



**Let's Talk About Royalties:
The continued uncertainty surrounding the
creation and legal status of the overriding
royalty**

Royalty Case Law Development

- Started in the early 1930s
- Judicial deliberation of whether royalties in general could be considered an interest in land, and whether a subject royalty was an interest in land
- Justice Laskin's dissent in *Saskatchewan Minerals v Keyes*

Common Law Indicia

Factors pointing to an interest in land:

- Royalty in all the petroleum substances found in, under or upon the lands (conveyance of the minerals *in situ*)
- Clear statement that the parties intend the royalty to be an interest in land, which runs with the land
- Formal granting clause, such as "grant, assign, transfer and convey" or "grant, bargain, sell, assign, transfer and set over all the estate, right, title, interest, claim and demand whatsoever"
- Active rights such as royalty owner permitted to take royalty in kind or given some type of power or discretion over the subject leases and lands
- Filing a caveat to protect royalty interest

Common Law Indicia

Factors pointing to a contractual obligation:

- Right to receive an amount of money (i.e. paid a "percentage of net proceeds of production")
- Expressed as a royalty *on* production of the petroleum substances
- Royalty paid only after substances removed from the property
- Passive rights granted to the royalty, such as not permitted to take in kind
- Conveyancing language by itself is not sufficient to create an interest in land
- Not filing caveat to protect interest

The *Dynex* Decision

- SCC Decision recognizing overriding royalties as interests in lands, subject to the intentions of the parties
- No "convincing policy reasons for maintaining the common law prohibition on the creation of an interest in land from an incorporeal hereditament"

The *Dynex* Decision

Two-Part Test

An overriding royalty can be an interest in land if:

1. The language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the oil and gas substances recovered from the land; and
2. The interest, out of which the royalty is carved, is itself an interest in land

Contractual Interest vs. Interest in Land

Interest exists strictly as an obligation between the parties

vs.

Interest attaches to the land

Interest does not support a caveat on title

vs.

Interest allows holder to register a caveat on title

Contractual Interest vs. Interest in Land

Interest can be disclaimed or "vested off" in an insolvency

vs.

Interest follows the land through an insolvency (???)

Insolvency 101

Insolvency basics:

- In bankruptcies and receiverships the property of the debtor is liquidated
- Creditors are entitled to proceeds of the sale of the property in accordance with the priority of their claims
- The purchaser acquires the debtor's liquidated property free and clear of encumbrances, which are “vested off” by court order and attach to the purchase proceeds
- The proceeds stand in place of the property and the claims attach thereto in the same priority
- Lower ranking creditors often receive nothing

Insolvency 101

A vexing question: How does a royalty fit into this scheme?

- Is the royalty the property of the debtor?
- What is the priority of a royalty holder to the proceeds?
- Does (or can!) the purchaser take free and clear of the royalty?

Insolvency 101

The practical impacts (they really matter):

- Whether or not a royalty can be vested off is often a significant and central issue in oil and gas insolvencies
- Many parties are affected:
 - Receiver – must market the property correctly
 - Purchaser – offer price will depend on whether or not property subject to the royalty
 - Creditors – amount of proceeds available will depend on the purchase price
 - Royalty holder – Could be unaffected or could lose everything

Third Eye Capital Corp v Dianor Resources Inc

- Dianor Resources entered insolvency proceedings in August 2015
- The Receiver sought a court order approving the sale of Dianor's Ontario diamond mining properties to Third Eye Capital (the "Assets")
- 2350614 Ontario Inc. (the "Royalty Owner") did not oppose the sale, but argued that the transfer was subject to a 15.4% GORR that would run with the Assets
- The Receiver valued the GORR at \$150,000 - \$300,000 and the terms of the sale to Third Eye specified a \$250,000 payment to the Royalty Owner

Third Eye Capital Corp v Dianor Resources Inc

- The Royalty Owner refused to release its royalty rights in exchange for the \$250,000 payment
- Third Eye argued that the GORR was contractual and could be cancelled by a vesting order and (in this case) the fair compensation offered
- The Royalty Owner argued that the GORR was an interest in land in accordance with the *Dynex* test

Third Eye Capital Corp v Dianor Resources Inc

- Newbould J. applied *some* of the indicia developed in the pre-*Dynex* case law:
 - The Agreements stated that the parties intended the GORR would run with the land
 - The Royalty Owner did not have a right to enter the property and explore for diamonds
 - The Royalty Owner's only right was a right to a percentage share in revenues produced from minerals, as calculated after they were extracted from the lands
- The Court concluded that the GORR was contractual in nature
- Result: The transaction was to proceed free from the GORR once Third Eye paid \$250,000 to the Royalty Owner

Third Eye Capital Corp v Dianor Resources Inc

Despite concluding that the GORR was not an interest in land, Newbould J. went on to state in *obiter*:

I need not consider the claim of Third Eye that even if the royalty rights were an interest in land, a vesting order could be made vesting clear title in the assets being sold on the proviso that fair value be paid to the holder of the royalty rights. I see no reason in logic however why the jurisdiction would not be the same whether the royalty rights were or were not an interest in land

Dianor (Court of Appeal)

- The Court of Appeal considered the history of GORRs at common law, concluding that:
 - Historically, incorporeal hereditaments could not support the creation of interests in land
 - As a result, a right to payments from a *profit a prendre* could not be an interest in land
 - Commercial practice evolved such that parties would ensure the GORRs they created had all of the necessary incidents to constitute an interest in land (aka the indicia)
- In *Dynex*, the SCC "quite deliberately" changed the common law "to keep the common law in step with the evolution of society"
 - In doing so, the SCC emphasized the importance of the parties' intentions

Dianor (Court of Appeal)

- With this in mind, the Court of Appeal identified three errors:
 1. The parties' intentions must be determined from the entire agreement as well as the surrounding circumstances, and are generally persuasive
 2. It is not necessary to grant the GORR holder a right to enter the lands and explore for the relevant minerals
 3. The fact that a GORR is expressed as a right revenues on production rather than an interest in the minerals is not fatal
- *Dynex* signaled a departure from the requirement that a royalty had to have the incidents of a working interest to be an interest in land

Dianor (Court of Appeal)

- The Court of Appeal then turned to Newbould J.'s comment that a judge has the jurisdiction to vest off an interest in land
- After surveying the law surrounding this assertion, the Court asked the parties to return to address the question of:

whether and under what circumstances a Superior Court judge can extinguish a third party's interest in land using a vesting order

Potential for Clarity from the SCC

- Third Eye has appealed *Dianor* up to the SCC
- Meanwhile, the "comeback" application took place in September 2018, but the Court of Appeal's decision remains outstanding
- The SCC leave application has been suspended in anticipation of the Court of Appeal's decision on the "vesting issue"

Re Manitok (ABQB)

- In June 2015, Freehold Royalties Partnership acquired a royalty from Manitok Energy Inc. in exchange for \$25 million
- Manitok paid the royalty to Freehold in cash until August 2017, at which point Freehold began to take in kind
- Freehold continued to take in kind until Manitok went into receivership in February 2018
- Freehold applied for declaration that royalty was an interest in land and that it was entitled to take-in-kind
- The Receiver opposed the application, taking the position that the royalty was not an interest in land

Re Manitok (ABQB)

Characteristics of the Royalty:

- Clear statement of intent that the royalty was an interest in land
- The royalty was not a fixed percentage; volumetric and decreased over time
- Granted Freehold the right to take in kind
- Granted Freehold the right to enter the lands upon certain defaults by Manitok
- Defined the royalty in terms of production, not in terms of the mineral in situ (the "in/on" distinction)
- Manitok could assign its interest in the royalty lands without consent on notice to Freehold, provided that it substituted a comparable property

Re Manitok (ABQB)

Horner J. followed the *Dianor CA* interpretation and application of *Dynex*, focusing on the clearly stated intentions of the parties:

I am satisfied, therefore, that a royalty in respect of produced substances, representing a fixed quantity of production per day, **may constitute an interest in land if the parties' intention to make it so is sufficiently clear**. I am also satisfied that a royalty may constitute an interest in land despite the absence of, or significant limitations on, a right of entry.

Just How Secure Are Royalties?

- Even if a royalty is an interest in land, it will only survive for so long as the underlying estate (the mineral lease) survives
- Both Crown and freehold GORRs can lapse if no one maintains the lease
- This is significant in the insolvency context, where the presence of a royalty that is an interest in land can diminish the value of the estate and decrease the chances that it will be sold in a sales process
- If a receiver cannot sell a license/lease, it is likely that the GORR will terminate

Takeaways

- *Dynex* test/indicia not as clear-cut
- 'Kitchen sink' drafting and registration practices
- Despite characterization, royalties are not necessarily secure into perpetuity
- Continuity of interests in land in insolvency proceedings?
- Scope of vesting orders
- *Dianor* comeback decision being watched closely

Questions?

David LeGeyt

(Restructuring & Insolvency)

dlegeyt@bdplaw.com

(403) 260-0210

Ashley Weldon

(Energy)

aweldon@bdplaw.com

(403) 260-0125

Natasha Wood

(Energy / Restructuring & Insolvency)

nwood@bdplaw.com

(403) 260-0159