA) publishes the most widely recognized standard form CO&O.[64] Although the PJVA form of CO&O does not incorporate the CAPL Operating Procedure, the PJVA form is influenced by the approach taken by CAPL.[65]

Users of a PJVA CO&O will typically customize their CO&O more so than users of the CAPL Operating Procedure, which results in more custom ROFR provisions in CO&Os. As such, while the baseline ROFR provision in CO&Os is similar to the CAPL Operating Procedure, it is more difficult to identify ROFR trends in CO&Os. The PJVA CO&O is not the focus of this article, but in Part III.C, below, the authors discuss some of the issues that may arise when an asset package contains ROFRs on both the lands and the facilities.

2. THE AIPN JOA

The Association of International Petroleum Negotiators (AIPN) Model International Joint Operating Agreement (the AIPN JOA)[66] has gained some acceptance in Canada owing to increased international investment in the Canadian oil and gas industry, and the emergence of large resource play joint ventures that contemplate more involved project governance. The AIPN JOA is one of the most widely used international forms for the joint operation of oil and gas assets, and it is a useful potential alternative to the CAPL Operating Procedure. Unlike the CAPL Operating Procedure, the AIPN JOA requires extensive modification to adapt it to the particular jurisdiction, the particular form of granting document (for example, a production sharing agreement, or a Crown or freehold lease), and the commercial agreement between the parties. Where a party seeks to use language from the AIPN JOA, that party must consider how to adapt that language to Canadian laws and, where appropriate, Canadian industry practices (commonly evidenced by the *2015 CAPL Operating Procedure*).

The AIPN approach to ROFRs differs from the CAPL Operating Procedure approach in several respects. The AIPN JOA provides three possible alternative approaches to a sale: (1) a consent requirement; (2) a ROFR that is conceptually similar to the CAPL Operating Procedure ROFR provision; and (3) a ROFO.[67] There is a further option to limit the ROFR

64 See the analogous ROFR provision in Petroleum Joint Venture Association, *1999 Model Operating Procedure: Construction, Ownership and Operation Agreement* (Calgary: PJVA, 1999), cl 901 (Alternate 901(C)).

65 With some key differences due to the subject matter, see *Annotated 2015 Procedure*, *supra* note 7 at A-5. The PJVA is also one of the industry stakeholders involved in the preparation of the CAPL Operating Procedure. See Letter of Endorsement from Petroleum Joint Venture Association to Nikki Sitch, President, Canadian Association of Petroleum Landmen (13 January 2015), online: <www.landman.ca/wp/wp-content/uploads/2015/11/2015-CAPL-documents-PJVA-endorsement.pdf>.

66 The last version was published in 2012: *AIPN JOA (2012)*, *supra* note 62. In 2014, the AIPN published a version intended for use with resource plays: Association of International Petroleum Negotiators, *2014 Model Unconventional Resource Operating Agreement* (Houston: AIPN, 2014), online: <https://www.aipn.org/forms/store/ProductFormPublic/unconventional-resources-operating-agreement-2014>.

67 See *AIPN JOA (2012)*, *ibid*, cl 12.2F (Alternative #1 and #2).

or ROFO to cash transfers only. Distinct from the CAPL approach, the AIPN JOA includes an optional ROFR or ROFO where an owner experiences a change in control.[68] In the authors' experience, parties will typically provide for exceptions to the change in control provisions where the parties are contemplating a particular transaction from the outset.[69]

The AIPN JOA includes an optional ROFR or ROFO on a change in control because of the structure of the international oil and gas industry. It is typical to have a special purpose company for every major international project because of the larger size of the project and given the need for flexibility in dispositions, tax planning, and limiting or compartmentalizing risks and liabilities. In Canada, unless the parties are developing a larger project, it is atypical to have a special purpose company for each lease or licence area and, as a result, there is less commercial need for a change in control clause as a ROFR anti-avoidance measure. However, the authors believe that there is a trend developing, especially in the context of the larger resource plays that involve international co-owners and special purpose companies, to include ROFRs upon a change in control.

Under the AIPN JOA, the exercising ROFR holder cannot complete its acquisition if the original sale is not completed; however, under the CAPL Operating Agreement, once the ROFR is properly exercised there is a binding obligation for the seller and the ROFR holder to complete the sale of the ROFR assets. This difference would have a significant impact on the example set out in Part II.A.1.b.i, above.

C. ROFRS AND GOOD FAITH

Although the concept of good faith has been around for some time, the Supreme Court of Canada's 2014 decision in *Bhasin* has led to a renewed focus on the principle.[70] In the authors' experience, good faith and the duty of honest performance have each become a standard pleading in almost every contractual dispute, including ROFR disputes. For the purposes of this article, *Bhasin* will be analyzed in the context of ROFRs in oil and gas agreements.

1. THE DECISION IN *BHASIN*

Before *Bhasin*, Canadian courts were split on the question of whether all contracts included an obligation to perform contractual duties honestly and in good faith. The Supreme Court of Canada in *Bhasin* resolved this issue and found that:

- there is an organizing principle of good faith that underlies and manifests itself in various more specific doctrines governing contractual performances; and

- there is a general duty of honest contractual performance arising from the organizing principle of good faith.[71]

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68 *Ibid*, cl 12.3C (Alternative #1 and #2). See also Flannigan, *supra* note 2 at 21–22.
69 For example, allowing a private company to go public and recognizing that the loss of control by the former controlling shareholder is not a situation where control has been conveyed from one person to another.
70 *Bhasin*, *supra* note 11.
71 *Ibid* at para 33.

2. THE PRINCIPLE OF GOOD FAITH

The Supreme Court of Canada distinguished between the duty of good faith and the duty of honest performance. The good faith principle "embodies the notion that parties should give appropriate regard to the legitimate contractual interests of their partners. This does not mean that one must act in [their] contracting partner's best interests."[72] The Supreme Court specifically found that no fiduciary duty was implied; rather, it requires the parties to "perform their contractual duties honestly and reasonably and not capriciously or arbitrarily."[73]

It is important to recognize that the duty of good faith is an organizing principle, out of which flows further legal doctrines — as the Supreme Court was careful to say: "An organizing principle … is not a free-standing rule, but rather a standard that underpins and is manifested in more specific legal doctrines and may be given different weight in different situations."[74]

3. DUTY OF HONEST PERFORMANCE

The general duty of honest contractual performance flows from the organizing principle of good faith.[75] This "'is a general doctrine of contract law that applies to all contracts' and consequently, parties are not free to exclude it."[76] The Supreme Court defined the doctrine as follows:

> This means simply that parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract. This does not impose a duty of loyalty or of disclosure or require a party to forego advantages flowing from the contract; it is a simple requirement not to lie or mislead the other party about one's contractual performance. Recognizing a duty of honest performance flowing directly from the common law organizing principle of good faith is a modest, incremental step.[77]

4. GOOD FAITH IN ROFRS

The concept of good faith is not new to courts undertaking a ROFR analysis. Courts have generally prevented the grantor of the ROFR (or seller in the context of a disposition of oil and gas assets) from exercising its discretion in a way to negate the ROFR holder's rights.[78] These decisions have recognized an implied duty of good faith (or some other duty) so that even if a party is in strict technical compliance with an agreement, it may still be in breach.[79]

In *Best Pacific Resources Ltd. v. Eravista Energy Corp.*,[80] the Alberta Court of Appeal found that "[i]t is clear that the grantor of a ROFR has a duty to exercise its rights in such a

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72 Finkelstein et al, *supra* note 57 at 368, citing *Bhasin*, *ibid* at para 65.
73 *Bhasin*, *ibid* at para 63.
74 *Ibid* at para 64.
75 Finkelstein et al, *supra* note 57 at 369.
76 *Ibid* at 369, citing *Bhasin*, *supra* note 11 at para 75.
77 *Bhasin*, *ibid* at para 73.
78 *GATX*, *supra* note 57. See also *Glimmer Resources Inc v Exall Resources Ltd* (1997), 35 BLR (2d) 297 (Ont Ct J (Gen Div)); *Eravista*, *supra* note 54.
79 Finkelstein et al, *supra* note 57 at 375.
80 *Supra* note 54.

manner to ensure that the other party's rights are not rendered meaningless."[81] Courts will also enforce performance standards or expectations where there is evidence of well-established industry standards as to such performance.[82]

A classic statement on the duty of good faith in the context of a ROFR comes from *GATX*, where the Court said:

> It is well established that the grantor of a right of first refusal must act reasonably and in good faith in relation to that right, and must not act in a fashion <u>designed</u> to eviscerate the very right which has been given. This is an illustration of the application of the good faith doctrine of contractual performance, which in my view is a part of the law of Ontario. The law in this respect is nicely summarized in the following passage:
>
> …
>
> > The grantor of a right of first refusal is not entitled to frustrate it by conveying the property in such a way as to avoid having to give the right in the first place.
> >
> > …
> >
> > As to the giver of the right, the law implies a duty of reasonableness and good faith on his part in entering into a cash and property exchange transaction. *The duty is not discharged if <u>the essential purpose</u> of the sale to the third party is to frustrate the right of first refusal.*[83]

The duty of honesty appears to be consistent with the expectations of the users of the *2015 CAPL Operating Procedure*. This standard appears to involve acting reasonably and being "upfront, honest, and thorough."[84] Jurisprudence further indicates that acting reasonably would include not acting 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,"[85] or in other words, having "appropriate regard to the legitimate contractual interests of the contracting partner," as set out in *Bhasin*.[86]

Typically, the issue of good faith arises in how a sale is structured. A court will consider if there are good reasons for structuring a sale in a certain way, or if the structure of the sale is evidence of intent to defeat the ROFR interest. By their very nature, assessments on the issue of good faith in ROFR-related disputes tend to be heavily fact-specific.

D. SHOULD YOU USE A ROFR?

ROFRs are often referred to as clouds on the marketability of assets — clouds that potentially last for the life of those assets. As such, parties should carefully consider granting

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81 *Ibid* at para 27, citing *GATX*, *supra* note 57 at para 71.
82 *Eravista*, *ibid* at para 21; Finkelstein et al, *supra* note 57 at 375.
83 *GATX*, *supra* note 57 at para 71, citing *Landymore v Hardy and White Rose Properties Ltd* (1991), 110 NSR (2d) 2 at 16–17 (SC (TD)) [citations omitted] [emphasis in original, underscore added].
84 Finkelstein et al, *supra* note 57 at 377. See also *Annotated 2015 Procedure*, *supra* note 7 at 57.
85 *IFP Technologies*, *supra* note 17 at para 187, citing *Mesa Operating Limited Partnership v Amoco Canada Resources Ltd* (1994), 149 AR 187 at para 22 (CA).
86 *Supra* note 11 at para 65.

a ROFR.[87] It is critical to analyze the potential benefits and burdens of being a seller or a ROFR holder, and to assess which exceptions and processes ought to be included.

There are several factors to consider when evaluating whether to include a ROFR provision in an agreement. In some cases, these factors may also cause the parties to consider a ROFR on a change in control:

- A ROFR can be an impediment on a seller's ability to get the best price for its interest. Where a ROFR holder can pre-empt the intended buyer, some potential buyers will be unwilling to invest the time, effort, and cost necessary to evaluate the asset and negotiate a sale agreement. Potential buyers may be concerned that they are effectively "stalking horses" for the ROFR holders, who will, in most instances, be better informed about the common attributes of the sale assets.

- ROFRs typically add complexity to sale agreements (for example, mechanisms to provide notice, allocate value, remove assets that are pre-empted from the sale and adjust the price, defend value disputes, as well as possible indemnities) and therefore adds costs and lengthens negotiations.

- There are increased land administration and other costs related to monitoring and complying with ROFR obligations.

- Practically, are the sale assets ones in which the parties have a desire to increase their interest? Do the parties generally all have the financial capacity to increase their interest? For example, a junior oil company that brings a super major into a large project will probably prefer to be able to monetize all or part of its interest, rather than try to re-acquire part of the interest that it has divested to the super major. Conversely, the super major may prefer a ROFR to consolidate its interest and control admission of new co-owners to the project. Differences in outlook could lead to asymmetrical ROFR provisions.[88] Alternatively, the ROFR provisions might include restrictions that limit the application of the ROFR to a specific period (as is an option in the *2007* and *2015 CAPL Operating Procedures*) or until certain operational milestones have been achieved.[89]

- The financial capacity of the parties: if one of the original parties has less financial capacity, the other parties may want to have the right to acquire the poorer party's interest if the poorer party's creditors enforce their security, or if the poorer party becomes the subject of bankruptcy or insolvency proceedings. Concerns over financial capacity may also cause the parties to include a ROFR or other buyout right upon a change in control or a failure to meet a financial capacity test.[90]

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87 We have seen examples of ROFRs and other restrictions on disposition only applying during limited periods where it was more important for the original parties to remain in the project and to exclude new parties.

88 For example, only one owner has a ROFR, but the other owner may gain some other benefit like a tag-along right.

89 For example, the ROFR would be in effect during exploration, but not after commercial production.

90 Some agreements include a test or criteria capacity, which may apply to consent situations.

- Regulatory obligations: the enhanced regulatory thresholds for the transfer of licences for assets in provinces such as Alberta means that parties should consider whether they would likely ever have the capacity to potentially exercise a ROFR in the future.

- The uniqueness or importance of the asset or project: if this is a core area for one party or the asset has some irreplaceable attribute, then a ROFR may be more desirable. For example, if there were only one pipeline that could transport the parties' oil or gas to market, it may be more important to maintain close ownership of that asset and prevent a commercial shipper from acquiring an interest and thereby causing a misalignment of interests between the upstream owners and the pipeline owners. It may not be important to have a ROFR over a more fungible asset.

At its core, the decision on whether to include a ROFR is a consideration about the potential future benefit of the potential ROFR as well as its future burden. Parties should consider their specific circumstances and not simply choose to include a ROFR as a matter of policy, practice, or whim, or they may find themselves bound by significant obligations that limit their ability to monetize their assets.

A related issue to the question of whether to include a ROFR within any new agreement is whether anything can be done to remove, or at least amend, a ROFR from an existing agreement. In the authors' experience, it seems that older, non-standard ROFR provisions contribute to a disproportionate share of ROFR difficulties. In addition to any drafting vagaries within them, these older ROFRs are less often subject to the broad range of exceptions that tend to exclude the application of more modern ROFRs from larger disposition transactions. Obviously, a party's request to have an existing ROFR suddenly and immediately dropped would elicit suspicion from its joint venture partners. They might assume that such party was planning to give notice of a proposed disposition if such ROFR modifications were made. If, however, the proposed change of the ROFR provision were not to take effect for a period (for example, two or three years), then the ROFR cleanup proposal would perhaps be viewed more favourably as mutually beneficial housekeeping. If the outright elimination of any ROFR goes too far, perhaps the parties would be more open to replacing an older or non-standard ROFR provision with a more modern form like that within the *2015 CAPL Operating Procedure*, complete with its list of exceptions. This concept of updating ROFRs might be more successful if an industry association such as CAPL took on the modernization of ROFR provisions as a project, rather than leaving it to individual parties to pursue.

III. SELECTED ROFR ISSUES

A. BUSTED BUTTERFLIES

"Busted butterfly" or "Texas two-step" transactions contemplate the transfer of the sale assets through the sale of the shares of an affiliate special purpose company that is vested with the sale assets.[91] The steps for a party seeking to dispose of certain assets in this manner generally involve some variation on the following: (1) creating a new affiliate entity that is controlled by the party; (2) transferring the sale assets into the new affiliate entity, where the transfer does not itself trigger the ROFR provision; and (3) selling all of the shares of the new affiliate entity to a third party buyer. Tax efficiency has traditionally been the primary reason for this type of structure, as it may allow parties to resolve tax pool valuation differences between themselves, or otherwise avoid or minimize taxation pertaining to the transfer of the assets.

1. FUNDING A ROFR'S EXERCISE

An example of a different transactional structure that contained a relevant discussion on busted butterflies was seen in *Barrick Gold Corporation v. Goldcorp Inc.*[92] In that case, among other allegations, the plaintiff buyer claimed that the exercise of a ROFR and a subsequent sale of the ROFR assets by the defendant ROFR holder were done in an unfair manner. The buyer and seller had an agreement in place for the purchase of shares of a company that held an interest in a gold mine. The shareholders' agreement for the company included a ROFR on the shares of each shareholder. Upon issuance of the ROFR notice pursuant to the sale agreement, the ROFR holder, being the other shareholder, entered into an agreement with a third party wherein the third party would lend the funds to the ROFR holder to exercise the ROFR. The ROFR holder exercised the ROFR to purchase the seller's shares, and then immediately sold those shares to the third party.[93]

In dismissing the plaintiff buyer's claims, the Court found that the exercise of the ROFR and the subsequent sale to the third party did not breach the agreements, and were validly carried out.[94] The Court considered cases such as *GATX*,[95] where the transaction under scrutiny was structured as a busted butterfly with the explicit intent of avoiding a ROFR, and discussed the following principles:

- A ROFR is "designed to protect the desire of each of the joint owners that it should not be forced into a joint ownership with another party against its will."[96]

- Courts must examine the transaction as a whole, and it "cannot be subdivided into isolated parts – each one of which, if considered out of context, might appear individually to be benign."[97]

[91] Smith & Denstedt, *supra* note 10 at 91–92.
[92] 2012 ONSC 3725, 99 BLR (4th) 1 [*Barrick Gold*].
[93] *Ibid* at paras 7–219.
[94] *Ibid* at para 379.
[95] *Ibid* at paras 489–98, citing *3869130 Canada Inc v ICB Distribution Inc*, 2008 ONCA 396, 45 BLR (4th) 1 at para 33; *GATX*, *supra* note 57.
[96] *GATX*, *ibid* at para 39, citing *Long Island Petroleums*, *supra* note 6 at 728.
[97] *GATX*, *ibid* at para 68.

- "[T]he grantor of a [ROFR] must act reasonably and in good faith in relation to that right, and must not act in a fashion designed to eviscerate the very right which has been given."[98]

Utilizing these factors in part, the Court in *Barrick Gold* held that the defendants did not offend these principles while noting that ROFR cases are extremely fact-specific by their nature.[99]

2. LEGITIMATE ALTERNATIVE BUSINESS PURPOSES

The degree to which parties may structure their transactions for legitimate business purposes that have the secondary effect of avoiding ROFR obligations was elaborated upon in the *Northrock* decision.[100] Albeit far from settled, *Northrock* recognizes that having a reasonable and legitimate alternative business purpose may make it possible to structure transactions in a way that avoids ROFR obligations, without violating the principle that a party should not be able to do indirectly what they cannot do directly.

In *Northrock*, Northrock Resources (Northrock) and ExxonMobil Canada Energy (ExxonMobil) were parties to two sets of custom unit agreements (the Unit Agreements) that governed certain assets, including the Battrum and Cantuar interests in Saskatchewan (the Battrum and Cantuar Interests). The Unit Agreements contained ROFR provisions preventing a seller from disposing of all or part of its interests without first making the same offer to the other party. The ROFR provisions included an exception where the transfer was to an affiliate.

ExxonMobil decided to sell the Battrum and Cantuar Interests through a bidding process, and advised bidders that it was seeking tax-effective transactional structures. Crescent Point Energy (Crescent Point) was ultimately the successful bidder and utilized the busted butterfly structure in its offer, which would result in significant tax pool benefits to ExxonMobil.

In carrying out the transaction, Northrock consented to the assignment of the Battrum and Cantuar Interests from ExxonMobil to its subsidiary, on the basis that this assignment did not trigger the ROFR. However, Northrock objected to the subsequent transfer of the shares of the ExxonMobil subsidiary to Crescent Point without issuing a ROFR notice, and sued ExxonMobil and Crescent Point for various claims, including breach of contract and breach of the duty of good faith.[101]

Ultimately, the Court dismissed the action and found that there was a legitimate rationale for the transactional structure of the busted butterfly, being the tax-based advantages, and that the parties were not primarily motivated to avoid the ROFR in deciding to transact through a busted butterfly.[102]

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98 *Ibid* at para 72. See also *Apex Corporation v Ceco Developments Ltd*, 2008 ABCA 125, [2008] 6 WWR 393 at para 35 [*Apex*], where the Alberta Court of Appeal stated that it was necessary to look at "the overall scheme and final result" rather than to adopt a "freeze-frame approach."

99 *Barrick Gold*, *supra* note 92 at paras 551–53.

100 *Northrock*, *supra* note 57 at paras 67–68, 104.

101 *Ibid* at paras 2–32.

102 *Ibid* at paras 104–105.

a. Breach of Contract

The Court found that the ROFR provisions were unambiguous and that neither the transfer to ExxonMobil's subsidiary nor the sale of the subsidiary's shares triggered the ROFR:

> I conclude that I am to construe the ROFR provisions on a plain, straightforward interpretation consistent with the ordinary meaning of the words and consistent with the other provisions of the agreements. If the ROFR provisions are unambiguous, I am to construe them accordingly and not inject terms that the parties had not inserted into the agreements.[103]
>
> …
>
> In addition, an examination of the ROFR provisions reveals that the parties to the agreements did not intend that every circumstance of a party divesting itself of an interest would trigger a ROFR. *In negotiating the ROFR provisions they chose which divestitures would be singled out for a restriction on the right of a party to deal with its own property.*[104]

In the authors' view, if the original parties to the Unit Agreements wanted to ensure that the ROFR provisions could not be avoided through legitimate transaction structuring, the Unit Agreements could have included a ROFR provision on a change in control.[105] Alternatively, parties could have included a requirement for the affiliate to transfer the asset back in circumstances where there is a change in control of the said affiliate.

b. Breach of the Duty of Good Faith

Northrock alleged that it was owed a duty of good faith and that duty was breached in the failure to provide ROFR notices. Following a review of *Bhasin*, the Court held that a breach of duty "may be established where a party is shown to have structured a transaction for the purpose of avoiding a ROFR."[106] However, "[i]f, on the other hand, a structure was chosen for reasons other than to avoid a ROFR, then the choice of that structure did not constitute a breach of a duty of good faith."[107]

In dismissing the claim, the Court accepted ExxonMobil's evidence that it was motivated to choose the busted butterfly structure for tax reasons only, and that the parties were not motivated by considerations of ROFR avoidance:

> The defendants did not lie. The defendants did not mislead. The defendants did not use the busted butterfly structure for the purpose of avoiding the ROFRs. *Rather, they used it for other legitimate purposes — albeit recognizing that it would have (in their view) the side effect of not triggering ROFR notices*. Knowledge does not always translate into intention, and in this case it did not.[108]

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103 *Ibid* at para 42.
104 *Ibid* at para 54 [emphasis added].
105 As the authors discussed in the context of the AIPN JOA in Part II.B.2, above.
106 *Northrock*, *supra* note 57 at para 66.
107 *Ibid* at para 67.
108 *Ibid* at para 104 [emphasis added].

These words demonstrate a certain level of tension in the law when structuring a transaction in a manner that avoids a ROFR. On one hand, so long as there is another legitimate rationale, parties may be successful in avoiding the ROFR's application in a strict sense. In contrast, courts have recognized that a ROFR is an important contractual right that parties should not be able to easily avoid. The test appears to be whether the transactional structure is an honestly made, bona fide business decision. However, such decisions are inherently made in the face of risk and uncertainty, which is the nature of business generally.[109] Ultimately, while the precedential use of the case is currently limited by the lack of consideration from a court of appeal, the wide extent of commentary suggests that it may yet become an influential precedent.[110]

B. ROFRS AND INSOLVENCY PROCEEDINGS

Insolvency proceedings have the potential to have an adverse impact on ROFR holders. Trustees and receivers have the power, granted by statute, to stay proceedings, disclaim real property interests, and avoid other obligations of an insolvent debtor. Such powers may conflict with the rights granted under a Head Agreement related to an insolvent company's assets, including any applicable ROFRs, especially given the unique nature of joint owners' interests within agreements such as the CAPL Operating Procedure.[111] Given the recent economic downturn, it is timely to examine how such proceedings may affect ROFRs and the applicable ROFR procedures.[112]

1. RECEIVERSHIP, BANKRUPTCY, AND *CCAA* PROCEEDINGS

Insolvency proceedings fall into two basic categories — restructurings and liquidations.[113] Restructurings involve an insolvent debtor entering temporary court-supervised protection and the appointment of a monitor or proposal trustee to supervise and assist the process, so that the debtor can present a proposal to its creditors which the creditors must vote to approve to allow the debtor to avoid receivership or bankruptcy.[114] Liquidations involve the formal legal states of receivership or bankruptcy. In receivership, a secured creditor typically applies to the court to appoint a receiver to take control of the debtor's assets and to obtain the net realizable value of the debtor's assets for the benefit of the creditors. In bankruptcy,

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109 *Ibid* at para 80. This analysis would appear to also provide guidance for parties considering any of the exceptions set out in the *2015 CAPL Operating Procedure*, *supra* note 4, cl 24.02.

110 See e.g. Nigel Bankes, "Of Busted Butterflies and the Duty of Good Faith – A Saskatchewan Right of First Refusal Case" (22 June 2016), *ABlawg* (blog), online: <www.ablawg.ca/2016/06/22/of-busted-butterflies-and-the-duty-of-good-faith-a-saskatchewan-right-of-first-refusal-case/>.

111 Melanie Gaston & Emily Paplawski, "The Effects of Various Insolvency Proceedings on Joint Operating Interests in the Alberta Energy Industry" in Janis P Sarra & Barbara Romaine, eds, *Annual Review of Insolvency Law 2016* (Toronto: Carswell, 2017) 1115 at 1130.

112 Particularly, there may yet be further twists in the closely watched case of *Redwater*, *supra* note 39, which may have further trickle-down effects as to receivers or trustees disclaiming assets subject to joint operating agreements and the effects on underlying ROFRs.

113 For a summary of the general processes, see Continuing Legal Education Society of British Columbia, "General Overview of Bankruptcy and Insolvency Law" (February 2011), online: <https://www.cle.bc.ca/PracticePoints/BUS/11-GeneralOverview.pdf>.

114 Debtors can avail themselves of bankruptcy protection and attempt to reorganize through either of the primary statutes respecting insolvencies: the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [*BIA*], which regulates liquidations as well and provides a process to bring proposals to the company's creditors, or the *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 [*CCAA*], which mirrors the *BIA* but provides greater flexibility to larger corporate entities with more than five million dollars of debt. To simplify, restructurings and reorganizations under the *CCAA* are the focus of this discussion.

which the debtor can commence voluntarily or by a creditor through application to the court, the debtor's assets vest in the trustee in bankruptcy. The trustee liquidates such assets to pay creditors some amount in a fair and orderly manner, as determined by the priority scheme in the *BIA*. Further, since each of these types of insolvency proceedings fall under federal jurisdiction, such proceedings can render any conflicting provincial laws inoperative to the extent of the conflict.[115]

Since the recent economic downturn in the Canadian oil and gas industry, there have been few restructurings of oil and gas companies under the *CCAA*. Instead, liquidations of assets, either en bloc or in smaller packages, have been more common, implying that most of the financially strained companies were incapable of returning to a profitable operation. Of the two liquidation processes, bankruptcy proceedings have been less common. Bankruptcy proceedings have been typically instituted for strategic reasons, such as for reversing certain priorities between the Crown and the debtor's secured creditors.[116]

2. STAY OF PROCEEDINGS AND ROFRS

The order granted by the court at the commencement of receivership proceedings under the *BIA* or restructuring proceedings under the *CCAA* provides that claims against the debtor are stayed, absent written consent from the receiver or monitor, as applicable, or leave from the court.[117] From a general standpoint, the language contained in such orders means that a ROFR holder seeking to enforce its ROFR is limited in initiating proceedings against the insolvent party. Obtaining such consent or leave to proceed with a ROFR-related claim against a debtor would be a challenge. The test is whether the ROFR holder can demonstrate that the stay would materially prejudice the ROFR holder or that it is equitable to lift the stay in the circumstances.[118] For example, a ROFR holder could claim that it needs an injunction to prevent a proposed sale so that it can proceed with its claim for specific performance. However, given that many oil and gas assets tend to be fungible and not unique, such an argument may not be successful.

The New Brunswick Court of Queen's Bench considered the scope of a stay of proceedings applicable to *CCAA* (and *BIA*) proceedings in *Blue Note Caribou Mines Inc., Re*.[119] The case involved a company that first entered *CCAA* protection and subsequently made a voluntary assignment into bankruptcy. Shortly after the assignment into bankruptcy, the trustee found a buyer for all of the assets of the bankrupt company. The sale was communicated to the ROFR holder under the Head Agreement, and such ROFR holder did not object to the proposed sale or purport to exercise its ROFR rights.[120] After the sale had partially completed, the ROFR holder commenced an action to enforce its ROFR and brought

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115 Through the operation of the constitutional doctrine of paramountcy: see *Redwater*, *supra* note 39.

116 A receivership order may include a provision allowing the receiver to make an assignment in bankruptcy on behalf of the debtor or consent to a bankruptcy order under the *BIA*, *supra* note 114.

117 See e.g. Alberta Template Order Committee, "Alberta Template Receivership Order: Explanatory Notes" (December 2012) at 5–7, online: <https://www.albertacourts.ca/docs/default-source/Court-of-Queen's-Bench/receivership-order-explanatory-notes-(pdf).pdf?sfvrsn=2>.

118 Gaston & Paplawski, *supra* note 111 at 1132, citing *Alignvest Private Debt Ltd v Surefire Industries Ltd*, 2015 ABQB 148, 608 AR 292 at paras 40–48.

119 2010 NBQB 12, 353 NBR (2d) 249.

120 *Ibid* at paras 9–11. It should be noted that despite a previous agreement that the relationship of the parties was to be governed by a Head Agreement, at the time of the *CCAA* protection and the assignment into bankruptcy, the parties were engaged in litigation over the Head Agreement.

a motion to lift the stay of proceedings. The Court dismissed the motion of the ROFR holder. The Court gave a wide interpretation to the stay of proceedings to include procedural motions related to claims that must also be stayed. It held that the ROFR holder had, in effect, acquiesced to the sale by its lack of earlier objection.[121]

In another case, the Saskatchewan Court of Queen's Bench ruled that during the sale of a property within a larger package sale under a *CCAA* order, the otherwise applicable ROFR was not triggered. In *Bear Hills Pork Producers Ltd., Re*,[122] a single property was subject to a ROFR within a larger group of properties that were all subject to a security interest that rendered the exercise of the ROFR difficult if not "economically impossible without the full cooperation of the lender."[123] The Court utilized its broad discretion to order that the proposed sale did not trigger the ROFR:

> It is clear from judicial pronouncements that a right of first refusal cannot be avoided by simply stacking together a few properties and claiming an exemption on this ground. Such is not the case here. The proposed sale is of course, motivated by the desire of the secured creditors to cut their ongoing losses and to realize upon their security as best they can. From the point of the view of the Court, operating under the *Companies' Creditors Arrangement Act*, the welfare of the business carried on by the companies and the avoidance of the economic dislocation which a liquidation or winding up would involve, are valid considerations. I am advised that the security of 160 jobs will be assured by the sale. I am requested to grant an order declaring that the rights of first refusal are not triggered by the presently contemplated transaction and I have concluded for the reasons alluded to above that such an order should issue, as part of the order confirming the sale.[124]

Bear Hills illustrates how courts may take a narrow view of ROFRs where circumstances exist to justify such limitations, despite acknowledging the multitude of judicial pronouncements that ROFRs represent an important right. However, keep in mind that the ruling has received no subsequent judicial attention and does not pertain to the oil and gas industry, meaning that its precedential value may be limited. The authors also wonder if the Court in this case may have prioritized the job security of 160 people over the ROFR holder's contractual rights. Nevertheless, the case serves as a reminder that parties should remain cognizant that courts have wide discretion to limit otherwise applicable contractual rights.

3. COURT-SUPERVISED SALES

Whether the debtor is subject to a restructuring proceeding under the *CCAA* or a receivership under the *BIA*, a court-supervised sales process will need to be conducted in respect of its assets in order to maximize value to the debtor's creditors. Depending on the structure of the sales process, an exception to the applicable ROFRs may apply, such as the sale of substantially all of the debtor seller's assets to a single buyer, allowing the sales process to proceed based on the said ROFR exception.

121 *Ibid* at paras 36, 38, 45–46.
122 2004 SKQB 213, 2 CBR (5th) 70 [*Bear Hills*].
123 *Ibid* at para 4.
124 *Ibid* at paras 9–10.

Where exceptions to the ROFRs are not applicable, courts have confirmed that the rights of the ROFR holder are not extinguished by a debtor's insolvency.[125] In court-supervised sales processes, the debtor or seller and buyer will negotiate a procedure to deal with any applicable ROFRs in the sale agreement, which must be approved by the supervising court. Such procedures often resemble the ROFR procedures used in transactions with solvent sellers. This means that the buyer will assign its bona fide allocation of value to the assets subject to a ROFR that will be included in the ROFR notice sent to the ROFR holders, who may then exercise the ROFR on the same terms or dispute the said valuation.

It is important to note that in sale agreements negotiated in the context of insolvency proceedings, there will be few conditions precedent to closing and limited ability for the buyer to seek indemnification. This means that buyers would benefit from comprehensive due diligence, but might still be at a disadvantage compared to ROFR holders, who, as co-owners of the assets, would typically have a greater understanding of the assets.

C. PACKAGE SALES

Sale agreements are often made in respect of packages of assets that include both oil- and gas-producing properties and major facilities, with some of each being subject to ROFRs, and which ROFRs could have different terms. This can pose unique challenges to the applicable ROFRs. Most often, the disputes that arise in these situations are about whether the value allocated to each group of assets that are subject to a ROFR was reasonable.[126]

In *Bearspaw Petroleum Ltd. v. ConocoPhillips Western Canada Partnership*,[127] the Alberta Court of Queen's Bench considered how to determine the price assigned to the ROFR lands that were part of a package sale. In this case, a defendant buyer had successfully bid on certain properties that were allegedly subject to a ROFR, and after such properties were transferred, the plaintiff ROFR holder brought an action against both the buyer and seller. The Court summarized the principles on package sales as follows:

- A package sale will trigger ROFRs even where the ROFR provision in the underlying agreement does not contemplate such a sale.[128]

- The seller owes a duty of good faith to the ROFR holder in setting a bona fide estimate of the value of the portion of the package subject to the ROFR.[129]

- It is not obvious in a package sale that the buyer owes a duty of good faith to the ROFR holder over a portion of the package. Regardless, the ROFR holder challenging the issuance of proper ROFR notices must establish that the purchase

125 *Eravista*, *supra* note 54; *Bank of Montreal v Probe Exploration Inc* (2000), 33 CBR (4th) 173 (Alta QB) at paras 15, 37, aff'd (2000), 33 CBR (4th) 182 (Alta CA). Where a ROFR is an interest in land, such as in Alberta by statute, the ROFR holder's right is strengthened further: see *Law of Property Act*, RSA 2000, c L-7, s 63(1). However, lacking statutory intervention, a ROFR may not constitute an immediate interest in land: see Perell, *supra* note 10 at 27.

126 *Apex*, *supra* note 98. See also the discussion in Part II.A.1.b, above.

127 2009 ABQB 202, [2009] 7 WWR 125.

128 *Ibid* at para 48.

129 *Ibid*.

price allocated to the part of the parcel subject to the ROFR is not a bona fide estimate of their value.[130]

1. COMPETING ROFRS ON LANDS AND FACILITIES

Blaze Energy Ltd. v. Imperial Oil Resources is a case dealing with other broader ROFR issues in package sales.[131] In that case, an expedited trial was held to determine whether Blaze Energy Ltd. (Blaze) had a ROFR arising from a series of transactions in relation to a gas plant and some related lands. The Alberta Court of Queen's Bench held that ROFRs apply only to the interest under the specific ROFR provision in the underlying agreement and nothing more.[132]

There were two transactions at issue in this case:

- Imperial Oil Resources Ltd.'s (Imperial) sale to Whitecap Resources Inc. (Whitecap) of many oil and gas interests in Alberta and British Columbia; and

- Whitecap's immediate sale of a subset of those same assets to Keyera Partnership (Keyera).[133]

The ROFRs at issue were in relation to two assets being sold in those transactions:

- the 90 percent interest that Imperial held in the West Pembina Gas Plant (the Gas Plant); and

- certain lands in the West Pembina Area (the Lands), which were comprised of gas-producing properties and certain oil-producing properties.[134]

The Lands were subject to a 1960 Operating Agreement (the Lands Agreement). The Gas Plant was subject to a 1988 Construction, Ownership, and Operation Agreement (the 1988 CO&O Agreement). Blaze was a party to both the Lands Agreement and the 1988 CO&O Agreement. Both the Lands Agreement and the 1988 CO&O Agreement contained ROFRs:

- The Lands Agreement provided that: "[i]n the event any [party] desires to sell all or any part of his or its interest which are subject to this agreement," the other parties shall have a preferential right to purchase those interests "for the offered price and upon the offered terms."[135]

- The 1988 CO&O Agreement provided a ROFR to other Gas Plant owners on the sale of an interest in the Gas Plant. However, article 1101 of the 1988 CO&O Agreement included an exception to the ROFR, providing that a Gas Plant owner "may, without restriction, dispose of an interest in the Plant in conjunction with the

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130 *Ibid*.
131 2014 ABQB 326, 28 BLR (5th) 111 [*Blaze*].
132 *Ibid* at paras 23–25.
133 *Ibid* at paras 26–27.
134 *Ibid* at paras 30–31, 33–36.
135 *Ibid* at para 31.

> disposal of the Owner's corresponding working interest in the lands in the West Pembina Area from which Gas is being produced into the Plant."[136]

a. First Transaction

Imperial's sale to Whitecap included (amongst other things) the Lands and Imperial's 90 percent interest in the Gas Plant. Prior to the closing of Imperial's sale to Whitecap, Imperial issued a ROFR notice under the Lands Agreement to Blaze, but Blaze chose not to exercise its ROFR. Imperial did not issue a ROFR notice to Blaze in respect of the sale of the Gas Plant, because Imperial determined that such sale was exempt from the requirement pursuant to article 1101 of the 1988 CO&O Agreement.[137]

b. Second Transaction

Immediately following the closing of the first transaction with Imperial, Whitecap sold some of the assets to Keyera, including an 85 percent interest in the Gas Plant and the gas-producing properties that were part of the Lands purchased from Imperial (Whitecap retained the oil-producing properties that were part of the Lands). Whitecap issued a ROFR under the Lands Agreement to Blaze, but did not issue a ROFR to Blaze in respect of the Gas Plant because it, like Imperial, determined that the sale of the Gas Plant interest was exempt from the requirement pursuant to article 1101 of the 1988 CO&O Agreement.[138]

c. Blaze's Claims

Blaze exercised its right under the ROFR notice issued by Whitecap. It claimed that by doing so, article 1101 of the 1988 CO&O Agreement no longer applied because Whitecap was no longer selling a "corresponding working interest" in the Lands to Keyera. As a result, Blaze claimed:

- a ROFR in relation to 4 percent of the 90 percent interest in the Gas Plant that Imperial was selling to Whitecap (on the basis that the Lands provided about 4 percent of Imperial's production to the Gas Plant over the previous five years);
- a ROFR in respect of either the entire 85 percent interest in the Gas Plant that Whitecap was selling to Keyera, or some other corresponding interest; and
- specific performance of its alleged ROFRs.[139]

d. Outcome

The Court dismissed Blaze's claims and held that since a ROFR is based in contract, the meaning and extent of a ROFR must be determined through "analysis of the contract that

[136] *Ibid* at para 37.
[137] *Ibid* at paras 46–57.
[138] *Ibid* at paras 61–64.
[139] *Ibid* at para 16.

created it."[140] With respect to the Lands Agreement and the 1988 CO&O Agreement, the Court held:

- "Offered terms" under the Lands Agreement did not extend to rights under other agreements, including any interest under the 1988 CO&O Agreement.

- The exercise of a ROFR under the Lands Agreement had no impact on rights under the 1988 CO&O Agreement, which was a completely separate and unrelated agreement.

- Nothing in the CO&O required land dispositions to all be to the same buyer. Therefore, the article 1101 exemption would still apply even if Blaze had exercised the ROFR to purchase the Lands from Imperial while Whitecap purchased the Gas Plant interest: "It is not reasonable to say that it was the parties' intention that the exercise of a ROFR *outside of the actual 1988 CO&O Agreement* could eviscerate the agreed rights of the parties under Article 1101."[141]

- The article 1101 exemption in the 1988 CO&O Agreement applied to both the transactions between Imperial and Whitecap and between Whitecap and Keyera. In this case, the first transaction was exempt because Imperial sold the entire 90 percent interest that it held in the Gas Plant to Whitecap as well as all of its working interests in the Lands. On the second transaction, Whitecap:

    - was selling 94.4 percent of its interest in the Gas Plant (85 percent of 90 percent); and

    - had estimated production from the gas-producing properties being sold at approximately 94.4 percent of gas production from all of the Lands, thereby equating to a 94.4 percent working interest in "the lands … from which gas [was] being produced into the Plant."[142]

According to the Court, "corresponding" did not mean "identical," but instead meant "to be congruous or in harmony with" or to be "similar or analogous."[143] The Court determined that Whitecap's on-sale of 85 percent of the 90 percent interest in the Gas Plant along with Whitecap's on-sale of the gas-producing properties forming part of the Lands was sufficient to meet the requirement of "corresponding working interest in the lands."[144]

Specific performance (an equitable remedy) was not available to Blaze because:

- on its claims to a 4 percent interest under the first transaction, Blaze's failure to comply with the terms of the ROFR notice, being the consideration stipulated in the ROFR notice, was fatal to its claim; and

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140 *Ibid* at para 71.
141 *Ibid* at para 148 [emphasis in original].
142 *Ibid* at para 135.
143 *Ibid* at para 144.
144 *Ibid* at paras 138, 158.

- Blaze was in default under the 1988 CO&O Agreement (because of previous failures to pay) and so did not come to court with clean hands.[145]

IV. CONCLUSION

ROFRs continue to pose challenges in drafting and negotiating oil and gas agreements and in structuring sale agreements. Over time, the drafters of industry standard agreements and those drafting custom ROFR provisions have attempted to address the mistakes of the past and to anticipate future issues. Unfortunately, no one has a crystal ball, and no one can completely anticipate the ingenuity of the dealmakers in creating new structures or the ingenuity of the litigators in finding unique ways to challenge those structures.

The developments in the Canadian oil and gas industry that have resulted from the most recent commodity cycle, and which have had an impact both on the way the industry does business and the contracts that govern such business, include:

- an increase and subsequent decrease in foreign investment;
- a greater focus on resource plays and the oil sands;
- greater regulation around financial responsibility for environmental liabilities;
- an increase in bankruptcies and insolvencies;
- the tendency of companies to focus more on core areas;
- the Canadianization of the oil sands; and
- creative financing through carried interests, royalties, and divestitures of midstream assets.

The authors believe that developing practice and recent case law are helping to illustrate some of the implications of these developments. Yet there is still more to come. The authors have forecasted some of the implications and possible future trends, including:

- more frequent modification of the standard forms;
- increased use of international standard forms;
- additional ROFR exceptions;
- asymmetrical ROFRs;
- ROFRs limited by time or milestones;

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[145] *Ibid* at para 178.

- greater obligations of good faith;
- greater attention to anti-avoidance measures at law and in contract;
- inclusion of ROFRs on a change in control;
- ROFR exceptions based on value and not net area;
- possible additional administrative burdens and confusion in managing non-standard agreements;
- increasing use of expedited trial processes and reliance upon summary judgment applications to resolve disputes; and
- initiatives by industry associations or individual joint venture parties to remove older, non-standard ROFR provisions from existing agreements, and perhaps replacing them with modern standard form ROFRs, with the typical exceptions.

Other implications and future trends are beyond the scope of this article, and the authors look forward to reading about such further developments in future Canadian Energy Law Foundation articles.