OIL AND GAS DEVELOPMENT CONTRACT—INTERPRETATION—FIDUCIARY RELATION BETWEEN OPERATOR AND NON-OPERATOR—DUTIES OF OPERATOR

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Midcon Oil and Gas Limited v. *New British Dominion Oil Company and Brook*, a recent decision of the Supreme Court of Canada, is of great importance to the oil and gas industry. The Supreme Court had to determine whether an operator under an oil and gas development contract is in a fiduciary relation to the non-operator under that contract.

The facts of the case are complex. Midcon and New British entered into a "joint working interest agreement" for the exploration for, and development and production of, petroleum, natural gas and related hydro-carbons under a Crown reservation which was beneficially owned by New British. The agreement provided that if oil or gas were found, New British would have the right to act as operator. Natural gas in large quantities was found and New British elected to exercise its right to act as operator.

The word "operator" was defined in the schedule to the agreement to mean "the party designated to conduct the development and operation of the leased premises for the joint account," and his duties were outlined in some detail.[2] The Supreme Court held that implied or included in these duties, although nowhere stated in the agreement, was the duty "of attempting to sell or otherwise turn to account minerals discovered,[3] which was subject to the provisions of the contract.[4]

Mr. Brook, the president of New British, had assumed that his company had the duty to sell. However, he was unable to find a market in the vicinity and he was unable to arrange for the sale of gas to companies exporting it by pipeline. In these circumstances, Brook and the New British Company, with other interests, promoted a company for the manufacture of chemical fertilizers, which would purchase natural gas. Brook undertook this project apparently without reference to Midcon; indeed, he seems to have negotiated with the other interests as owner or as a person in absolute control of the entire gas resources included in the contract. On incorporation, the operator purchased 3,300 preferred shares (approximately 33%) in the company at the part value of $100 and 749,988 common shares (approximately 22%) at the price of 1 cent each. At the time of the trial, the common shares were selling at an amount well over $1.50 per share.[5]

In its subsequent action against New British, Midcon argued that New British as operator owed to Midcon, as non-operator, a fiduciary duty which it had breached when it purchased shares in the fertilizer plant and that Midcon

[1] [1958] S.C.R. 314.

[2] *Ibid.* pp. 317-9, 323-4.

[3] *Ibid.*, p. 323. This finding is in accordance with the understanding by the oil industry of the operator's duties.

[4] Especially Paragraphs 15 (b), 16 and 20.

[5] New British and Midcon together later incorporated another company for the construction of a pipeline. This transaction was not important to the case.

was therefore entitled, on payment of its share of the cost, to one-half of the shares in the chemical company issued to New British.[6] At trial, Primrose, J. held for New British and his decision was upheld on appeal to the Appellate Division[7] and to the Supreme Court of Canada.[8]

Before discussing the actual decision in the case, we must note one possible defence of New British which was not discussed fully in any of the judgments. It is clear that a person with a fiduciary duty to his principal can make a profit out of his trust if the principal knows that the fiduciary is making a profit and with full disclosure by the fiduciary of the facts the principal either consents or does not object. The evidence here established that at some unspecified time an official of Midcon asked Brook if they could obtain some of the chemical company's stock at the price paid or to be paid by Brook. The request was refused. This would seem to be evidence of assent by Midcon to Brook's dealings. However, there was little or no evidence of any full disclosure by New British to Midcon of the circumstances; indeed, Brook made it clear in his evidence that what he was doing was "none of their business."

Locke, J. relies on Midcon's assent to the contract of sale of natural gas to the fertilizer company. However, as Rand, J., in his dissenting decision, points out, this assent was given "without prejudice to the controversy which had then arisen between Midcon and New British."

The principal argument by Midcon was that New British, the operator, was in a fiduciary relationship with Midcon and that New British had not carried out its fiduciary duties. In the result, it was unnecessary to determine whether the operator had a fiduciary duty to the non-operator as the Supreme Court held that, even if such a duty did exist, it had not been breached. However, by way of dictum, the majority of the Court[9] went on to state that the operator under this agreement had no fiduciary duties to the non-operator. It is this point of the case that I wish to discuss.

The duty resting on people in a fiduciary position is succintly stated by Viscount Sankey in *Regal (Hastings) Ltd.* v. *Gulliver*:[10] "The general rule of equity is that no one who has duties of a fiduciary nature to perform is allowed to enter into engagements in which he has or can have a personal interest conflicting with the interests of those whom he is bound to protect. If he holds any property so acquired as trustee, he is bound to account for it to his cestui que trust." Maitland, paraphrasing Lewin, says, ". . . wherever a person clothed with a fiduciary character gains some personal advantage by availing himself of his situation as a trustee, he becomes a trustee of the advantage so gained."[11] The extent of this rule is indicated by Lord Russell of Killoween in the *Gulliver* case when he remarked that the rule "in no case

[6]19 W.W.R. p. 317.

[7]21 W.W.R. p. 228.

[8]Locke, J. delivered the judgment of the majority, (Kerwin C.J.C., Taschereau and Locke JJ.) and Rand J. dissented on behalf of himself and of Cartwright J.

[9]See also Primrose J. at trial. But cf. Johnson J.A. (Appellate Division).

[10][1942] 1 All E.R. 378.

[11]Maitland on Equity, p. 80.

depends on fraud or absence of *bona fides;* or upon such qustions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefitted by his action. The liability arises from the mere fact of a profit having, in the stated circumstances, been made . . . ."[12]

This doctrine was first applied to trustees, as in *Keech* v. *Sandford,*[13] but has been extended to many other relationships although, as *Re Biss*[14] points out, with different degrees of strictness. Therefore it was necessary for the Supreme Court first to decide what sort of relationship existed between the operator and the non-operator. From the judgments in the Supreme Court of Canada, it appears that the appellant argued three possible descriptions of the operator-non-operator relationship, namely, partnership, joint venture or a principal-agent relationship. All of the judges in the three courts who heard the case rejected the partnership argument. But they were equally divided in the question whether this was an agency or a joint venture contract.[15]

Those judges who could find neither an agency nor a joint venture and hence no fiduciary relationship relied on two main arguments. The first, stated by Primrose J. and impliedly accepted by the majority of the Supreme Court of Canada, was that the agreement set out in great detail the obligations of the operator and therefore the courts must not imply any other duties or liabilities. Surely, however, the question which the Court should have asked was; "What relationship have the parties created by this agreement?" As Sir Montague Smith stated, speaking for the Judicial Committee in *Mollwo, March and Co.* v. *The Court of Wards* (1872) L.R. 4 P.C. 419, ". . . the determination of cases of this kind is . . . to depend, not on arbitrary presumptions of law, but on the real contracts and relations of the parties."[16] If the result of this examination reveals that the contract does create a joint venture or an agency, then the fiduciary duties will attach whether the parties have stipulated to that effect or not. These relationships are not implied from the acts of the parties; they are imposed by the law "in the interests of good conscience and without reference to any express or implied intention of the parties"[17] and sometimes, indeed, even in opposition to those intentions.

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[12]p. 386.

[13](1726) 25 E. R. 223.

[14]In *Re Biss* [1903] 2 Ch. 40, the Court divided those relationships subject to a fiduciary duty into two classes, class 1 including trustees, executors, administrators and agents, and class 2 including mortgagees, joint tenants and partners. The difference between the two classes is that in the case of those individuals included in class 1 the presumption of personal incapacity to retain the benefit they get from their position is one of law and cannot be rebutted, whereas the members of class 2 are subject only to a rebuttable presumption of fact. See *Re Biss,* at p. 56 (Collins M.R.), and pp. 60-64 (Romer L.J.). See also *Ex Parte James* (1803) 32 E.R. 385, *Hamilton* v. *Wright* (1842) 8 E.R. 110, *Zwicker* v. *Stanbury* [1953] 2 S.C.R. 438.

[15]The three-member majority in the Supreme Court of Canada and Primrose J. at trial held that there was no agency or joint venture contract and therefore no fiduciary duties here. The reverse was held by the two dissenting judges in the Supreme Court of Canada, who followed the reasoning of the Appellate Division (Johnson and McBride JJ.A.).

[16](1872) L.R. 4 P.C. 419 at p. 435.

[17]Keeton on Trusts. pp. 192, 212.

The second argument relied on by those judges finding no agency or partnership and therefore no fiduciary relation was based on paragraphs 15 (a) and 20 of the agreement. These paragraphs expressly stated that the operator should be deemed to act as an independant contractor and that "no agency or partnership relationship is created by or between the parties hereto by the execution of this agreement or by the provisions hereof." Although neither the trial judge nor the majority in the Supreme Court of Canada expressly state that these clauses are conclusive of the matter, they are clearly given some weight in the final decision. There is no doubt that these clauses are excellent evidence of what relationship the contracting parties wanted to create. But it is respectfully submitted that the question for decision was, not what the parties wanted to create, but what they in fact did create.

There are relatively few cases dealing with this sort of problem. It is clear, of course, and many cases state, that the use of the term 'agent' or 'partner' does not create that relationship if the real agreement is different.[18] But what is the position in the reverse situation, that is, where the agreement expressly negatives the relationship? Where the covenantors seek to raise these clauses against third parties, the cases have decided that the court will look to the substance of the contract, and not to mere words or declarations to the contrary.[19] I have been unable to find a case other than the *Midcon* case where the interpretation of such a clause has arisen in a dispute between the parties to the contract, although there are dicta which suggest that the result would be the same as the case where third parties are involved.[20]. The same sort of attitude is indicated in the decision of the Supreme Court of Canada in *Firestone Tire and Rubber Co. of Canada Ltd. v. Commissioner of Income Tax.*[21] There a clause in the agreement in question stated that it was "not to be construed as constituting the Distributor the agent of the Company for any purpose". The Supreme Court eventually found that there was in substance no agency relationship but the judges did not use the clause quoted above as a shortcut, nor did they refer to it in any way.

There is no express statement in the decision of Locke, J. as to the extent to which he is relying on paragraphs 15 (a) and 20 of the agreement. In the absence of such a statement, it is still open for the courts to adopt what I submit is the correct approach to this type of clause, as stated by Johnson J.A. in the Appellate Division.[22]

> Paragraph 20 of the agreement has been quoted. It provides that no agency or partnership is created by the agreement or between the parties. If in fact agency is created by the agreement a denial of that fact in the agreement will not prevent it being so.

The question was the determination of the true nature of the relationship between the operator and the non-operator. The refusal of the courts to

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[18]For example, see *Ex Parte White* (1870-71) 6 Ch. App. 397.

[19]*Mollwo, March and Co. v. The Court of Wards* (1872) L.R. 4 P.C. 419, *Botham v. Keeper* (1878) 2 O.A.R. 595, *Beattie v. Dickson* (1909) 14 O.W.R. 565, *Trustees, etc. v. Oland* (1902) 35 N.S.R. 409. Cf. *Darling v. McLelland* (1876) 11 N.S.R. 164.

[20]*In Re Randolph* (1876-7) 1 O.A.R. 315 at 326. See also Lindley on Partnership, 11th ed., p. 50, fn. (i).

[21][1942] 4 D.L.R. 433.

[22]p. 236.

characterize the operator as partner or joint adventurer will not be discussed here. However, I will consider the question of agency as it is difficult to see how the Court was unable to find a principal-agent relation.

An agent is defined in Black's Law Dictionary as follows:

> One who represents and acts for another under the contract or relation of agency; one who undertakes to transact some business, or to manage some affair, for another, by the authority and on account of the latter, and to render an account of it.

Halsbury states:[23]

> The relation of agency arises whenever one person, called 'the agent', has authority, express or implied, to act on behalf of another, called 'the principal', and consents so to act . . . An agent, though bound to exercise his authority in accordance with all lawful instructions which may be given to him from time to time by his principal, is not subject in its exercise to the direct control or supervision of the principal.

Do the duties of the operator bring him within these definitions? It is submitted that they do. First, the operator had the duty of attempting to sell or otherwise turn to account any minerals discovered, including the undivided interest of Midcon in the minerals. Expenses and profits were to be borne and shared equally, with the operator receiving a management fee based on specified monthly rates for each drilling and producing well. The operator was required to account to the non-operator regarding the "development and operation of the leased premises" which clause was held to include sales. The operator had to seek the consent of the other party regarding "any matters of capital and serious Consequence affecting the rights of the respective parties therein." These clauses would seem to indicate that the operator was an agent of the non-operator for sale of oil and gas owned in part by the non-operator.

Although not all agents are in a fiduciary relationship with their principals, it is clear that fiduciary duties are imposed on an agent whose duty it is to sell his principal's property and that these duties are as strict as those placed on trustees, administrators and executors.[24] The general duty of an agent is stated clearly by Bowstead:[25]

> No agent is permitted to enter as such into any transaction in which he has a personal interest in conflict with his duty to his principal, unless the principal, with a full knowledge of all the material circumstances, and of the exact nature and extent of the agent's interest, consent. Where any transaction is entered into in violation of this rule, the principal, when the circumstances come to his knowledge, may repudiate the transaction, or may affirm it and recover from the agent any profit made by him in respect thereof.

Is there any conflict of interest and duty here? The conflict is obvious. The agent's duty is to sell at as high a price as possible, but his interest as a shareholder is to keep the price low. In fact, the price of the oil and gas sold to the chemical company was a fair price, but the cases are clear that this make no difference.[26]

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[23]Vol. 1, pp. 145-6. (3rd. ed.).

[24]See footnote 13.

[25]Bowstead on Agency, 11th ed. pp. 85-6. See also *Aberdeen Ry. Co.* v. *Blaikie Brothers* (1854) 1 Macq. 461, *Parker* v. *McKenna* (1874) 10 Ch. App. 96, *De Bussche* v. *Alt.* (1878) 8 Ch. D. 286, *Nordish Insulinlaboratorium* v. *Bencard* [1952] 2 All E. R. 1040. There are numerous Canadian cases. For a good review of them, see *Chas. Baker Ltd.* v. *Chas. Baker Sr.* [1954] 3 D.L.R. 432.

[26]*Gillett* v. *Peppercorne* (1840) 49 E. R. 31.

If an agent for sale sells to himself or his colleagues, either directly, or collusively through the intervention of a third party, a conflict of interest and duty exists. Does it make any difference that the sale is to a company in which the agent holds approximately 25% of the shares? There is some conflict in the cases on this point and, indeed, Underhill goes so far as to say that the rule "does not prevent a trustee selling to a limited company (other than a 'one-man company') in which he is a mere shareholder; for a sale by a person to a corporation is not, either in form or in substance, a sale by him to himself and others."[27] He cities as his authority for this proposition *Farrar* v. *Farrars, Limited.*[28] In that case, three mortgagees in possession, of whom Farrar was one, and who acted as their solicitor, sold under the powers of sale in their mortgage deed to a company formed for the purpose of purchasing the property. The company was to some extent promoted by Farrar who became solicitor to the company and had a substantial (one-tenth) interest as a shareholder. But in *Re Biss* it was pointed out that the duty of the mortgagee, unlike that of the trustee or agent, is not absolute, and in this case the presumption against the transaction was rebutted. Also the decree refused in the *Farrar* case was a decree to set aside the sale and Lindley L. J. in the case states that if the decree asked for had been to declare the shareholder constructive trustee of his shares for the plaintiff, the results might have been different. The reason Lindley L.J. drew this distinction was the case of *Turner* v. *Trelawny.*[29] In that case, an assignee of a bankrupt company sold goods to a new company in which the defendant held shares which he had purchased from the assignee. Despite the defendant's ignorance of the assignee's double position, he was held to be a trustee of the shares for the old company. This approach has been followed in other cases[30] and it is submitted that it is correct as the conflict of interest and duty in an agent for sale in this situation is not materially different from the case where he sells to himself.

Even if we assume that New British was under no fiduciary duty, still it is submitted that the Court might have considered the recent case of *Reading* v. *A.G.*[31] before deciding that the operator was free of all duty towards the non-operator. In that case a sergeant in the British Army on active service abroad consented on several occasions to accompany civilian lorries transporting illicit spirits to specified destinations. He always wore military uniform in order to avoid inspection of them by the police, and for his services he received in all £20,000. The military authorities took possession of several thousand pounds found in his hands, and he was tried by court-martial and convicted of conduct prejudicial to good order and military

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[27]Underhill on Trusts, 10th ed., p. 380.

[28](1888) 40 Ch. D. 395.

[29](1841) 59 E.R. 1049.

[30]*Salomons* v. *Pender* (1865) 159 E.R. 682, *Transvaal Lands Co.* v. *New Belgium (Transvaal) Land and Devt. Co.* [1914] 2 Ch. 488, *Roxborough Gardens of Hamilton* v. *Davis* (1919) 52 D.L.R. 572.

[31]*Reading* v. *A.G.* [1948] 2 K.B. 268 (T.J.), aff [1949] 2 K.B 232 (C.A.), aff. [1951] A.C. 507 (H.L.).

discipline. After his release from prison he claimed, by petition of right, the return of the money seized.

The courts all held for the Crown that it could keep the money seized, but for different, and interesting, reasons. Denning J. began by holding that "This man Reading was not acting in the course of his employment, and there was no fiduciary relationship in respect of these long journeys nor, indeed, in respect of his uniform."[32] However, his Lordship nevertheless found that the money could be retained by the Crown on the following ground:

> In my judgment, it is a principle of law that if a servant, in violation of his duty of honesty and good faith, takes advantage of his service to make a profit for himself, in this sense, that the assets of which he has control, or the facilities which he enjoys, or the position which he occupies, are the real cause of his obtaining the money, as distinct from the mere opportunity for getting it, that is to say, if they play the predominant part in his obtaining the money, then he is accountable for it to the master.[33]

The Court of Appeal found it unnecessary to consider this statement by Denning J. as they were able to find that Reading had a fiduciary duty, although they had to state that ". . . the term fiduciary relation in this connexion is used in a very loose, or at all events a very comprehensive, sense."[34] But Lord Porter in the House of Lords, speaking for the Lord Chancellor and himself, quoted and applied the statement of Denning J. cited above and went on to state:

> As to the assertion that there must be a fiduciary relationship, the existence of such a connexion is, in my opinion, not an additional necessity in order to substantiate the claim; but another ground for succeeding where a claim for money had and received would fail.[35]

Are these statements to be restricted to the case of master and servant or even to a servant of the Crown in some sort of official position? Are they to be extended to the case of principal and agent? Are they wide enough to place upon this operator as agent of the non-operator a duty not to use his position as operator and his knowledge gained in that position except for the non-operator? The decision by the Court that no fiduciary duty rested upon New British did not preclude the application of these statements in the *Reading* case.

As indicated above, the narrow decision of the Court in the instant case is, not that the operator owned no duty at all to the non-operator, but that even if he did owe the full fiduciary duty, then that duty was never breached. However the majority in the Supreme Court of Canada clearly stated that no fiduciary duty rests on the operator under this sort of contract. This is not to say that the operator is under no duty at all to the non-operator. Locke J. states that the operator does "owe to the (non-operator) the duty to act in good faith in its efforts to sell.[36] In other words, in the terminology of *Re Biss,* the operator falls within the second class of cases, the presumption that the operator's transaction is fraudulent being only a rebuttable presumption of fact.

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[32]p. 276.
[33]p. 275.
[34]p. 236.
[35]p. 516.
[36]p. 326.

The reasons why the Supreme Court of Canada held that the full *Keech* v. *Sandford* duty does not apply to the operator are indicated by Locke, J.

> The principle upon which *Keech* v. *Sandford*[37] and *Ex Parte James*[38] were decided has no application to a relationship such as here existed. The reason for the rule applied in these cases, as pointed out by Lord Redesdale, L.C. in *Griffin* v. *Griffin*,[39] is public policy. *Keech* v. *Sandford* was an infant's case and *Ex Parte James* that of a purchase by a solicitor to the commission of a bankrupt's estate.[40]

In other words, the rule, developed in cases where the parties were not on the same footing, has no application to the present case where we have two companies who do bargain on the same footing.[41]

Moreover the Court may well have considered the fact that one oil company may well be a party to several of these agreements and a strict application of the equitable rules might result in a a great loss of flexibility so essential in dealings in the oil industry. Indeed, the decision is perhaps an illustration of the attitude expressed by Bramwell, L.J. in *New Zealand and Australia Land Co.* v. *Watson* when he said, "I would be very sorry to see the intricacies and doctrines connected with trusts introduced into commercial transactions."[42]

However, before our courts refuse too quickly to apply to new situations the duties and liabilities of the fiduciary, they should remember the basis of these duties as set out by Lord Eldon in *Ex Parte James*.

> (The doctrine) rests upon this; that the purchase is not permitted in any case, however honest the circustances; the general interests of justice requiring it to be destroyed in every instance; as no Court is equal to the examination and ascertainment of the truth in much the greater number of cases.[43]

Is it any simpler in the case of the operator than it was in the case of the trustee to examine and ascertain the truth? Moreover, although these new relationships may seem quite different from anything which the law has seen before, I have suggested above that upon analysis the operator has some affinity to at least one person known to the law, the agent.

Finally the argument that freedom to contract is essential to the particular business in question was raised as long ago as 1840 in the case of *Gillett* v. *Peppercorn*.[44] To it, Lord Langdale made this reply:

> It is said that this is every day's practice in the city. I certainly should be very sorry to have it proved to me that such a dealing is usual; for nothing can be more open to the commission of fraud than transactions of this nature . . . . If a person employed as agent on account of his skill and knowledge is to have, in the very same transaction, an interest directly opposite to that of his employer, it is evident that the relation between the parties then becomes of such a nature, as most inevitably lead to continued disappointment, if not to the continued practice of fraud.[45]

The courts may, in the future, have to consider this warning, when they are called upon to apply the principles stated in the *Midcon* case.

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[37] *Supra*, footnote 12.
[38] *Supra.*, footnote 13.
[39] (1804) 1 Sch. and Lef. 352.
[40] p. 326.
[41] However, is it always true that two oil companies bargain on the same footing? The small companies are not in the same position as the large companies.
[42] *New Zealand and Australia Land Co.* v. *Watson* 7 Q.B.D. 374, cited in *Henry* v. *Hammond* [1913] 3 K.B. 515.
[43] *Ex Parte James, supra*, at pp. 326-7.
[44] *Supra.*, footnote 25.
[45] p. 33. See also *Brookman* v. *Rothschield* 57 E.R. 957.