OIL AND GAS LAW—LEASE SUBJECT TO USUAL TERMINATION ON DEFAULT OF PRODUCTION CLAUSE—WHEN LEASE TERMINATED THEREUNDER

A recent decision of the Supreme Court of Canada undoubtedly has caused some concern throughout the oil industry of Western Canada and resulted in petroleum lawyers re-examining the standard form of oil and gas leases which have been in general use by the industry over the past fifteen years.

That decision is *Canada-Cities Service Petroleum Corporation* v. *Kininmonth* (1964), 45 D.L.R. (2d) 36, the facts of which are as follows. On May 11, 1951, Kininmonth, as lessor, entered into an oil and gas lease with one Machon, as lessee, who subsequently assigned his rights to the company, the appellant. The demised lands were the south half of section 26, township 27, range 2, west of the fifth meridian and the duration of the lease was set out in the following clauses:

> TO HAVE AND ENJOY the same for the term of 10 years from the date hereof and so long thereafter as the said substances or any of them are being produced from the said lands, subject to the sooner termination of the said term as hereinafter provided. [this clause will hereinafter be called the first clause]
> AND FURTHER ALWAYS PROVIDED that if at any time after the expiration of the said 10 year term the said substances are not being produced on the said lands and the Lessee is then engaged in drilling or working operations thereon, this Lease shall remain in force so long as such operations are prosecuted, and if they result in the production of the said substances or any of them, so long thereafter as the said substances or any of them are produced from the said lands, provided that if drilling, working or production operations are interrupted or suspended as the result of any cause whatsoever beyond the Lessee's control, other than the Lessee's lack of funds, the time of such interruption or suspension shall not be counted against the Lessee, anything hereinbefore contained or implied to the contrary notwithstanding [this clause will hereinafter be called the second clause].

In February of the tenth year, the company applied for and received permission to drill a well. The company commenced drilling to the Jumping Pound Sand formation on March 21, 1961. While so drilling, crude oil was encountered at a lesser depth in the Cardium Sand formation; but the company, in the hopes that discovery would be made at a greater depth, continued to drill, without producing from the Cardium formation.

Those hopes were not satisfied; and, as a result, the company on March 30, 1961, obtained permission to plug back the well to the successful formation, subject to compliance with certain spacing unit requirements.

On April 1, 1961, the well had been successfully plugged back, but required a certain fracturing treatment which would open the producing formation. However, because of a municipal road ban of March 17, 1961, the company was unable to get its equipment to the well site in order to properly work the well. This ban continued until May 11, 1961, although it was later found to be *ultra vires*.

At any rate, when the road ban was lifted, the company brought in its equipment and production was obtained on June 26, 1961. On July

6, the company was compelled to cease production for failure to comply with spacing unit regulations.

Kininmonth thereupon gave notice to the company to proceed upon its caveat pursuant to Section 144 of the *Land Titles Act*, R.S.A. 1955, c. 170.

In the words of Martland, J., who gave the decision of the Supreme Court of Canada, "The question in issue was as to whether the petroleum and natural gas lease still subsists, or whether it terminated at the end of the 10 year primary term."[1]

The trial judge held that the lease was still subsisting; but the Appellate Division of the Supreme Court of Alberta (MacDonald, J.A., dissenting) relying on the second clause, held that the burden was on the lessee to establish that the interruption was from causes beyond its control and that this burden had not been satified.[2]

Upon further appeal to the Supreme Court of Canada, Martland, J., while recognizing that the second clause had some role to play, nevertheless rejected it from the facts under consideration and relied solely upon the first clause. By so doing, he rejected the entire basis of the decision in the Appellate Division.

> . . . there is no provision in it to enable the extension of its term beyond 10 years, save only by the production of one of the substances from the land within and continuing beyond that period. Such production did not occur in the present case and, accordingly, in my opinion, the lease terminated at the end of its primary term.[3]

In arriving at this conclusion, he expressly rejected a large body of American authority to the effect that there are exceptions to the general rule that the lease terminates upon expiration of the primary term.

It is proposed here to examine the reasoning behind this rejection, to state and to look at the two divisions of authority, and to try and ascertain which is the superior rule.

It is important to understand the distinction between the nature of the interest granted and the estate that is created in that interest. There are several schools of thought in regard to the nature of the interest granted. The first is the "absolute ownership in place" theory,[4] whereby the lessee is the absolute owner of the strata for a certain term. The second theory is that the interest created is a *profit à prendre*,[5] which in essence is a licence coupled with a grant whereby the lessee is entitled to go upon the land, to explore, to produce, and is then granted the absolute ownership of such oil and gas as he reduces to his possession, subject of course, to a right of royalty held by the lessor.

While the nature of the interest granted is determined by the granting clause, the duration of such interest is determined by the *habendum* clause. From the duration aspect, the estate created may be any of the various estates which may be lawfully created, such as an estate for years or a determinable fee.[6]

It may be of value, at this point, to examine the evolution of the oil

1 (1964), 45 D.L.R. (2d) 36, 40.
2 (1963), 42 D.L.R. (2d) 56, 44 W.W.R. 392.
3 *Ante*, n. 1, at 44.
4 Lewis and Thompson, *Canadian Oil and Gas*, Vol 1, § 31.
5 *Berkheiser* v. *Berkheiser* (1957), 7 D.L.R. (2d) 721.
6 Kuntz, *Law of Oil and Gas*. Vol 2, § 26-2.

and gas lease over the past hundred years.[7] The first type of lease used was adapted from agricultural leases and was for a fixed term of years. This was soon found to be unsatisfactory in the petroleum industry, especially when a company was required to give up a producing well after the expiration of its five or ten year term. As a result, the "thereafter clause" evolved which extended the fixed term for so long as there was production. As the technological advances in the industry became more sophisticated, the lease followed suit. In the result, two distinct types of leases developed. The first was the "drill or pay" type of lease, whereby the lessee was obliged to either drill a well or pay an annual rental for a fixed term. Such a clause was held to be part of the conditions of a lease, as opposed to part of the grant itself, and the lessee was obliged to make payments for the full term and could not surrender at his option. The other type of lease was known as the "unless" lease, whereby the obligations, instead of being part of the conditions of the lease, were in fact a limitation on the grant. As a result, the lessee had the option of either drilling, paying, or terminating by doing neither. The lease involved in the *Kininmonth* case was such a lease. Moore, J., has said of this type of lease, that from its nature "it carries within its own phraseology an automatic termination which clicks when the lessee fails to commence drilling operations within the time specified . . ."[8] With experience as a guideline, there developed certain other clauses which may be termed saving provisions, such as the surrender clause, dryhole clause, and the cessation of production clause (such as clause two in the present lease).

The important question remains, what type of estate does the *habendum* clause create in the present case? The significance of this question will perhaps be better appreciated when the remedies are examined.

Martland, J., made reference to two divisions of American authority with respect to failure to produce within the primary term. He acknowledged the authorities that were relied upon by MacDonald, J.A., in the Appellate Division, but seemed to reject that school of thought when he stated:

> It may be noted that in Summers *The Law of Oil and Gas*, Permanent Edition, Vol. 2, the learned author deals with the interpretation of the *habendum* clause in a petroleum and natural gas lease in chapter ten. In particular, in §§ 292 to 301 in that chapter, he refers, on various occasions, to the general rule that production within the definite term is a condition precedent to the extension of the lease beyond that term.[9]

Among the various occasions on which Summers refers to the general rule are the following passages:

> One situation, in which there has been a departure from the rule that production in paying quantities within the definite term is a condition precedent to the extension of a lease beyond that term, is where the lessee has drilled a well and discovered gas in paying quantities but has been unable to actually produce it because a market therefor was not available.[10]
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> The second and third situations which have caused the courts in some jurisdictions to depart from the general rule that production within the definite term is a

7 Williams, *Oil and Gas Law*, 601.
8 *Richfield Oil Corp.* v. *Bloomfield* (1951), 229 Pac. (2nd) 838, 840.
9 *Ante*, n. 1, at 43, 44.
10 Summers, *The Law of Oil and Gas*, (Permanent edition) Vol. 2, § 229 at p. 220.

condition precedent to the extension of the lease beyond that term are so closely related that they may be considered together.[11]

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The fundamental objection to the first of these theories lies in the fact that 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.[12]

In order to better appreciate Summers' argument, it would be well to examine the other division of authority. Hereafter Summers' theory will be referred to as the "condition precedent" theory, and the other division of authority will be referred to as the "equitable theory."

The rationale behind the "equitable theory" has two foundations. First, the mere discovery of petroleum in paying quantities vested in the lessee a right to produce the petroleum from the land, even though there was no production within the primary term. Miller, P., has stated: "Our cases seem to clearly hold that discovery of oil or gas is alone sufficient to vest thė right—a right, it is true, which may be lost by abandonment, manifested by neglect to produce or pursue the work of production and further development."[13] The second foundation is that equity should provide the lessee with equitable relief against the termination of the lease because he has substantially complied with its provisions. In the landmark case with regard to this foundation, Poffenbarger, J., stated:

The clause, relating to subsequent time, says, in very general and indefinite terms, the lease shall remain in force so long thereafter as oil or gas is produced . . . . Unless the qualifying clause, 'as oil or gas is produced' alters the nature of the tenancy or estate, it remains what it was within the term, a right to take out the oil, burdened with the duty to exercise diligence, skill, and good faith in the discharge thereof . . . . May we not, therefore, say the qualifying clause 'as oil or gas is produced' really means 'as long as the premises are diligently and efficiently operated, provided minerals shall have been discovered within the fixed term'? Which construction harmonizes the more completely and naturally with the manifest purposes of the parties as indicated by the other provisions of the lease, their situation, and the surrounding circumstances?

In the interpretation and application of a contract, the spirit and purpose of the instrument as well as its letter must be regarded, and made effective in all directions and as to all parties . . . . It is going too far to say either party at the time of the execution of the lease, intended general and indefinite terms employed by them to be used as instruments of extreme hardship by the operation of technical rules . . . .[14]

The proponents of the "condition precedent" theory attack this concept of vesting on production on the basis that the rights are vested from the outset. Summers states:

Prior to discovery, the lessee's interest was said to be inchoate, but after discovery to be vested. The fallacies of this theory have long since been exposed, and practically all courts now hold that the lessee has a vested interest for the purpose of the lease immediately upon the execution thereof, and one of those purposes is undoubtedly the production of the mineral.[15]

With regard to the equitable relief from forfeiture and the substantial compliance basis, the "condition precedent" proponents answer that it is an established principle of law that condition precedents must be literally performed:

Precedent conditions must be literally performed and even a Court of Chancery will never vest an estate, when by reason of a condition precedent, it will not

11 *Id.*, § 300 at pp. 231-233.
12 *Id.*, § 300 at p. 238. Other references at pp. 241, 244, 250.
13 *Eastern Oil Co.* v. *Coulehan* (1909), 64 S.E. 836 (S.C. of App. West Virg.).
14 *South Penn Oil Co.* v. *Snodgrass* (1912), 76 S.E. 961 (S.C. of App. West Virg.).
15 Summers, *ante*, n. 10, § 300 at p. 235.

vest in law. It cannot relieve from the consequence of a condition precedent unperformed.[16]

The "condition precedent" theorists maintain that the courts which apply the equitable theory and ignore the two principles noted above are in effect supplying a different set of conditions which the parties did not provide for or contemplate when they executed the lease. As was said by Robinson, J., dissenting, in the *Snodgrass* case: "The decision makes the contract between the parties other than that which they must have contemplated when the lease was executed."[17]

Looking at both these theories, it is respectfully submitted that neither is perfectly correct, and that a conceptual analysis will bear this out.

Both Summers and Martland, J., believed the general rule to be that production during the primary term is a condition prcedent to an extension of the lease beyond the primary term—a condition precedent to the vesting of a future interest in the lease. By definition, a "condition precedent is one that delays the vesting of a right until the happening of an event."[18] If this is so, then what right is delayed in vesting until production? With respect, it is submitted that there is none. As was said by Kerr:

> From the plain language of the granting and *habendum* clauses it is clear that the estate in the land covered by the lease and all the rights granted in connection therewith, including the right to drill wells thereon and to produce oil and gas therefrom, are created and vested at the moment of the execution and delivery of the lease. Nothing further remains to be acquired by the lessee or granted to him.[19]

Such reasoning is in accord with what was said by the Supreme Court of Oklahoma:

> In other words, it was a grant of the exclusive right, for the time specified, to take all the oil and gas that could be found by drilling wells upon the particular tract of land, with the accompanying incidental right to occupy so much of the surface as required to do those things necessary to the discovery of and for the enjoyment of the principal right so to take oil or gas. No more greater right, except perhaps as to duration, with respect to oil and gas, could be granted.[20]

Nor can the primary term and the thereafter term be split up, the former being treated as an estate for years and the latter being treated as a future interest. Summers would appear in this regard to be inconsistent, for at one point he states that the "lessee has a vested interest for the purposes of the lease immediately upon execution thereof . . .";[21] and yet in the same section he states that "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 . . . ."[22] Kuntz has said that:

> Although the fixed term and the thereafter or indefinite term are separately described, they are undoubtedly indivisible. Such a lease cannot be classified as an estate for years followed by a determinable fee . . . .[23]

It is submitted that a correct analysis would indicate that, where the lease provides for a fixed term with provisions for annual renewals thereafter by drilling or paying rentals and with a further provision for

16 4 *Kent's Comm.* 125.
17 *Ante*, n. 14.
18 Osborn, *Law Dictionary*.
19 Kerr, *Maintaining the Lease in Effect*, Fifth Annual Institute of Oil and Gas Law 337.
20 *Rich* v. *Doneghey* (1918), 117 Pac. 86, 89, 90.
21 Summers, *ante*, n. 10, § 300 at p. 235.
22 *Id.*, § 300 at p. 238.
23 Kuntz, *ante*, n. 6, § 26.4 at p. 252.

duration so long as oil or gas is produced, the estate created is a determinable fee,[24] vested from the outset.[25] One of the limitations on this estate is production within the primary term; and, failing such production, the lease is automatically terminated as distinguished from forfeiture or the loss of a future estate.

By definition, a limitation on an estate "is to mark out the extreme period during which it is to continue."[26] It is submitted, therefore, that the *habendum* clause in the present lease provides for alternative limitations—*viz.*, "for the term of 10 years from the date hereof" and (the second alternative) "so long thereafter as the said substances or any of them are being produced from the said lands"—on the estate that is vested from the outset.

Similarly, in regard to a condition subsequent, Megarry states:

> The difference between a determinable fee and a fee simple defeasible by a condition subsequent is not always easy to discern. The essential distinction is that the determining event in a determinable fee itself sets the limit for the estate first granted. A condition subsequent, on the other hand, is an independent clause added to a limitation of a complete fee simple absolute which operates so as to defeat it.[27]

The traditional example of a determinable fee is as follows: To A and his heirs so long as St. Paul's Cathedral stands, but if St. Paul's falls, the estate to terminate.[28] As a determinable fee automatically terminates when the specified event occurs, under such a grant the only inquiry should be as to whether the event has occurred. The inquiry should not be as to whether it is equitable for the event to have occurred, or whether it is equitable for the estate to have terminated. Admittedly, however, there may be problems as to what extent St. Paul's must fall, and it is possibly in this area that the "equitable theory" arises.

By way of example, one might question what is meant by production. Is discovery enough? Must it be in paying quantities? Some leases have in fact used the word "discovered" instead of "production," with the resulting effect that termination has been prevented; but from such terminology has arisen further problems such as how long a lessee who discovers oil or gas may hold the land without producing.

At any rate, it would appear that if the "determinable fee" theory is followed, the proponents of the equitable theory still have no firm foundation upon which to base their position. The estate would still seem to vest from the outset. Thus, nothing further can vest upon discovery of production. Under the "determinable fee" theory there is still an automatic termination from which a court of Equity can give no relief; nor can equitable relief be given for substantial compliance, for under such a grant it is well established that time is of the essence.

In conclusion, it is submitted that both the "condition precedent" theory and the "determinable fee" theory have a firmer basis on sound, well-established principles of law (providing for certainty and stability that are in accord with precedent) than has the "equitable theory" (which would appear to foster uncertainty, induce arbitrary decisions, and reject

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24 *Id.* at § 26.2.
25 Kuntz, *id.* at § 26.3; Summers, *ante*, n. 10 § 300.
26 Osborn, *ante*, n. 18.
27 *Megarry and Wade, Real Property* (2nd ed. 1959) 76.
28 *Id.* at 75.

established principles of law which the parties must be taken to have relied upon when entering into the lease). It is difficult to dispute that, at first impression, there would seem to be an injustice where a company, having spent over $100,000 to develop the land, loses a well worth probably five times that amount on what may be termed a technicality. But several facts must be brought to mind to keep the proper perspective. Firstly, notwithstanding the decision in the Supreme Court of Canada, the company would have lost the well on the basis of the decision in the Alberta Appellate Division; and, secondly, it was the company that presented the terms of the lease and it was its responsibility to eliminate ambiguity and uncertainty.

As mentioned earlier, both the oil industry and the lease document have been subject to evolution, there being continuing adaptation to new environments and conditions. As a result of the decision in the *Kinimonth* case, the industry is now keeping closer check upon its old leases and altering its exploration and production deadlines accordingly. In regard to new leases, it is interesting to note that the saving clause has now been altered to read:

> AND FURTHER ALWAYS PROVIDED that if at the end of the said 10 year term the leased substances are not being produced from the said lands (whether or not the leased substances have theretofore been produced therefrom) and the Lessee is then engaged in drilling or working operations thereon . . . then this lease shall remain in force so long as drilling or working operations are prosecuted . . . and if they result in the production of the leased substances or any of them, so long thereafter as the leased substances or any of them are produced from the said lands . . .[29]

It will be interesting to follow the interpretations which arise from this alteration, on the industry's path to maturity.

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[29] Imperial Oil Enterprises 1964 revisions of its Oil and Gas Lease.

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