THE SCOPE OF THE FIDUCIARY RELATIONSHIP

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INTRODUCTION

The preceding papers have grappled with the elusive problem of the fiduciary relationship and its application, if any, to situations commonly encountered in the oil and gas industry. Assuming that certain situations in the oil and gas industry do, in fact, create a fiduciary relationship, it is the purpose of this paper to trace the legal impact of that relationship on the parties and on their actions. This area is largely unexplored in Canadian case law. Where sign posts are to be found they always seem to be accompanied by counterparts pointing with equal authority in the opposite direction.

It is difficult to leave the problem of the creation of a fiduciary relationship without at least a passing bow to the theory of intention of the parties. The courts are tireless in their solemn declaration that, in construing statutes or contracts, they seek out the intention of the parties or the legislature as the case may be, and, unless that intention violates public policy, it will be carried out. Of course, what the courts have in mind when they speak of "intention of the parties" is quite different from what an innocent layman would conceive it to be. The court does not attempt to peer into the inner mental processes of the parties when it addresses itself to the agreement; rather it confines itself to the wording used by the parties and, by applying certain formal and technical rules to that wording, arrives at what the court feels the parties have actually said regardless of whether it bears any relationship to their actual thoughts.

Nowhere is the court's meaning of the word "intention" more at variance with the actual intention of the parties than in those situations where fiduciary relationship has been invoked in conventional oil and gas situations. Most of us have had a unique opportunity to know, and know well, the men who have negotiated the contracts that are being scrutinized by the courts today. These men, for the most part, were reared and nurtured in the ungentle disciplines of "the law of capture", the right of the individual, and "the Oklahoma contract". All of us can visualize the reactions, ranging from startled incredulity to outrage, if one suggested to these negotiators that, by entering into agreements for sharing the substantial financial risks of exploration, they were creating a subtle and entangling fiduciary relationship. The president of the defendant company in the *Midcon Case*[1] expressed this attitude to perfection when he testified that he considered the sale of jointly owned gas to be "none of their business". But the courts have made it very much their business.

As the previous discussions have brought out, there are many types of fiduciary relationship, each appearing to demand a different code of conduct on the part of fiduciary. The oil and gas industry offers examples ranging through the various trustee relationships; principal and agent, master and servant and other relationships which are fiduciary

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1 (1956) 19 W.W.R. (N.S.) 317.

simply because one party appears to be in a dominant position. Following Lord Porter's example in the *Reading Case,*[2] the term fiduciary relationship is used in a wide and loose sense for the purposes of this paper. The oil and gas industry is replete with examples where one party appears to be in an advantageous position which, accordingly, could tempt the courts to protect the other by employing the fiduciary concept. Examples that spring immediately to mind are the petroleum and natural gas lessor-lessee relationship; the relationship between the operator of a joint venture and the non-operating party or parties; drilling, seismic, logging and other sub-contractors, relationship with the property owner; and the employee of an oil and gas company who, while in its employ, comes into possession of confidential and valuable information.

The relationship between the operator and non-operators of a joint venture is the most significant source of fiduciary problems in the oil and gas industry. The greater part of this paper is devoted to exploring the implications of that situation. First, however, passing reference will be made to some of the other relationships.

DRILLING, SEISMIC CONTRACTORS AND EMPLOYEES

Technical information and data must be one of the most important factors in an industry such as oil and gas where success or failure depends on the ability to find the elusive petroleum substances. In the course of their work, drilling and seismic contractors constantly acquire information which could be extremely valuable if they were free to act upon it. Similarly certain categories of employees in an exploration company have constant and ample opportunities to acquire confidential information. It is submitted that it is now beyond question that a person in any of the above positions cannot lawfully take advantage of information so acquired for his own purposes. The court would only have to apply the traditional law of master and servant or principal and agent to deprive any such person of the fruits derived from his breach of duty. Clearly the court would hold that any benefit acquired had been acquired for the sole benefit of the principal.

LESSOR-LESSEE

Certainly as far as the freehold mineral lessor is concerned, all the technical advantages lie with the lessee. Almost without exception today, the average mineral lessee will be a corporation with the advantage of substantial technical services and information. The lessee collects relevant seismic and geological data and keeps fully informed on overall developments in the industry. Obviously, if he is permitted to act in his own uncontrolled discretion, he is in a position to harm or destroy the lessor's assets at will. The lessor, however, has a powerful ally. The legislatures of the provinces have been energetic to limit and circumscribe the lessee's freedom of action. Many factors have motivated this interference, including the preservation of a valuable natural resource. But the importance of protection of the mineral owner's rights and property is manifested by an express declaration that one of the objects of conservation legislation is to promote equitable sharing among owners of the resource.[3]

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[2] [1951] A.C. 507, [1948] 2 K.B. 268.
[3] See, for example, the Oil and Gas Conservation Act, 1957, (Alta.) c. 63, s. 3.

The legislatures do not refer to fiduciary relationships, but the undoubted effect of the legislation is to require the mineral lessee to conduct himself for the purposes of the lease as though he were a fiduciary in the strictest sense. Because of the protection afforded to the lessor by the legislation, and also because of the express terms of the well-standardized mineral lease, it is submitted that it is unlikely that the courts will be required to devote much attention to the fiduciary relationship between the lessee and lessor.

Before leaving the lessor-lessee situation, it should be noted that the "law of capture" is firmly entrenched in Canada,[4] and there may yet be some interesting problems of implied obligation where the unrestrained application of this rule, in a situation not covered by conservation legislation, otherwise would create hardship on the lessor. Another interesting problem which may yet cause some judicial brooding is the position of the Crown as lessor. In Alberta the Crown is the owner of slightly less than 90% of the mineral rights and is by far the most common lessor. The Crown has its own highly skilled and organized Mineral Resources Department, and has the all-powerful legislative weapon to protect its interests. Clearly it is no ordinary lessor. Will the courts treat a lessor-lessee relationship as fiduciary where the Crown, with its power and resources, is the lessor?

Operator—Non-Operator

The manner in which a joint venture for the exploration and development of mineral rights is created has been analysed in the preceding papers. It is sufficient to note that one joint adventurer will be selected as the operator of the project and will be charged with the responsibilities and obligations of this position. In the oil and gas industry it can be assumed for all practical purposes, that the joint venture will be created by a written contract which, almost invariably, will be detailed, specific and of incredible length.

Starting from the point that there is a fiduciary relationship of some nature between the operator and non-operator of a joint venture, there are three logical areas into which the consequences of this relationship might spread; (a) the relationship might be confined to the "four corners" of the agreement; (b) the relationship might extend beyond the agreement but be confined to the subject matter covered by the agreement; or (c) the consequences of the relationship might spill over and influence every transaction between the fiduciary and his co-adventurers which has even the most tenuous connection with the subject matter of the agreement. There is a fourth possibility that scarcely bears contemplation; namely, that the relationship once established colors and affects every subsequent transaction involving the same parties regardless of whether or not the original subject matter of the joint venture is involved.

The agreements establishing the joint venture fairly bristle with clauses designed either to deny completely the fiduciary relationship or to confine such relationship to the terms of the agreement. Examples of this type of clause are the "independent contractor", "no partnership, agency", and "entire agreement" provisions. One might think that these

[4] *Borys* v. *Canadian Pacific Railway* (1953) 7 W.W.R. (N.S.) 546.

clauses, which are uniformly specific and clear in their language, reflect the true intention of the parties and would negate or severely restrict the existence of any fiduciary relationship. However, as indicated earlier, the courts are in pursuit of an entirely different type of "intention" and, as a general rule, pay scant attention to this type of clause.[5]

Any attempt to define the scope of the fiduciary relationship in the Canadian oil and gas industry must take the *Midcon Case*[6] into consideration. This case, which went to the Supreme Court of Canada, involved the joint operation of a Crown reservation covering substantial acreage. The reservation was owned by the defendant company. The plaintiff company had the right to obtain a half interest in the reservation by drilling a test well. Under the agreement, the defendant company was to act as operator of the property and would also act in that capacity during the actual drilling of the test well. The test well encountered productive quantities of gas and subsequently additional wells were drilled on a joint basis with the result that the parties owned and controlled five productive wells. The corporate defendant, as operator, made several unsuccessful attempts to market the gas to existing pipeline systems in area. The president of the corporate defendant then learned from outside sources that it might be feasible to build a chemical fertilizer plant in the general area owing to the availability of natural gas and other raw materials. The president of the defendant company actively entered negotiations with outside interests for the construction of such a plant. These negotiations culminated in the construction of a fertilizer plant, and the defendant company purchased a substantial block of the shares of the fertilizer company at a figure which was only a small fraction of their value on the market. The defendant company, under its agreement with the plaintiff company, also entered into a long term gas sales contract whereunder substantial volumes of natural gas from the jointly-owned field were sold to the fertilizer company. The price for the gas was very favorable to both the plaintiff and the defendant companies and was substantially better than the price received at that time by producers of natural gas in other parts of western Canada. The defendant company made no attempt to have the plaintiff company approve the sale of gas to the fertilizer company as it felt it was authorized to enter into such contracts under certain provisions of the agreement. Shortly after the signing of the gas contract with the fertilizer company, the defendant company negotiated the sale of additional volumes of gas to the community of Medicine Hat and, on the advice of its solicitors, had the plaintiff company ratify both gas sales contracts. The plaintiff company ratified both contracts but reserved its position on a claim for a share of the fertilizer company stock. In order to deliver the gas to both the fertilizer plant and the City of Medicine Hat, it was necessary to construct a pipeline system from the field. The plaintiff and the defendant companies joined in forming a pipeline company for this purpose, and each bore their respective 50% share of the costs of such pipeline construction. The plaintiff company then sought a declaration that it was entitled to a proportion of the shares in the fertilizer company issued to the defendant company.

5 *See*, for example, the decision of The Alberta Appellate Division in *Midcon Oil & Gas Ltd.* v. *New British Dominion Oil* (1957) 21 W.W.R. 228.
6 *Supra* ns.(1) and (5) and [1958] S.C.R. 314.

The joint venture operating agreement between the plaintiff and defendant companies contained a provision which prohibited the plaintiff, non-operator, from taking its share of production in kind or from making any arrangements for the disposal of such production. The inference is that the defendant company was to have the sole right to dispose of production. If so, surely the defendant company became the agent of the plaintiff company in any transaction for the sale of production. The operating agreement also contained the usual express provision that no agency or partnership relationship was created by or between the parties.

The trial judge,[7] impressed by the detailed clauses in the agreement which spelled out the rights of the parties under various situations, concluded that there was nothing in the agreement which created a fiduciary relationship between the parties. This conclusion effectively disposed of the case, but the learned trial judge went on to find that even if there had been a fiduciary relationship, the responsibilities of the defendant company to the plaintiff company ceased with the operation and development of the area and that, since the defendant had promoted the fertilizer company independently, the plaintiff company had no claim to any of the shares of that company.

The Appellate Division found that a fiduciary relationship did exist between the parties by virtue of the provision in the agreement preventing the plaintiff company from disposing of its share of production. The court held that the defendant company became the agent of the plaintiff company to sell the gas, and that this agency created a fiduciary relationship between the parties. This finding immediately confronted the court with the necessity of defining the limits to which the relationship extended. The Appellate Division adopted the test set forth in *Reading* v. *A.G.*,[8] that the use of the fiduciary position must be the real reason why the profit was obtained and not merely a contributory cause. The court also adopted the language of Lord Russell in *Regal Ltd.* v. *Gulliver*:[9] "Were acquired by reason, and only by reason of the fact that they were directors of Regal, and in the course of their execution of that office". The phrase "by reason, and only by reason" became the pivotal point in the decision of the Appellate Division. It was fairly clear from the evidence that the defendant company had not been allotted the shares of the fertilizer concern because it controlled the gas supply but, rather, because it took an active and leading part in the promotion of the fertilizer project.

The majority decision of the Supreme Court of Canada held that, while the agreement expressly provided that the operator should not act in the capacity of agent, this did not mean that the plaintiff was free of any responsibility to the plaintiff in its efforts to find a market for the gas. The majority found that the defendant company had a duty to act in good faith in its efforts to market the gas. The test of good faith is nebulous at best, but the Supreme Court went on to give an example of what it would consider to be a breach of good faith. If the defendant company, having in mind its own interest in the chemical enterprise, had negotiated a sale at a price which was, to its knowledge, less than the fair

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7 *Supra* n.(1).
8 *Supra* n.(2).
9 [1942] 1 All E.R. 378, at p. 389.

value of the gas, or less than could have been obtained, then such action would have constituted a breach of the duty to act in good faith. However it would appear that disclosure by the defendant company could cure the breach. In fact, the price obtained by the defendant company was very favourable and, in addition, the plaintiff company had expressly approved the contract. The Supreme Court then went on to hold that even if there had been a fiduciary relationship requiring more than mere good faith with respect to the sale of gas, there would still be no liability to account to the plaintiff for the shares of the chemical company. In this part of its decision, the court adopted the test set forth in *Regal v. Gulliver,*[10] and followed the line of reasoning developed by the Alberta Appellate Division.

Unquestionably, the *Midcon Case* has made a substantial contribution to the law concerning fiduciary relationships in Canada. The position may be summed up as follows: Canadian courts will recognize various types of fiduciary relationships with varying degrees of responsibility, such responsibilities not being confined necessarily to the "four corners" of the agreement itself; the question whether responsibility will be confined to the subject matter of the agreement remains unsettled; finally, the "by reason and only by reason" test stated in *Regal* v. *Gulliver*[11] is firmly entrenched in Canadian law. With considerable reservations, it may also be added that the *Midcon Case* indicates that the court will pay some attention to clauses indicating that the parties do not intend to create a partnership or agency. The reservations stem from the fact that the general jurisprudence is replete with examples where the court supports such declarations of intent when they coincide with the judicial view of the case but otherwise disregards them.

The difficuly of applying tests and principles to the fact pattern of any particular case is well illustrated by the dissenting opinion of Mr. Justice Rand in the *Midcon Case.* The learned judge agreed with the Alberta Appellate Division in finding a fiduciary relationship, which he expressed as constituting a trust relation. Just what degree of responsibility attached to this definition is not clear, but it is submitted that it is substantially greater than that with which flows from the majority's test of "good faith". Mr. Justice Rand concerned himself more with the duty of the fiduciary than with the question of the relevance or remoteness of the alleged breach to the advantage gained. This difference in emphasis led to a radically different result. He cites a long line of cases which define the position of the fiduciary, including *Parker* v. *Mckenna,*[12] where Sir W. M. James, L.J., stated at p. 124:

> . . . the rule is an inflexible rule, and must be applied inexorably by this court, which is not entitled, in my judgement, to receive evidence, or suggestion, or argument as to whether the principal did or did not suffer any injury in fact by reason of the dealing of the agent; for the safety of mankind requires that no agent shall be able to put his principal to the danger of such an enquiry as that.

The important question, to Mr. Justice Rand, is not the degree of remoteness but rather the capacity in which the fiduciary participated in the gainful activity. His view was that the defendant had participated in the

10 *Ibid.*
11 *Ibid.*
12 (1874) L.R. 10 Ch. 96.

capacity of operator and thereby attracted fiduciary implications. Once the defendant has been categorized as a fiduciary then his performance is measured against the exacting tests set forth in the existing cases and, if his performance falls short in any respect, the booty and spoils must be shared.

This approach is an example of the well-known judicial technique of categorization. Under this process, the main question is to find the proper legal slot for the problem and then all results flow with mathematical precision. This approach has the appeal of logic, but it suffers from the weaknesses inherent in a system which attempts to superimpose the tests and criteria developed under the strict law of express trustee, of principal and agent, and of master and servant to the radically different and complex activities of the oil and gas industry.

The majority opinion also leaves a certain degree of disquietude. The plant of the chemical customer was located some 45 miles from the gas field. Before the sale could be finalized, it was necessary that a pipeline be constructed, at very considerable cost, from the field to the plant. The plaintiff company joined with its co-adventurer, the defendant company, in financing this costly project. None of the learned judges attached any weight to this fact, but it is suggested that this joint participaion extended the scope of the joint venture and brought it into a very close relationship with the chemical plant and, consequently, the source of benefit to the defendant company.

Secondly, even the modest "good faith" duty imposed by the majority required the fiduciary to avoid placing himself in a position of conflict. It would seem that the defendant company in the *Midcon* situation had placed himself in a position where he could scarcely avoid conflict. The initial price received for the gas was certainly fair to the producer. Most long term gas contracts, however, contain a provision for renegotiation of price either at the end of a stated period of time or on the happening of certain external circumstances. The evidence does not disclose whether this particular contract had such a provision, but let it be assumed. As operator of the gas field, the defendant company would be required to negotiate the best possible field price. On the other hand, it had a very substantial interest in the welfare of the customer. This is a classic example of conflict. If the contract in the *Midcon* situation did not contain a renegotiation clause, then, since the contract was for a period of 20 years, it would seem that the defendant company would be in breach of its duty to the plaintiff company.

Manning v. *Calvan Consolidated Oil & Gas Company Limited* and *Imperial Oil Limited* (No. 2)[13] involved the consequences of a breach of fiduciary responsibilities arising directly from the subject matter of the agreement. The plaintiff had acquired a 20% interest in a petroleum and natural gas permit owned by the defendant Calvan. This defendant continued as operator and, under the terms of the agreement, had the right to dispose of the permit as it saw fit. Subsequently it entered into an agreement whereby the defendant Imperial acquainted a certain interest in the permit together with two other permits owned solely by Calvan in consideration of the payment of certain sums of money and the

13 Unreported, Alberta S.C. but *see* *Canadian Oil & Gas*, Lewis & Thompson, Dig. 183.

undertaking of exploratory obligations. The plaintiff was not invited to participate in these negotiations and was not kept informed, but was ultimately presented with a very lengthy and complicated agreement which he refused to execute. The defendant Imperial had knowledge of the interest of the plaintiff but contended itself with extracting a letter of indemnity from Calvan. The defendant Imperial drilled an unproductive exploratory well on the permit and, as a consequence, earned drilling credits under government regulation. These drilling credits can only be used to reduce the financial and work commitments under exploratory permits. Often, surplus credits will be built up with respect to one permit and, under certain conditions, this surplus can be transferred to the benefit of other permits. The agreement between the two defendants provided that in the event Imperial acquired credits with respect to the permit in which the plaintiff had an interest, such credits would be distributed to the benefit of the two remaining permits in which the plaintiff had no interest. The evidence indicated that the plaintiff had suffered no harm through this arrangement, for he either had no permits which could be benefited by an apportionment of the excess credits or there were excess credits still available, which, upon request, would have taken care of his commitments. The courts seemed to regard this point as irrelevant and followed the categorization approach of determining that a fiduciary relationship existed and that certain consequences automatically flowed therefrom. The learned trial judge adopted the language from *Regal* v. *Gulliver*,[14] "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 he is bound to protect." Viewed in this light, the provision as to credits became one whereby the defendant Calvan used joint property to secure a special advantage for itself.

There was evidence also that, despite the existence of separate contracts for each of the permits, the defendant Imperial regarded all the permits as one deal, and took a more lenient view of the reimbursable costs attributable to the separate Calvan permits than of those costs attributable to the joint venture permit. Under these conditions the court assumed that the defendant Calvan had obtained a monetary advantage in breach of its fiduciary obligations.

The defendant Imperial was held to have specific notice of the interest of the plaintiff. Accordingly it was elevated to the uneasy position of a fiduciary and held equally responsible with its co-defendant for the breach of duty.

The judgment in the *Manning Case* clearly takes the scope of the fiduciary relationship beyond the "four corners" of the agreement. The agreement gave the defendant Calvan the right to dispose of the permit as it saw fit. Nevertheless the court did not hesitate to impose severe limitations and restrictions on this right as a result of the fiduciary relationship.

It may be worthwhile to postulate a sort of half-way house between the *Manning* situation and the *Midcon Case*. Assume that Company A is the operator of joint venture lands with Company B as the non-operator.

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[14] *Supra* n.(9).

Substantial reserves of gas are discovered on the joint venture lands and Company A proceeds to promote and finance a pipeline company to transport the gas to a distant market. Company A receives substantial qualities of promoter stock at a nominal price. Company B attempts to attach this benefit on the ground that Company A is under a fiduciary relationship. Is Company B's position better under this situation where the pipeline project is the benefit under attack?

Could it bring itself under the *Regal* v. *Gulliver* rule—"by reason and only by reason"—where it owned only a portion of the gas reserves required for financing, or would this partial ownership knock out its claim on a basis that it was only a contributory reason? What would be its position in the more usual case where it owned as non-operator only a very small fraction of the total gas reserves required to be committed to the pipeline project?

The acquisition of petroleum rights in lands adjoining or, in the vicinity of, the joint venture property carries the seed of many a dispute over fiduciary responsibilities. Suppose the operator, Company A has adjoining lands put up for bid and acquires them independently of the non-operator. Frequently this situation may be expressly covered by the after-acquired clause in the agreement, but let it be assumed that the joint venture agreement does not contain such a clause. Can Company A retain its full interest in the after-acquired property or must it share this interest with Company B? Is this situation different if the contract contains a clause requiring Company A to provide Company B with detailed exploratory information and Company B has received such information, for could it not be said that Company B is then in the same position as Company A, and both parties are free to act independently? Assume that Company B is merely the owner of an overriding interest and, as such, is not provided with information, but the information is available for its inspection at the office of Company A. In the absence of an after-acquired clause, is Company A free to acquire adjoining rights independently? Does it make any difference whether Company B has availed itself of the opportunity to inspect the information?

In view of the present state of the law, it is not entirely inappropriate that this paper ends in a series of question marks. It can be said however, with some degree of assurance, that, if the benefit received by the fiduciary forms a part of the subject matter of the relationship, he probably will be forced to share the benefit, despite whatever attempt is made to protect him by the terms of the agreement. There is also a distinct possibility that the categorization approach of Mr. Justice Rand, followed by Mr. Justice McLaurin in the Manning case, may result in a much wider application of the rule from the wholesale importation of concepts derived from the traditional type of trust. It would seem that disclosure and ratification are the only truly effective safeguards for the operator to follow when he contemplates dealing with joint venture property.

Life has become hazardous for the third party as well. If he obtains notice of the mere existence of the beneficiary's interest, then he might as well resign himself to obtaining the whole story on the nature of that interest. For mere notice of the existence of such an interest appears to place the third party in the same position as the fiduciary, and to make him equally liable.

If nothing more, the current state of law indicates that an operator cannot afford to treat his co-adventurers in a cavalier fashion. It would appear that even the most explicit language in the agreement negativing creation of a fiduciary relationship will not, by itself, be sufficient. No matter how ingenious the draughtsman, the operator should still pay careful attention to all the outside factors and weigh his position in the light of those factors. Only then can he make a decision as to whether the interests of the co-adventurers may safely be disregarded.