THE NEGOTIATOR

The Magazine of the Canadian Association of Petroleum Landmen
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NO ONE LIKES BAD NEWS. It stings, but it's a fact of life in any business and there is value in knowing when to anticipate bad news and plan for it, instead of being blindsided by it.

Article 301(b): A Potential Landmine

Energy companies are concerned with risk management, which includes avoiding surprising bad news. Companies take on partners, in part, to spread risk around and be better positioned to deal with problems when they occur. Industry players structure operations so that bad news – increased financial exposure – can be foreseen and budgeted for as much as possible. This article highlights the potential for uncertainty and risk arising from Article 301(b) of the CAPL 1990 Operating Procedure ("CAPL 90"), which gives an Operator significant authority, in prescribed circumstances, to exercise a power to unilaterally incur costs on behalf of its Joint-Operators.

First some background. Since you are reading *The Negotiator*, you probably know what CAPL 90 (and its older and newer versions) does: it standardizes how Joint operations are to be conducted without the need to have constant recourse to the common law (judge-made) to determine how laws and rules will apply. Additionally, most oil and gas assets involve tenants in common, but industry

practices – arising from the inherent risks in producing hydrocarbons – differ from how the common law treats property owners that are tenants in common. CAPL 90 is useful because it gathers industry-specific practices in one place for parties that want to use them.

Article 301(a) creates a duty for Operators to keep Joint-Operators up to speed and sets the ground rules for the Operator/Joint-Operator relationship. The provision states:

> The Operator shall consult with the Joint-Operators from time to time with respect to decisions to be made for the exploration, development and operation of the joint lands and the construction, installation and operation of any production facilities, and the Operator shall keep the Joint-Operators informed with respect to operations planned or conducted for the Joint account. Subject to the provisions hereof, the Operator is hereby delegated the management of the exploration, development and operation of the joint lands and the construction, installation and operation of any production facilities for the Joint account on behalf of the Joint-Operators.

In most situations the Operator gives the Joint-Operators notice of what is planned, and outlines the cost. Two common ways of doing this are by Independent Operations Notices ("ION") and by Authorizations for Expenditure ("AFE"). An ION is used in situations where the proposing party is willing to give all of the other interest holders an election to participate, but participation is not required. When the Operator requires all of the parties to participate, an AFE is employed.

With an ION, in most cases the Joint-Operators have specific time periods within which they can elect to opt in and pay their proportionate share. If no election is made during the prescribed period, they lose their right to participate in whatever is proposed. There are consequences for choosing not to participate, but each Joint-Operator gets to make that decision for itself. With an AFE, the operation does not take place unless all Joint-Operators agree to participate. It is simple enough stuff most of the time. Article 301(b) tries to address the situations when sending an ION or an AFE is impractical.

The Need for Article 301(b)

The operational part of the industry consists of extracting highly combustible, compressed substances that are located in hard to reach places. There will be times when an Operator has to fix a problem quickly and doesn't have time to run the proposed operation by all of the Joint-Operators and provide them with the opportunity to elect to participate or not. When trying to extract and then process these compressed, combustible substances there are any number of potential dangers that have to be monitored. If an accident is about to happen, or has happened, the Operator is concerned with putting out a fire (often literally) and not getting in touch with Joint-Operators to talk about whether or not the Blue Jays played the night before and the proposed extinguishment steps and their cost. From a policy and operational perspective, the industry wants and needs exactly this kind of mechanism.

The potential for conflict comes from this simple problem – what is required to trigger Article 301(b)? The exact language in Article 301(b) is:

> The Operator shall be entitled to make or commit to such expenditures for the Joint account as it considers necessary and prudent in order to conduct a good and workmanlike operation on the Joint lands for the Joint account. However, the Operator shall not make or commit to an expenditure for the Joint account for any single operation, the total estimated cost of which is in excess of twenty-five ($25 000) thousand dollars, without an approved Authority for Expenditure from the Joint-Operators, unless the expenditure is *reasonably considered by the Operator to be necessary by reason of an event endangering life or property or is required by the Regulations and failure to make such expenditure could result in the prosecution of the Operator thereunder.* If the Operator is required to make such an expenditure, it shall promptly advise the Joint-Operators of the nature of such event or requirement and the expenditure anticipated to be associate therewith.

Does that seem clear and definite to you?

What is the Test For "Danger to Persons or Property"

How does an Operator determine when "the expenditure is reasonably considered by the Operator to be necessary by reason of an event endangering life or property"? What is the moment or event that triggers danger to persons or property? Every active well site or facility has the potential to be a danger to persons or property. No one wants an accident to happen, but Article 301(b) is not intended to run roughshod over the basic industry principle that an Operator has to give its partners the choice to participate in an operation before their money is spent. There is a line between the right use and abuse, between legitimate emergency and an operation that should properly require a consultation. Like anything, at the extremes of the spectrum the distinction is clear, but towards the middle the analysis gets harder.

In the event of a dispute over whether a situation presented danger to life or property – and how the Operator evaluated it – the test is likely to be one of subjective reasonableness. There is established caselaw for this concept, and it boils down this question: in the circumstances, what would a reasonable person do if equipped with the information, expertise and perspective that the Operator had at the critical moment in time? The answer is rarely exact. There are usually a range of options that fit within a spectrum of what constitutes reasonable.

What Do "Required By Statute or Regulation" and "Fear Prosecution" Mean?

The alternative test is, admittedly, easier to work with than the initial one. This test has two parts: the step or steps must be required by regulations and a failure to take that step or steps may result in the Operator being prosecuted. Laws can impact people or companies in two ways: (1) a law can require someone to do something or not do something or (2) a law can create the option of doing something. This provision provides that the step or steps taken must be required by regulation. Required by regulation means that the steps are compulsory, much the way obeying traffic laws is compulsory and failure to do so risks prosecution.

Stopping for red lights is compulsory. One doesn't have the option of deciding to stop or not, the law requires it. Prohibiting or obligatory language includes terms like: is not permitted to, is prohibited from, shall, must, will, has to and is required to.

Remember the second part of this test – may result in prosecution. We are back to the issue of evaluating subjective reasonableness. It's possible to run a red light without getting prosecuted for it (getting a ticket), but it's reasonable to assume that running red lights will lead to prosecution. It might not happen the first time, but eventually it is certain to happen. On the other hand, is there anyone who worries about getting a speeding ticket for driving 1 km/h over the posted limit? Suggesting that

one feared prosecution for driving 111 km/h in a 110 km/h zone probably doesn't meet the test of subjective reasonableness.

"Reasonably Considered by the Operator" Applies to Everything

And to further muddy the waters, consider the fact that all of this is as "reasonably considered by the Operator". While the issue has yet to be determined by the Court of Queen's Bench of Alberta, the likely standard will be subjective reasonableness. The subjective concern of prosecution and the subjective evaluation of whether an event is endangering persons and property have been discussed. But the Operator's assessment matters in interpreting the Regulations, too. An Operator can determine that it is required to take action in order to comply with the Regulations on its own, or on the basis of professional advice. However the determination was made, if a dispute arises the Operator will have to explain how it determined that the expenditure was necessary to comply with the Regulations. This means that if the Operator relied on documents or outside advice – even a legal opinion – they will have to be produced so the Joint-Operators, and potentially the court, can properly analyze the Operator's decision.

Judicial Interpretation: Stay Tuned For Developments

To-date, there aren't any reported decisions that interpret when an Operator can properly choose to invoke Article 301(b). For the oil and gas industry uncertainty means risk. We have a general idea of what an emergency is and what isn't, but the potential for disputes remains in situations that are farther away from that elusive line. Given this relatively blank slate, there are no easy answers. But there are some tips that can help avoid a nasty surprise.

Ideas for Operators

To state the obvious: it is always better to err on the side of safety. It's better to fight over the cost of a preventative step, or a step to actually extinguish a fire, than to fight over who pays for the clean-up in the aftermath of property damage, or even worse, serious injury or death. But that doesn't mean that an Operator can spend lavishly while yelling "safety first". Don't spend in a way that will make your Joint-Operators question your motivation.

Each situation is different and you have to use common sense. You might legitimately think that you face prosecution for violating regulations, or that persons or property are in danger. But have a defensible basis for that position. Sure, if you get legal advice about the application of a regulation you might have to later disclose it – but only if a dispute arises. If you get legal advice that supports your position, what's the harm in showing it to a judge, and thus the public at large, too, saying "our company always tries to obey the law"? If the advice you get doesn't support invoking Article 301(b) then send an ION, an AFE or sit tight (with or without a lawyer and/or fire extinguisher by your side).

Ideas for Joint-Operators

If you are a Joint-Operator who is presented with a bill for steps that you didn't agree to, you should step back and consider your options; there are good questions to ask the Operator. What prompted these steps? What lead the Operator to fear danger to persons or property, or prosecution for regulatory non-compliance? Ask to see the data or the documents that underlie the opinion. No one likes a bully taking liberties, but if the Operator's position is defensible, the best option may be to accept the conduct as reasonable instead of getting into a lawsuit about it.

But there are times when lawsuits may be necessary. No one hopes to be in litigation, but lawsuits protect the rights that a party has contracted to receive. You don't have to obediently pay any and all invoices that an Operator sends.

The Future

This article is intended to point out potential uncertainty. We know that the minefield is there, but we don't have a map around the particular danger spots, yet. The industry would benefit from a dispute that goes all the way to trial. The trial judge would provide an interpretation of Article 301(b) and apply it to the particular facts of that lawsuit. While each dispute turns on its own facts, the industry as a whole would have one signpost showing parties what the test is for seeking Joint-Operators' approval. It hasn't happened yet, but stay tuned.