CASE COMMENTS

OIL AND GAS — CAPPED GAS WELL ON UNITIZED LANDS — WHETHER LEASE CONTINUES IN FORCE WHEN SHUT-IN ROYALTY IS PAID AFTER EXPIRATION OF PRIMARY TERM

CANADIAN SUPERIOR OIL OF CALIFORNIA LTD. v. *KANSTRUP*

The problems relating to shut-in royalty clauses in oil and gas leases had received very little attention by Canadian courts until the recent Supreme Court of Canada decision in *Canadian Superior Oil of California Ltd.* v. *Kanstrup.*[1]

The facts were as follows: by a petroleum and natural gas lease dated July 2, 1948, Canadian Superior[1a] acquired the right to search for and produce oil and gas from a quarter section of land owned by Kanstrup, the consideration being $240.00 and the usual royalties. The lease specified a primary term of ten years and as long thereafter as oil or gas was produced,[2] with provision for termination unless yearly delay rental was paid.

Late in 1957 the lease was amended by the addition of clause 14A[3] which was entitled "Pooling Due to Regulation". Canadian Superior explained in the accompanying letter that the object of the clause was, ". . . forming a 640 acre spacing unit with the object of drilling a well in the section."[4]

Canadian Superior having entered into a pooling and joint operating agreement drilled a well on Legal Subdivision Seven of Section 9, which was not a part of the Kanstrup Quarter. The completed well was found to be capable of production, but because there was no market for the gas, upon Board approval, the well was shut-in on June 13, 1958. At this point the primary term had less than a month to run.

In the meantime, Kanstrup had granted a "top lease"[5] to Scurry-Rainbow Oil Ltd., who filed a Caveat in respect of its interest under this option.

1 [1965] S.C.R. 92.

1a The company's name at that time was Rio Bravo Oil Co. Ltd.

2 2. "Subject to the other provisions herein contained, this lease shall be for a term of 10 years from this date (called 'primary term') and as long thereafter as oil, gas or other mineral is produced from said land hereunder, or as long thereafter as Lessee shall conduct drilling, mining or re-working operations thereon as hereinafter provided and during the production of oil, gas or other mineral resulting therefrom."

3 14A POOLING DUE TO REGULATION
"The Lessee is hereby given the right and power at any time and from time to time to pool or combine the said lands, or any portion thereof, with other lands adjoining the said lands, but so that any one such pool or unit (herein referred to as a 'Unit') shall not exceed one drilling unit as hereinbefore defined, when such pooling or combining is necessary in order to conform with any regulations or orders of the Government of the Province of Alberta, or any other authoritative body, which are now or may hereafter be in force in relation thereto. In the event of such pooling or combining, the Lessor shall, in lieu of the royalties elsewhere herein specified, receive on production of leased substances from the said unit, only such portion of the royalties stipulated herein as the area of the said lands placed in the unit bears to the total area of lands in such unit. Drilling operations on, or production of leased substances from any land included in such unit shall have the same effect in continuing this Lease in force and effect during the term hereby granted or any extension thereof as to all the said lands, as if such operation or production were upon or from the said lands, or some portion thereof."

4 The complete letter is set out in [1965] S.C.R. at 98.

5 For a discussion of the nature of the interest acquired by a top lessee see *Pan American Petroleum Corp.* v. *Potapchuk* (1964), 46 W.W.R. (NS) 237.

On July 9, 1958, seven days after the expiration of the primary term, Canadian Superior forwarded to Prudential Trust (as assignee of Kanstrup's gross royalty) a cheque for $100.00, indicated to represent a royalty payment due on the capped well, pursuant to clause 3 (b) of the lease, which provided:

> . . . where gas from a well producing gas only is not sold or used, Lessee may pay as royalty $100 per well per year, and if such payment is made, it will be considered that gas is being produced within the meaning of paragraph 2 hereof . . . [the habendum clause].

These monies were distributed by the trust company. Kanstrup then wrote Canadian Superior stating that the lease had expired on July 2, and subsequently, after receiving notice from Scurry-Rainbow to commence proceedings under its caveat, the lessee brought action seeking a declaration that its lease was still in force and effect.

There having been no production during the primary term, the question was whether the lease was extended by any of the terms of the lease, or whether the lease automatically terminated on the expiration of the primary term. Special reliance was placed upon the shut-in royalty clause.[6]

Canadian Superior argued that the lease was continued in force by the combined operation of clauses 14A, 3 (b) and 2. Mr. Justice Martland, for the Supreme Court of Canada found, as had the Appellate Division of the Alberta Supreme Court[7] and Mr. Justice Kirby at trial,[8] that the lease had terminated. He stated three main grounds: first, that the pooling clause could not be construed as enabling Canadian Superior to treat a capped gas well anywhere on the unit as equivalent to one located on the northwest quarter. On this point he agreed with the Court of Appeal in declining to follow the reasoning of the trial judge, Mr. Justice Kirby, who had concluded that it was ". . . a proper inference that gas produced from a unitized well is drawn from all the lands comprising the unit."[9] Having drawn this inference, he had reasoned that the lease did not terminate since upon payment of shut-in royalty the unit well was by clause 3 (b) deemed to be a producing well within the habendum clause. All the unit lands including the Kanstrup quarter were therefore being 'produced', and it followed that the lease remained in force after the primary term.

Secondly, on the question of time for payment of shut-in royalty, Mr. Justice Martland said:

> I agree with the learned trial judge that payment of the $100 royalty after the primary term had expired was not effective to continue the term of the lease thereafter. At the time the primary term came to an end, no oil, gas or any other mineral was being produced from any part of the unit, nor was there any gas which could be considered as being produced as a result of the operation of cl. 3 (b). That clause did not impose upon the appellant any obligation to pay a $100 royalty in respect of a non-producing gas well. The appellant had a choice to pay or not to pay and the clause only because operative 'If such payment is made'. *If the appellant sought to continue the lease in operation after the primary term, by the combined operation of cl. 3 (b) and cl. 2, then it was essential that it should have paid the royalty before the primary term expired.*[10]

6 Cl. 3(b) which is set out *ante*.
7 (1964), 47 W.W.R. 129.
8 (1963), 39 D.L.R. (2d) 275.
9 *Id.* at 290.
10 *Ibid.* Emphasis added.

Finally, he found that receipt by Kanstrup of a portion of the two $100.00 payments made by Canadian Superior after the primary term gave rise to no election or waiver of forfeiture on the part of Kanstrup. The lease terminated automatically upon the expiration of the primary term by reason of the machinery contained in the habendum clause. This being so, there was no forfeiture to relieve against.

In reaching its decision, the Supreme Court implicitly relied upon several leading American decisions on the nature and construction of shut-in royalty clauses. The petroleum producing states of the United States have, developed a fairly extensive jurisprudence relating to shut-in royalty clauses. Drafting inadequacies have been exposed; with the result that modern American shut-in clauses are more comprehensively and soundly drafted than most found in contemporary Canadian lease forms. It is proposed therefore to determine whether the reasoning of the court, underlying the conclusions on the shut-in royalty problems raised in the *Kanstrup* case, accords with the growing body of American case law on the subject, and with the critical analyses and comments of American writers.

At this point it is perhaps appropriate to outline the purpose of the shut-in royalty clause and sketch shortly its introduction into the lease and its evolution as an integral part of it. The problem dealt with by this clause arises from the physical nature of gas. Whereas oil is capable of storage in above-ground tanks and may be trucked to market where no gathering system exists, gas is capable of safe, economical storage only in the stratum in which it is found or in other depleted strata.[11] When a gas well is completed and no market exists, or pipeline connections cannot be completed immediately, the operator faces a dilemma. On the one side, the lessee is faced with the prospect of no market for his gas and conservation regulations preventing flaring,[12] so that there is no way in which he can produce the gas. On the other side, there is a well on the land from which the lessor is receiving nothing, and there being no production, he would probably have an action for termination of the lease.[13]

Prior to the introduction of the shut-in clause in the United States, courts in West Virginia and Pennsylvania were disinclined to declare leases with shut-in gas wells to have terminated at the expiration of the primary term.[14] They determined that a well capable of producing gas meant the same thing as a producing gas well, and therefore the habendum clause would extend the lease whether there was actual

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11 See Wallace G. Malone, *Some Legal Problems Incident to the Underground Storage of Gas*, South Western Legal Foundation (1955).

12 *The Oil and Gas Conservation Act*, 1957 (Alta.) c. 63 sections 34-37 and section 39 and orders and regulations thereunder.

13 See W. G. Malone, *The Evolution of Shut-in Royalty Law* (1959), 11 Baylor L. Rev. 19; L. Moses, *Problems With Shut-in Gas Wells* (1962), 7 Rocky Mountain Mineral Law Institute 41 at 44.

14 Williams, *Oil and Gas Law*, vol. 3, p. 394. See also the authority collected in Malone, *ante*, n. 15, at 22-27.

15 *Bristol* v. *Colorado Oil & Gas Corp.* (1955), 225 F. (2d) 894, 50. & G.R. 50; *McCutcheon* v. *Enon Oil and Gas Company* (1926), 135 S.E. 238; *Eastern Oil Company* v. *Coulehan* (1909), 64 S.E. 836. Underlying this view was the fact that in those states discovery giving a right of production under an oil and gas lease was considered to create a vested estate in the lessee in the right to produce oil or gas, subject to termination in the future through serious misconduct. The interest created was an estate upon condition subsequent.

production or not.[15] A covenant on the part of the lessee to market the gas produced was also implied by the courts.[16]

However, the need for a clause in the lease to cover the shut-in gas well situation became painfully apparent as a result of the decision in the case of *Stanolind Oil and Gas Company* v. *Barnhill.*[17] The Texas court held that the habendum clause must be literally construed, and that actual production within the primary term is requisite. This is the position today in Texas and the other "determinable fee states", except to the extent that a softening has been effected by the equitable view espoused by another Texas court in *Guleke* v. *Humble Oil and Refining Company.*[18] A further expedient has been to allow the lessee a "reasonable time" in which to secure a market after capping.[19]

The provision that appeared in subsequent leases was designed to balance the interests of the lessor, to whom no royalty would be forthcoming during the period of shut-in, and those of the lessee, anxious to recover the substances discovered and recoup the large amount invested in drilling operations. The clause was designated "shut-in gas royalty clause" and took the form of a monetary substitute for actual paying production. One writer has explained that:

> Generally speaking, their aim regardless of their wording is to state that the lessor and lessee have agreed that discovery of gas is the same as producing the gas so as to keep the lease alive beyond its primary term if the lessee makes certain payments. This is why a shut-in gas well payment is frequently referred to as 'substitute production'.[20]

The reasons for inclusion of a shut-in royalty clause may be summarized:

(1) to allow the lessee to extend the lease beyond its primary term where there is a shut-in well.

(2) to give a lessee a way to avoid lease termination where the shut-in well is completed prior to the beginning of the last year of the primary term.[21] This situation arose quite frequently in the United States where early "dry hole clauses", which allowed a lessee to resume payment of delay rentals where the well was dry or where production ceased, did not apply literally to shut-in gas wells capable of production. In Canada the problem has been avoided by lease provisions which authorize a return to delay rentals if during the primary term operations have been conducted then discontinued without production having commenced.

Since there is no generally accepted form, shut-in royalty clauses have varied considerably in any given period. Generally though, the early clauses were relatively simple, and most resembled fairly closely the clauses found in the leases in the *Kanstrup* and *Gunderson*[22] cases.

16 *Lowther Oil Company* v. *Miller-Sibley Oil Company* (1903), 44 S.E. 433.
17 (1937), 107 S.W. (2d) 746 (Tex. Civ. App.). In Texas an oil and gas lease vets in the lessee a determinable fee which vanishes if any of the limitations thereon including production during the primary term, are not met. A similar theory (or at least a condition precedent theory) prevails in Alberta and is discussed *post.* See also, E. McRery (1965), 4 Alta. L. Rev. 175.
18 (1939), 126 S.W. (2d) 38 (Tex. Civ. App.). But Malone, *ante,* n. 13, at 29 suggests that the *Guleke* case doctrine of "fireside equities" can be confined to its own particular facts.
19 Malone, *ante,* n. 13, at 29-31.
20 Snider, *Shut-in Gas Well Provisions* (1962), 3 National Institute For Petroleum Landmen 129 at 132.
21 See Masterson, *The Shut-in Royalty Clause in an Oil & Gas Lease,* (1959), 4 Rocky Mountain Mineral Law Institute 315 at 323.
22 [1960] S.C.R. 424.

There have been relatively few cases involving construction, of shut-in royalty clauses, but those that have come before the courts have left their mark, and as a result, present day shut-in clauses have grown longer and more complex—reflecting those decisions, as well as critical analyses by leading writers.[23]

SHUT-IN WELL UPON POOLED LANDS

The Supreme Court of Canada placed a strict construction upon the shut-in royalty clause in the *Kanstrup* case and held it not sufficient to extend the lease, the capped gas well being on unit lands other than the leased quarter. While citing no authority, and indeed making no reference to the matter of construction, Mr. Justice Martland stated shortly:

> The wording of that clause [pooling clause] does not extend beyond the effect which it gives to operations of that kind. It does not say that a non-producing gas well not in the North West quarter, is to be equivalent to a non-producing gas well on the North West quarter, so as to enable the appellant to rely upon the latter portion of Cl. 3(b) [shut-in royalty clause].[24]

The result appears to be ". . . yet another example in a long line of strict interpretation in favour of the lessor."[25] The argument in favour of this theory of construction is based upon the fact that the lease is normally a standard form drafted by the lessee. It is simply offered to the mineral owner for his signature or rejection *in toto*. The danger in this approach is that courts often rely on it to ensure that the lessor receives a "fair deal", while virtually ignoring clear language in the contract. This amounts to disregard of the cardinal principle that the intention of the parties governs and is gathered from the expressions they have used.[26]

If a liberal theory of construction were applied to the facts in the *Kanstrup* case, the argument would run somewhat as follows: The court is justified in looking at the entire contract in order to ascertain the true intent of the parties. Such "true intent" is the court's guiding principle. It must place that construction upon the agreement (within the reasonable limits of its language) which will best effectuate that intention.[27] If the shut-in clause does not apply to the entire spacing unit as eventually constituted, then the rights given under the pooling clause are meaningless where a capped gas well results within the pooled lands but outside the leased lands, and remains shut-in beyond the primary term. Such could not have been the intent of the parties. Rather, it must surely have been intended that by performing its obligations under clauses 3(b) and 14A the lessee could extend the lease in such circumstances. These obligations would include tender of the shut-in payments under each lease in the spacing unit each year, as royalty.[28]

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23 For examples of current American shut-in royalty clauses see Williams, *Oil and Gas Law*, vol. 3, pp. 396-398.

24 *Ante*, n. 1, at 102.

25 W. H. Angus, *Voluntary Pooling in Canadian Oil and Gas Law* (1961), 2 Alta. L. Rev. 481, 485. The author was there referring to the decision in *Shell Oil* v. *Gunderson, ante*, n. 22.

26 See Odgers, *The Construction of Deeds and Statutes* 22 (4th ed. 1956).

27 See G. M. Burden, *The Capped Gas Well Clause and the Gunderson Case* (1962), 5 Can. Bar Journal 37, where much of the relevant authority is collected at pp. 45-50.

28 *Id.* at 48.

This suggested construction is consistent with the current American position regarding shut-in wells on unit lands. Courts in both Louisiana[29] and Oklahoma[30] have held that a shut-in well anywhere on the unit, will maintain all of the leases in the unit, provided yearly shut-in payments are made to all the lessors. There have been no cases on point in Texas, but one writer has observed that

> if all of the leases contained proper pooling clauses and shut-in provisions, it would appear reasonable to presume that the lessee should be able to maintain all of the leases in the unit by completing a shut-in gas well on one of the leases. *It appears axiomatic that contractual production has been established to the satisfaction of each of the leases involved.*[31]

The reasoning above by which the lease is construed to allow one well to deem production on all unit lands is, in the writer's opinion, to be preferred to that of Mr. Justice Kirby who arrived at the same conclusion. He distinguished the pertinent words in the Kanstrup lease — "well producing gas . . . from the said lands" from those considered in *Shell Oil* v. *Gunderson*[32]—"for all wells on the said lands". In the *Gunderson* case Mr. Justice Martland, after noting that the shut-in clause was restricted in its application to capped wells "on the said lands" and that "said lands" was earlier in the lease defined to mean "the lands hereinbefore described", concluded that the only lands which fitted that description in the lease were the quarter leased. Since the capped well was not located on that quarter, the shut-in clause could not be invoked.

Relying on this difference in the wording of the shut-in clause in the Kanstrup lease, Mr. Justice Kirby proceeded to draw the rather questionable inference that gas produced from a unit well is drawn from under all the lands comprising the unit. While it is accepted that oil and gas wells do drain the surrounding territory, whether a well drains a particular tract nearby cannot be proven conclusively without drilling. Oil and gas *in situ* are no longer considered by the courts to be "migratory substances" analogous to percolating waters, though it is recognized that they do move about within their natural reservoir once it is pierced by a well.[33] Professor Summers states:

> Just how far and to what extent a given well in a particular oil or gas reservoir will drain either gas or oil from the surrounding territory is a problem of several unknowns, the chief of which are the coarseness of the oil and gas sand, the amount of pressure in the reservoir, and the force of the vacuum created by pumping.[34]

Since there had been only one well drilled in the unit, it is difficult to find any basis for the trial judge's inference that the unit well drained all the tracts in the unit. He also considered that his view was supported by the use of the word "pool" in section 72 of the Oil and Gas Conservation Act[35] This, it is submitted, is even more tenuous.

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29 *Delatte* v. *Woods* (1957), 94 So. (2d) 281.

30 *State* v. *Carter Oil Co.* (1959), 336 P. (2d) 1086. It should be noted that the West Virginia "condition subsequent" theory which makes discovery the equivalent of production, prevails in Oklahoma.

31 Moses, *ante*, n. 13, at 72. Emphasis added.

32 *Ante*, n. 22.

33 *Borys* v. *C.P.R.*, [1953] A.C. 217, 219-20.

34 Summers, *The Law of Oil and Gas* (Permanent Edition) Vol. 2, No. 411, p. 497.

35 *Ante*, n. 12.

One apparent difficulty does however threaten the construction suggested above. The pooling clause states:

> . . . the lessor shall in lieu of the royalties elsewhere herein specified, receive in production of leased substances from the said unit only such portion of the royalties stipulated herein as the area of the said lands placed in the unit bears to the total area of lands in such unit.[36]

The shut-in royalty clause provides that a $100.00 royalty shall be paid the lessor each year if a gas well is shut-in on the leased lands. If shut-in payments are indeed royalties[37] paid as a substitute for royalties on production, then such payments ought to be shared ratably by all the unit lessors. If this is the case, the two clauses would seem to be inconsistent since *pro-rata* payment of shut-in royalty would not deem production within the habendum clause. This is because literally the shut-in clause provides that substitute production can be achieved only by tendering the full amount to the lessor. Such an inconsistency would leave the shut-in clause unclear and liable to be construed *contra proferentes*[38] against the lessee. This commonly applied rule of construction calls for construction against the party preparing the instrument (in this case the lessee) where there is uncertainty or ambiguity as to the intent or meaning of the language. Application of the doctrine here would probably result in the clause being held insufficient to prevent termination of the lease.

The answer to this lies in the fact that shut-in royalty, while providing the lessor some return in lieu of production, is not true production royalty in the traditional sense of a share of production. Rather, it serves as a *substitute for production* under the habendum clause. It must be paid in full and in good time. If a fractional payment is made there is no deemed production since the act expressed in the lease to be a substitute for production (i.e., payment of the specified sum as shut-in royalty) will not have been completely performed. Having determined that the primary function of shut-in royalty is to trigger deemed production under the habendum clause and not to provide a share of production profits for the lessor, the apparent inconsistency between the shut-in and production royalty provisions vanishes.

In the *Kanstrup* case then, if the foregoing argument predicated upon a liberal construction of the lease is sound, Canadian Superior had, by the combined effect of the pooling and shut-in royalty clauses, the right to extend its lease beyond the primary term. It could do so by timely tender of shut-in royalty payments to the depository trust company. That it was held unable to take advantage of this right was the unfortunate result of its failure to tender the shut-in royalty in time. This view of the combined effect of pooling and shut-in clauses may yet prevail in the courts, since both Mr. Justice Kane in the Appellate Division and Mr. Justice Martland in the Supreme Court of Canada preferred to rely on another point—timely tender of shut-in payment. Their opinion that a shut-in well within the unit but outside the leased lands will not extend the lease might therefore be regarded as *obiter*.[39]

36 *Ante*, n. 3. Emphasis added.
37 In *Morriss* v. *First National Bank of Mission* (1952), 249 S.W. (2d) 269, a Texas court found that shut-in payments were royalties and not mere rental payments.
38 Summers, *ante*, n. 34, at p. 417.
39 See *ante*, n. 1, at 103.

However, the *Kanstrup* facts were, because of the absence of the words "said lands" from the shut-in clause, even more consistent with a decision upholding the lease than were the facts considered in the *Gunderson* case. The Supreme Court's decision that the lease terminated makes the *Kanstrup* case strong persuasive authority for the proposition that an ordinary shut-in clause is ineffective when the capped well is on unit lands other than the leased lands.

Only one recommendation can be made. Either the pooling clause or the shut-in clause must come under the draftsman's pen. This has indeed occurred, and most present-day shut-in clauses are expressed to apply to "the leased lands or any lands with which they might be pooled or unitized".[40]

TIME FOR PAYMENT OF SHUT-IN ROYALTY

This was the pivotal question in the *Kanstrup* case, and was answered, by Mr. Justice Martland, in expressed agreement with the trial judge as set out above.[41] Shortly, he found it necessary that payment be made before the expiry of the primary term.

In the Trial Division, Canadian Superior had argued before Mr. Justice Kirby that failure to pay the royalty before the anniversary date did not invalidate the lease. The cheque had been sent out in the ordinary course of business and time for payment ought not on general equitable principles to be enforced strictly, as according to the nature of the contract created by the lease, stipulation as to time was a non-essential term. They contended that the court had jurisdiction to relieve against any such forfeiture under section 32 (0) of the Judicature Act.[42]

In the United States, a similar argument—that time for payment ought not on general equitable principles to be strictly enforced—has been raised by lessees in two forms. First, it has been suggested that shut-in royalty clauses should be construed as affording the lessee a *reasonable time* after the gas well has been shut-in in which to get the well into production or make the payment.[43] It is generally accepted contract law that when no time is stated within which a contractual undertaking is to be performed a reasonable time is to be implied.[44] This rule has been stated to apply to oil and gas leases.[45] There is much to commend this position, for it gives effect to the reasonable and probable intent of the contracting parties. It should make no difference that the shut-in clause is "permissive", for a close analogy can be drawn to ordinary option agreements. That the interest held under the lease is a determinable fee (or condition precedent) and hence subject to automatic termination, may be no answer to the "reasonable time" argument, since it is axiomatic that implied terms in contracts are to

40 Eg. "If all wells on the said lands or on land with which the said lands or any part thereof are then pooled, combined or unitized . . ., are either before or after production there from shut in . . . ."
—from a British-American lease, presently in use in Alberta.

41 *Ante*, p. ——

42 R.S.A. 1955, c. 164. This provision grants the Supreme Court of Alberta power to relieve against all penalties and forfeitures.

43 *Tate v. Stanolind Oil and Gas Co.* (1952), 240 P. (2d) 465. See also: Williams, *ante*, n. 14, at 459; Noel, *Shut-in Gas Well Payments* (1961), 12 Institute on Oil and Gas Law and Taxation 171 at 204-210.

44 Noel, *ante*, n. 43, at 209.

45 Summers, *ante*, n. 34, at p. 497.

be accorded the same force as express terms.[46] If a lessee can write into the lease provision for a sixty or ninety day period in which to pay shut-in royalty after capping, there would seem to be no reason why an implied term that would give the same result could not be upheld.[47]

In one important recent case however, this view was unequivocally rejected. The Texas Supreme Court in *Gulf Oil Corp.* v. *Reid*[48] held, where the shut-in had occurred after the primary term, that the lessee was not to be allowed a reasonable time after the gas well was capped in which to tender shut-in royalty. This case was cited and agreed with by Mr. Justice Kirby who stated the result of the case to be that, "the lease did not allow the lessee 'reasonable time' in which to pay shut-in royalty".[49]

The second version of the reasonable time proposition places emphasis not on the time for performance of the obligation of producing or paying shut-in royalty, but on the lessee's implied covenant to use reasonable diligence in marketing the product.[50] Summers has summarized the law as follows:

> Where, therefore, oil and gas leases do not state the time, manner and extent of performance of express and *implied* duties to test, develop *and market the product, the courts have of necessity tested the lessee's performance by the standards of reasonable time and reasonable diligence.*[51]

It seems not unreasonable that if the lessee has diligently searched for a market, the time for shut-in payment ought not to be enforced strictly. The lessor's rights would not be harmed. He receives the benefit of the implied covenant as well as shut-in royalty payments (when these are commenced) until such time as actual production begins.[52] It is not clear though, whether the reasonable time for payment here is the same as that under the first argument above.

The decision in *Gulf Oil Corp* v. *Reid*,[53] as well as denying the lessee a reasonable time in which to pay shut-in royalty, expressly denied him a reasonable time after discovery within which to market the product. The court stated:

> Just as the provisions in this lease have been held to deny a reasonable time to find a market after discovery of oil, so they have been construed to deny a reasonable time within which to pay 'shut-in' royalty after the 'shut-in' has taken place.[54]

The result that seems to follow from the Texas Supreme Court's decision is that the mere presence of a shut-in royalty clause, by means of which 'substitute production' can be established by tendering payment, abrogates the implied covenant to use reasonable diligence in marketing the gas and renders the lessee liable to lose his lease for lack of timely shut-in payment, despite his diligence in attempting to find a market.

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46 See Summers, *ante*, n. 34, at p. 496. But see *post* as to the effect of classification of interest granted under an oil and gas lease as a determinable fee or condition precedent.
47 See Noel, *ante*, n. 43, at 209.
48 (1960), 337 S.W. (2d) 267, 120 & G.R. 1159.
49 *Ante*, n. 8, at 196.
50 See *McVicker* v. *Horn, Robinson & Nathan* (1958), 322 P. (2d) 410. The dissenting judges in the *Reid* case (*ante*, n. 48) employed this reasoning.
51 Summers, *ante*, n. 43. Emphasis added. This passage was quoted by the dissent in the *Reid* case (*ante*, n. 48).
52 Shimer, *Constructional and Drafting Problems in Shut-in Royalty Clauses* (1956), 3 U.C.L.A.L. Rev. 564, 573.
53 *Ante*, n. 48.
54 12 O. & G.R. at 1164.

That the shut-in clause does not in fact destroy the implied covenant to market is relatively clear.[55] Further, the *Reid* decision has provoked barbed, though it is submitted, justified criticism, such as that James Noel, who has written:

> It is a strange construction, indeed which requires the lessee to perform an act within a reasonable time, and yet denies him the reasonable time within which to perform it.[56]

As previously mentioned, the *Reid* case was cited with approval at trial and its principle was endorsed by the Supreme Court of Canada in the *Kanstrup* case. It is suggested however, from the American views discussed above that there are two sound bases upon which a contrary decision might have been reached apart from the habendum clause. The former argument whereby a reasonable time in which to pay shut-in royalty is found by construction is the one more likely to be adopted in Canada. The latter view, based on an implied covenant, is distinctly foreign, since Canadian courts have not as yet seen fit to go outside express lease clauses by implying covenants. The attractiveness of the reasonable time theory is evident in the final words of James Noel's assessment of *Gulf Oil Corp.* v. *Reid*:

> To allow the lessee a reasonable time within which to make such payments is in no way unfair to the lessor and affords the lessee a practical opportunity to protect the product of his risk and investment by a clause both parties intended to have such effect. I know of no other type of contract involving property of such value in which the courts have imposed such harsh and exacting requirements upon condition of termination.[57]

SHUT-IN PAYMENT MUST BE MADE BEFORE EXPIRY OF PRIMARY TERM

The foregoing arguments have subjected the court's construction of the Kanstrup lease to scrutiny. But the Supreme Court did not rest its decision on so shaky a foundation as construction. The court went further, and found implicit support in the very nature of an oil and gas lease and the interest granted thereunder, or at least what they determined the nature of that interest to be.

Mr. Justice Martland concluded that for the shut-in payment to be effective to extend the lease beyond the primary term, it must be tendered to the lessor before the end of the primary term. He did however, express himself to be in agreement with the trial judge who had approved the decision in the leading American case of *Freeman* v. *Magnolia Petroleum Co.*[58] The facts in that case were similar to those in *Canadian Superior Oil* v. *Kanstrup*. The shut-in clause in the lease provided:

> 3. The royalties *to be paid by the lessee* are: . . . (b) on gas . . . a royalty of $50 per year on each gas well from which gas only is produced while gas there from is not sold or used off the premises, and *while said royalty is so paid, said well shall be held to be a producing well under paragraph 2 hereof.*[59]

The court held that, since at the end of the primary term there was no actual production, and since the shut-in royalty clause providing for

55 *Risinger* v. *Arkansas-Louisiana Gas Co.* (1941), 3 So. (2d) 289.
56 Noel, *ante*, n. 43, at 207.
57 *Id.* at 210.
58 (1943), 171 S.W. (2d) 339.
59 *Ibid.* Emphasis added.

substitute production was effective only *"while said royalty was so paid"*, as there had been no payment before the expiry of the primary term, the lease terminated automatically through the operation of the "thereafter" provision in the habendum clause.

The application of this reasoning in the *Kanstrup* case appears incontrovertible. There, the shut-in royalty clause deemed substitute production "if such payment is made". Payment was not made during the primary term, and therefore the lease terminated.

The principle behind this automatic termination is found in the nature of the interest held by the lessee under an ordinary oil and gas lease and the mechanics of its extension by production or substitute production under the habendum clause. In Alberta it appears that the lessee under an oil and gas lease acquires an interest on condition precedent.[60] The estate is vested from the outset, with production during the primary term a condition precedent to the vesting of a future interest. The "unless" clause is stated in a Canadian text to

> effect a limitation on the interest granted rather than merely a condition subsequent entitling re-entry by the lessor upon non-performance.[61]

This applies equally to the shut-in royalty clause, as appears below. The American position (at least in Texas and Louisiana) appears to be similar.[62]

Mr. Justice Kirby quoted extensively from the judgment of Mr. Justice Frank Ford in *East Crest Oil Co.* v. Strohschein.[63] That case was one in which delay rental was not paid on the specified date, but Mr. Justice Kirby found the same principle applicable to shut-in royalty payments. After quoting Mr. Justice Ford, where he in his judgment quoted Mr. Justice Shepherd (the trial judge in that case) as follows:

> The lessee is not bound to either drill or pay but may do either of these things only if he so chooses. The lease carries within its own phraseology an automatic termination which becomes effective when the lessee fails to commence drilling operations within the time specified and also fails to exercise his privilege of paying delay rental in advance,[64]

and later where he stated:

> The clauses containing the provision concerning 'delay rental' merely confers a privilege on the lessee to have the lease continued for a further period of a year beyond the first without any obligation on him to exercise the privilege. There is, in my opinion, no penalty or forfeiture involved,[65]

Mr. Justice Kirby continued:

> The situation here is similar to that stated in the words of Shepherd, J. quoted above. The lessee is not bound to pay royalty. He may do so if he chooses. The lease contains an automatic termination which becomes effective in this case when the lessee fails to exercise his privilege of paying the $100.00 royalty.[66]

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60 *Canada-Cities Service Petroleum Corp.* v. *Kininmonth* (1964), 45 D.L.R. (2d) 36, 44, where Martland, J. appears to endorse Summers' theory.

61 Lewis and Thompson, *Canadian Oil and Gas*, vol. 1, No. 104.

62 Summers, *ante*, n. 34, No. 300, p. 238 states:
"The act of drilling wells and the production of oil and gas from the demised land within the definite term is a condition precedent to the creation of a future interest in the land and not a condition subsequent, the breach of which would result in the forfeiture of an existing estate or interest in lands." (or at least a determinable fee, the special limitation being the lapsation of production during the secondary term. See Malone, *ante*, n. 13, at 29, 49).

63 [1952] 2 D.L.R. 432.

64 *Id.* at 436.

65 *Id.*, at 437.

66 *Ante*, n. 8, at 293.

Agreement with the views enunciated by Mr. Justice Frank Ford in the *Strohschein* case[67] was also expressed by Mr. Justice Martland in the Supreme Court of Canada.[68] Clearly, given that the interest obtained by an oil and gas lessee is an estate capable of extension upon condition precedent (the condition being production or substitute production at the end of the primary term) and not an estate upon condition subsequent, forfeiture of which might disclose grounds for equitable relief, the decision in *Canadian Superior Oil Co.* v. *Kanstrup* would seem to be unassailable. However, aside even from the critical appraisal already advanced upon the construction aspect, a caveat must be added at this point.

All three courts made much of the shut-in royalty clause being of a "permissive" rather than an "obligatory" nature. This approach aided the court in applying the reasoning of the *Strohschein* case that case being concerned with delay rentals, which because of the "unless" clause are necessarily permissive. However, it is difficult to see how the permissive nature of the shut-in royalty clause can make any difference when the shut-in payment is due at[69] or after[70] the end of the primary term.

Under a permissive clause, shut-in royalties if paid during the primary term do in some respects partake of the nature of delay rental payments, in that payment is a condition, which if left unfulfilled will result in termination of the lease.[71] Under an obligatory clause on the other hand, it appears that non-payment during the primary term will not have the effect of terminating the lease. The lessee is bound to pay and must do so unless there are surrender provisions by which the lease can be avoided. In this situation, an action will lie against the lessee only for the unpaid royalties and not for termination of the lease.[72]

But this distinction loses all force when the question is time for payment of shut-in royalty at the end of the primary term or during the secondary term. The termination mechanism built into the habendum clause overrides in these situations. If there is no production or substitute production the lease terminates. Indeed, the shut-in clause construed in *Freeman* v. *Magnolia Petroleum Co.*[73] was of the obligatory rather than the permissive type; yet, as pointed out above, it was there held that the lease terminated automatically, payment no being forthcoming before the expiration of the primary term. In *Gulf Oil Corp* v. *Reid*[74] on the other hand, the shut-in provision was permissive, yet the court applied and extended the doctrine of the *Freeman* case. The reasoning in *Freeman* was expressly adopted by Mr. Justice Kirby and implicitly by the Supreme Court of Canada in the *Kanstrup* case. The conclusion appears to follow is that the permissive nature of the shut-in royalty clause in the *Kanstrup* case should have had no bearing on the

67 *Ante*, n. 63.
68 *Ante*, n. 1, at 105.
69 As in the *Kanstrup* case.
70 As in *Gulf Oil Corp.* v. *Reid*, *ante*, n. 48.
71 Moses, *ante*, n. 13, at 59. The view has also been advanced, and it is perhaps a better one, that where delay rental continues to be paid during the primary term, the lessee need not pay shut-in royalty, so long as the first payment is made before the end of the primary term: A. W. Walker (1945-46), 24 Tex. L. Rev. 478, 481.
72 Williams, *ante*, n. 14, at p. 436.
73 *Ante*, n. 58.
74 *Ante*, n. 48.

decision, since the question of timeliness of shut-in payments during the primary term was not before the court.

Following the actual decision of the Supreme Court of Canada, the principle that should guide operators in making timely shut-in payments may be shortly stated. Where the lease is within the primary term, if shut-in royalty payments are to be employed to extend the lease, the first of such payments must be made before the end of the primary term, especially if the shut-in clause is permissive. A statement by Leslie Moses may be usefully adopted by way of summation.

> In view of the *Freeman* and *Reid* decisions [and, it might be added, the *Kanstrup* case] the ultimate test of timeliness of payment can be summarized in one short sentence: 'Would actual production on the date of the shut-in royalty payment have been sufficient to maintain the lease in force?[75]

There are several methods of avoiding the problem that becomes a possibility every time drilling is in progress either late in the primary term or during the secondary term. If a gas well that must be capped is brought in a bare few days before the expiry date of the primary term, shut-in-royalty must be paid before that date. Where the lease is in the secondary term, if the *Reid* decision is followed in Canada, royalty must be tendered before the date of shut-in. It can be readily appreciated that ordinary office procedure may make it impossible for the lessee to tender the money to the person or persons entitled, or his depository for at least several days after the shut-in. By the time this is completed, the lease may have terminated despite his diligence.

One expedient sees the lessee, who is drilling late in the primary term, tender the shut-in payment by way of insurance *before* the well is completed, and consequently before he knows whether or not it will have to be shut-in. But the surest solution, is the inclusion in the shut-in clause of provision for a sixty or ninety day period for payment of shut-in royalty after the well is capped. Such provisions are found in the shut-in royalty clauses included in most lease forms presently in use in Alberta.[76]

ESTOPPEL BY RECEIPT OF PAYMENTS

The other point concerning shut-in royalty provisions dealt with by the court in *Canadian Superior Oil* v. *Kanstrup* was whether the receipt of payments by the lessor after the primary term had expired gave rise to any estoppel, election, or waiver of forfeiture that might serve to preclude him from denying the continuation of the lease into the secondary term.

Williams has suggested that in some cases an estoppel may arise in this situation. He cites several cases and enlists the support of Professor Kuntz.[77] Several other authorities have ventured the same opinion.[78]

75 Moses, *ante*, n. 13, at 58.

76 See Williams, *ante*, n. 14 at p. 459.
A typical provision reads:
". . . lessee shall pay as royalty in respect of such well within 60 days after the completion or capping thereof . . . the greater of [$100 or $1 per acre]"
—from a Pan-Am. lease (1964 revision)

77 Williams, *ante*, n. 14, at 482. The cases cited are *Bristol* v. *Colorado Oil & Gas Corp.* *ante*, n. 15 and *Shell Oil* v. *Goodroe* (1946), 197 S.W. (2d) 395. In the latter an alternative ground for the decision was stated: "the acts of the appellees in accepting the payment of the shut-in royalty, in our opinion, estops them from contending that the lease had expired." (197 S.W. (2d) at 399). Professor Kuntz' statement is taken from discussion Notes (1956), 5 O & G.R. 59, 61.

78 See Noel, *ante*, n. 43, at 215-216; Adoue, *Royalty and Pooling Provisions in Oil, Gas and Mineral Leases* (1951), 2 Institute on Oil and Gas Law and Taxation 195, 218-219.

The Supreme Court of Canada however, decided that there was no election or waiver of forfeiture that could affect the legal position of the lessor *Kanstrup*. Mr. Justice Martland concluded:

> In my opinion no question arises in this case as to election or waiver of forfeiture by the respondent Kanstrup. *This lease contained within itself a provision which operated automatically to terminate it upon the expiration of the primary term.* Thereafter, there were no steps required to be taken by Kanstrup in order to bring it to an end. There was no election for him to make. There was no obligation on the part of the appellant to make any royalty payment in respect of the capped well, even assuming that cl. 3(b) was applicable to it. *There was no default on the part of the appellant in not paying that money before the primary term had expired. There was therefore no forfeiture to relieve against.*[79]

This is entirely consistent with the court's previous finding on the question of time for payment of shut-in royalty. Having proceeded, in determining that issue, on the footing that the interest held by the lessee is an estate upon condition precedent, subject to automatic termination if the precedent event does not occur, it followed that payment not having been made before the expiry of the primary term, termination resulted. This having occurred, Mr. Justice Martland's closing words follow—"There was therefore no forfeiture to relieve against."

American law on this point suggests that estoppel will in some cases operate in favour of the lessee. It is difficult, however to justify decisions which revive or renew the lessee's interest by looking to subsequent events and actions of the parties. This is so especially when it is realized that failure to perform the condition precedent results in absolute disappearance of the interest.[80] The determination in the *Kanstrup* case that equitable doctrines of estoppel or waiver as well as the concept of novation[81] have no application to interests upon condition precedent granted by oil and gas leases is, it is suggested, quite consistent with the nature of the estate granted.

CONCLUSION

The decision in *Canadian Superior Oil* v. *Kanstrup* at least provides an authoritative Canadian decision on the problems involved in construing shut-in royalty clauses which are discussed above. It shows that American case law is helpful in this area; though it seems clear that only cases from states[82] which recognize that production or substitute production is a limitation upon the interest granted under an oil and gas lease will, or ought to be held up as persuasive. Certainly the aberrations of American courts on the issue of estoppel or waiver by reason of acceptance of shut-in payments beyond the primary term will not be followed.

As to the future of the shut-in royalty clause, this appears to be in the hands of the draftsmen. Recognition is universal in the industry

79 *Ante*, n. 1, at 105 (Emphasis added).

80 See Scurlock, *Practical and Legal Problems in Delay Rental and Shut-in Royalty Payments* (1953), 4 Institute on Oil and Gas Law and Taxation 17, 31.

81 The company had advanced the argument of novation at the trial. Kirby, J. disposed of it with reference to *Langlosis* v. *Can. Superior Oil of California Ltd.* (1957), 12 D.L.R. (2d) 53 (Man. Q.B.) wherein Williams, C.J.Q.B. pointed out that the grant of a *profit à prendre* could only be made under seal. The Appellate Division dealt cursorily with this argument and Mr. Justice Martland omitted consideration of it entirely.

82 Texas, Arkansas, Mississippi, New Mexico, California and Louisiana.

that the shut-in royalty clause is necessary in a modern oil and gas lease, if the lessee's valuable interest is to be accorded maximum protection. With this in mind draftsmen have striven to design more flexible shut-in clauses. This trend may in the future lead more and more to particular shut-in clauses being designed to cover particular fact situations rather than one standard form for general use. To date however, improvements have taken the form of additional provisions to cover contingencies that have, on the basis of past judicial decisions, caused lessees grief, or on the projections and analyses of commentators, are likely to do so in the future. So the matter stands today in Alberta.

ALASTAIR LUCAS*

*B.A., LL.B. (Alta.) of the 1966 graduating class.