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

David LeGeyt, Ashley Weldon, Natasha Wood & Brendan Downey[*]

I. INTRODUCTION

Since the Leduc No 1 oil well was drilled in 1947, the petroleum and natural gas industry has grown to become a cornerstone of the Alberta economy and a major industry for the Canadian economy. The oil and gas industry is active in 12 of 13 Canadian provinces and territories, and Canada is the fifth-largest producer of natural gas and the sixth-largest producer of crude oil globally.[1]

Royalties are central to the financing, development, and operation of oil and gas projects and other mineable resources in Canada. Traditionally, royalties allowed resource owners to participate in and reap the benefit of production from their properties, and also to raise funds to finance exploration and production activities. In Alberta alone, royalty revenues from natural gas, conventional oil and oil sands production were over $500M, $700M and $1.4B, respectively, for 2016/2017. In 2013/2014, these revenues were even higher, totaling $1.1B, $2.4B and $5.2B, respectively.[2] Given the significant value associated with these royalties, ensuring the viability of such interests is paramount to industry participants. In response to this need, industry developed a practice whereby parties would attempt to create royalties that would "run with the land"[3] with the intention that the resulting royalty survives for so long as the underlying interest from which it was granted survives, binding successors in interest to the underlying leasehold or freehold estate. The benefit of this designation is clear: a royalty that runs with the land can provide its owner with certainty as to their rights and interest, regardless of what happens to the original grantor. In fact, it was this very industry practice that led to the Supreme Court of Canada's groundbreaking decision in *Bank of Montreal v Dynex Petroleum Ltd*,[4] which recognized that mineral lessees could carve out real property interests in the form of royalties. *Dynex* was revolutionary in recognizing a new property right and changing the common law.

Almost two decades after *Dynex*, there are now public and private companies with oil and gas royalties as the principal or sole focus of their business. For example, PrairieSky Royalty Ltd and Freehold Royalties Ltd are two public companies that focus primarily on obtaining royalty interests and payments. PrairieSky's 2017 royalty revenues alone topped $265 million[5] and it

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[*] David LeGeyt and Ashley Weldon are partners at Burnet, Duckworth & Palmer LLP in the Restructuring and Insolvency and Energy practice groups, respectively; Natasha Wood is an associate at Burnet, Duckworth & Palmer LLP in both the Restructuring and Insolvency and Energy practice groups; and Brendan Downey is an associate at Burnet, Duckworth & Palmer LLP in the Energy practice group.

[1] Canadian Association of Petroleum Producers, "Canada's Energy Resources", online: <www.capp.ca/canadian-oil-and-natural-gas/canadas-petroleum-resources>.

[2] Government of Alberta, "Resource Revenue Collected" (2017), online: *Alberta Energy* <www.energy.alberta.ca/AU/Royalties/Pages/RRCollected.aspx>.

[3] Phrase from *Strathcona (County) v Half Moon Lake Resort Ltd*, 2013 ABQB 236 at para 61.

[4] *Bank of Montreal v Dynex Petroleum Ltd*, 2002 SCC 7, [2002] 1 SCR 146 [*Dynex* SCC], aff'g 1999 ABCA 363 [*Dynex* CA].

[5] PrairieSky Royalty Ltd, "Consolidated Financial Statements for the Year Ended December 31, 2017" (26 February 2018), online (pdf): <www.prairiesky.com/files/galleries/2017_Annual_PSK_Financial_Statements_Sedar.pdf>.

currently has a market capitalization of $5.8 billion.[6] Similarly, Freehold's 2017 royalty revenues reached $133 million[7] and its market capitalization is $1.4B.[8] In recent years, royalty interests that are interests in land have been created by working interest owners and then sold to third parties for values of up to $250 million.[9] These examples clearly illustrate the magnitude and importance of royalties in the oil and gas industry and the need for commercial certainty in dealing with these valuable interests.

Despite guidance from the Supreme Court of Canada and the obvious commercial importance of royalties, the law in this area remains unsettled. Recently, however, the Ontario Court of Appeal's decision in *Third Eye Capital Corporation v Ressources Dianor Inc/Dianor Resources Inc*[10] and the Alberta Court of Queen's Bench's decision in *Re Manitok Energy Inc*[11] have apparently simplified the understanding of royalties as property interests. In this paper, we explore the overriding royalty, its common law evolution, the uncertainties surrounding its proper legal characterization, the implications of such legal uncertainty, and the shift that the *Dianor* and *Manitok* decisions represent. Throughout our discussion, we will consider the nature of the interests that royalties represent, the manner in which industry has attempted to protect those interests, and the efficacy of such attempts.

II. ROYALTIES AND THE IMPORTANCE OF AN "INTEREST IN LAND"

1. What is a Royalty?

Royalties come in many forms in the natural resources sector. For example, a particular set of mineral rights may be encumbered by a lessor royalty, a net profits interest, and/or a gross overriding royalty ("GORR"). Each of these is a royalty, but each operates in a different manner. A lessor royalty is reserved by the lessor from the minerals leased to the lessee, and paid by the lessee as a fraction of production to the lessor.[12] The lessor royalty is, in effect, a payment for the right to extract mineral or petroleum resources, and may be payable to a private freehold mineral owner pursuant to a lease or, if the Crown is the mineral owner, the government in accordance with a legislated royalty scheme. A net profits interest is payable by the working interest owners,

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[6] S&P Capital IQ, (2018), *PrairieSky Royalty Ltd: Public Company Profile*. Retrieved 1 August 2018, from S&P Capital IQ database [S&P].

[7] Freehold Royalties Ltd, "Annual Report 2017" (8 March 2018), online (pdf): <www.freeholdroyalties.com/sites/default/files/uploads/reports-filings/fru_annual_report_2017_final.pdf>.

[8] S&P.

[9] PrairieSky Royalty Ltd, "PrairieSky Announces Royalty Acquisition and Concurrent Bought Deal Equity Financing", *Marketwired* (14 December 2016), online: <www.marketwired.com/press-release/prairiesky-announces-royalty-acquisition-and-concurrent-bought-deal-equity-financing-tsx-psk-2183335.htm>;
Athabasca Oil Corporation, "Athabasca Oil Corporation Announces a $129 Million Contingent Bitumen Royalty and Repayment of US$221 Million Term Loan", *Marketwired* (20 June 2016), online: <www.marketwired.com/press-release/athabasca-oil-corporation-announces-129-million-contingent-bitumen-royalty-repayment-tsx-ath-2135554.htm>;
BlackPearl Resources Inc, "BlackPearl Announces the Sale of a Royalty Interest on Its Onion Lake Property for $55 Million", *Marketwired* (1 December 2016), online: <www.marketwired.com/press-release/blackpearl-announces-sale-royalty-interest-on-its-onion-lake-property-55-million-tsx-pxx-2180233.htm>.

[10] *Third Eye Capital Corporation v Ressources Dianor Inc/Dianor Resources Inc*, 2018 ONCA 253 [*Dianor*].

[11] *Re Manitok Energy Inc*, 2018 ABQB 488 [*Manitok*].

[12] *Dynex* CA, *supra* note 4 at para 30.

and is often a percentage of the net proceeds of production.[13] Generally, a GORR signals a percentage ownership in production or production revenues before the costs of production are deducted (though such deductions are subject to negotiation). GORRs are paid to the GORR owner by the grantor, which may be a current or former lessee or one of potentially many working interest partners.

Depending on the negotiated terms, a royalty may be payable in kind (by a share of the physical product produced) or payable in money (based on the price received) and calculable at any point from the wellhead to the point of sale. How the royalty is described in the royalty agreement will determine what sort of royalty it is. To that end, it is up to the parties to determine whether a royalty will be an interest in land or not, and to give effect to such intention. If the royalty is not an interest in land, it is merely executory and only exists as between the parties to the contract that created the royalty. If the royalty is an interest in land, however, it will attach to the underlying leasehold or freehold interest from which it was created, binding successors in interest and securing the interest of the royalty holder. Owners of a royalty expressed to be an interest in land are afforded the ability to register a caveat on the subject land title, thereby giving notice to potential purchasers and protecting the royalty against third parties and successors in interest.[14]

As the Alberta Court of Queen's Bench has surmised, royalties are granted for a wide variety of reasons each and every day in the oil and gas industry.[15] Commonly, a lessee will farmout certain lands to a company with the capital and expertise to drill a well in exchange for a working interest subject to a GORR. This royalty structure ensures the lessee can retain an interest in and benefit from the lands it has acquired rights to, despite the fact that it was not equipped to conduct the drilling operations itself. GORRs are also granted as remuneration for geological expertise or obtaining a particular lease.

In our experience, a new royalty mechanism and practice has developed over the past two decades in which industry participants manufacture a royalty to sell in exchange for capital investment. These royalties typically take the form of a GORR over the grantor's working interest and have become an important component of the financing structure in oil and gas development. Given the risks inherent in upstream resource development, the investing party will seek to protect its interest to the greatest extent possible, generally by ensuring the agreement characterizes the GORR as an interest in land.

2. Royalties in the Insolvency Context

The characterization of a royalty becomes a crucial issue in the event of a royalty grantor's insolvency. Whether or not the royalty runs with the land may have a dramatic impact on the economics of the estate. In an insolvency proceeding, the question becomes whether the receiver or trustee must attempt to sell the underlying mineral interest subject to the royalty or whether it

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[13] Schlumberger, *Oilfield Glossary*, sub verbo "net profits interest", online: <www.glossary.oilfield.slb.com/Terms/n/net_profits_interest.aspx>; *Dynex* CA, *supra* note 4 at para 32.

[14] Note that the current law in Alberta is unclear as to the proper forum for registration in circumstances where the overriding royalty interest is granted by the lessee of Crown-owned mines and minerals (as opposed to freehold). Section 202(a) of the *Land Titles Act* prohibits registration of a caveat or encumbrance affecting Crown mineral interests. The *Mines and Minerals Act* provides for a limited exception applicable generally only to financial institutions.

[15] *Bank of Montreal v Dynex Petroleum Ltd* (1995), 39 Alta LR (3d) 66, [1995] AJ No 1279 (Alta QB) at para 85.

can rely on the court's power to vest property in a purchaser "free and clear" of the encumbrances of the debtor. This 'interest in land' issue is directly related to the vesting issue, and is of the utmost importance to the parties. As discussed herein, these issues have recently collided in *Dianor*, and remain before the Ontario Court of Appeal and, potentially, the Supreme Court of Canada.[16]

Whether a royalty is an interest in land will impact insolvency proceedings generally, and, more specifically, will impact: i) the solicitation process by the court officer or debtor; ii) potential purchasers; iii) the purchase price for the assets; iv) the recovery for creditors; and v) the royalty holder. These impacts have been particularly pronounced throughout the most recent downturn experienced in the Canadian natural resources sector.

Oil and gas and mining industry insolvencies are already complex given the nature of the assets, the business, and the current regulatory environment. In normal course dealings between solvent parties, if a particular royalty is an interest in land, it is an incident of the underlying estate and binds the purchaser of such estate. Conversely, if the royalty is only executory and the agreement is not assigned to the purchaser, the vendor retains the payment obligation (notwithstanding that it no longer owns the interest on which the royalty is payable), or, at the very least, is liable under the contract that created the royalty. In both cases, the royalty holder has legal recourse to enforce the payment of the royalty, though the creation of an interest in land provides greater certainty. In an insolvency, however, the receiver, bankruptcy trustee or debtor in possession can disclaim executory contracts, leaving the contractual royalty owner with only an unsecured claim against the estate. For example, a British Columbia court recently concluded that a particular GORR was a mere contractual royalty and the assets in a restructuring could be sold and vested in the purchaser free and clear of the royalty agreement.[17] This determination allowed the debtor in possession to terminate the royalty agreement to enhance the prospects of restructuring.[18] Had the Court concluded that the royalty was an interest in land, it would have survived the insolvency and the payment obligation would have bound the purchaser. It is therefore clear why the characterization of the royalty is of critical importance to the royalty holder: an interest in land will always protect its right to payment.

A justice of the Ontario Superior Court of Justice further complicated matters in the trial decision in *Dianor*, commenting in *obiter* that there was "no reason in logic" why the court would not have the jurisdiction to disclaim a royalty regardless of whether "the royalty rights were or were not an interest in land".[19] These comments raised eyebrows in both the natural resources and insolvency industries as they effectively dismissed the express policy reasons underlying the Supreme Court's determination that overriding royalties can be interests in land. As discussed in detail below, the *Dianor* SCJ decision was overturned on appeal, but the question of whether a debtor's property can be sold free and clear of a royalty interest found to run with the land remains before the courts. It is the position of the authors that royalties that are interests in land are effectively ownership rights in the property, and the protections afforded by such status mean that it cannot be vested off like an encumbrance held by a creditor.

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[16] On 21 June 2018 the Supreme Court of Canada granted an order extending the time for serving and filing an application for leave to appeal to thirty days following the Court of Appeal for Ontario fully disposing of the matter. The Court of Appeal has yet to release its decision on this matter. For further details, please visit https://www.scc-csc.ca/case-dossier/info/dock-regi-eng.aspx?cas=38106.

[17] *Re Walter Energy Canada Holdings Inc*, 2016 BCSC 1746 [*Re Walter*] at para 72.

[18] *Ibid*; *Companies' Creditors Arrangement Act*, RSC 1985, c C-36, s 32.

[19] *Third Eye Capital Corp v Dianor Resources Inc*, 2016 ONSC 6086 [*Dianor* SCJ] at para 40, rev'd *Dianor*, *supra* note 10.

III. THE HISTORY OF ROYALTIES AS INTERESTS IN LAND IN CANADA

Historically, the common law was not entirely clear on whether a mineral lessee—a holder of a *profit a prendre*[20] in Crown or freehold lands—could create a royalty that was an interest in the land. It was not clear whether producer-granted royalties could be interests in land. In the face of this uncertainty, Canadian courts have deliberated the legal nature of these overriding royalties for at least 50 years, fashioning a complicated basis on which GORRs could be interests in land. In short, if the parties to an overriding royalty endowed it with a number of ostensibly superfluous incidents of an interest in land, the court would recognize it as such. On paper, this was a triumph of form over substance. Industry participants had no choice but to create instruments called royalties that were not in fact royalties, laden as they were with rights no one ever intended to exercise.[21] Rather than recognizing that GORRs could themselves be interests in land, Canadian courts would recognize interests in land that happened to operate like royalties.

We note that this formalistic approach likely arose from the jurisprudential uncertainty underlying the early royalty decisions: can a producer carve a royalty interest out of their mineral lease such that it runs with the land? The Supreme Court of Canada's decision in *Dynex* attempted to provide a definitive answer to that question. There were no "convincing policy reasons for maintaining the common law prohibition on the creation of an interest in land from an incorporeal hereditament".[22] The customs and commercial realities in the oil and gas and mining industries warranted a shift in the law to recognize overriding royalty interests as interests in land where: i) the parties' intention to create an interest in land was sufficiently clear and; ii) the underlying interest from which the royalty was carved could support it.

Dynex represented an abrupt change in the common law, creating a novel property interest on the strength of widespread industry practice.[23] Unfortunately, the *ad hoc* nature of the pre-existing body of case law made it difficult to fix the parameters of this two-step test. Post-*Dynex*, the question confronted by Canadian lawyers and courts was whether *Dynex* affirmed the prior case law, or whether it exhausted its relevance by applying an old test to a newly recognized property interest. Until recently, the apparent consensus was that *Dynex* affirmed these principles. However, *Dianor* and *Manitok* suggest that this view is incorrect, advocating a simplified approach that keeps with the spirit of the *Dynex* test by focusing primarily on the intentions of the parties.

1. Overriding Royalties as Interests in Land: It is Theoretically Possible

St Lawrence Petroleum v Bailey Selburn Oil & Gas Ltd was one of the first Canadian cases to confront the question of whether a share in the net proceeds of production could be an interest in land.[24] In this case, the Supreme Court ultimately determined the royalty at issue was not an interest in land. However, the judgment of Martland J is notable for two reasons: i) it opened up

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[20] See, for example, *Berkheiser v Berkheiser*, [1957] SCR 387, 7 DLR (2d) 721, in which the Supreme Court determined that oil and gas leases are *profits à prendre*—a form of incorporeal hereditament.
[21] *Dianor*, *supra* note 10 at para 71.
[22] *Dynex* SCC, *supra* note 4 at para 18.
[23] *Ibid* at paras 17–20.
[24] *St Lawrence Petroleum Limited et al v Bailey Selburn Oil & Gas Ltd et al*, [1963] SCR 482 at paras 11, 22, 41 DLR (2d) 316 [*St Lawrence Petroleum*].

the common law to the possibility that overriding royalties *could* be interests in land if such an intention was expressed in "plain and unmistakable words";[25] and ii) his reasoning appears to consider the entirety of the agreement, an element that came to inform much of the later jurisprudence.[26]

In identifying the intentions of the parties, the Court held that a royalty agreement in which the grantor remained in complete control of the royalty lands and the grantee's sole entitlement was a share in the net proceeds of production is inconsistent with an interest in land.[27] This finding arguably established the first "indicium" of a royalty interest in the land—control over the lands. In considering this matter, courts would ask, "Does the grantee have a right to enter and win the minerals for themselves? Is the royalty an entitlement to a percentage of the "moneys to be derived from the sale of production"[28], or is it an interest in the mineral in the ground?"

Later courts came to view this distinction as an important factor to consider when asked to determine whether a royalty was an interest in land. Six years later, for example, an Alberta appellate court applied *St Lawrence Petroleum* to hold that a royalty calculable and payable on produced hydrocarbons was a contractual right and not an interest in land.[29] More broadly, the concepts and questions articulated in *St Lawrence Petroleum* crept into subsequent courts' decision making, influencing the development of the law of royalties in unpredictable ways.

2. The Keyes Dissent: A Harbinger of Future Changes?

Laskin J further advanced the law of royalties with his dissent in *Saskatchewan Minerals v Keyes*.[30] At issue in the *Keyes* case was the respondent's entitlement to a royalty payable on anhydrous salt produced from two leases. The respondent could only succeed in his application if the royalty was an interest in land.[31]

As identified in Laskin J's reasons for dissent, three clauses were of central import to his interpretation of the royalty agreement: i) a clause assigning all of the respondent's right, title and interest in the underlying leasehold and minerals; ii) a reservation of a royalty carved out of that underlying leasehold interest; and iii) a clause providing that the royalty agreement would enure to the benefit of and bind the parties, their heirs, administrators, successors and assigns.[32] Absent these clauses, there were no clear expressions of intent.

In his analysis, Laskin J appears to have been of the view that a royalty expressed as a right to payment on the production of some mineral *can* be an interest in land, even if the right to payment does not arise until after the mineral has been severed and reduced to a chattel. This conclusion flowed from his opinion that royalties are analogous to rents, which were historically treated as interests in land:

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[25] *Ibid* at para 36.
[26] *Ibid* at paras 28, 32–33.
[27] *Ibid* at para 32.
[28] *Ibid* at para 37.
[29] *Emerald Resources Ltd v Sterling Oil Properties Management Ltd* (1969), 3 DLR (3d) 630 (Alta SC(AD)) at paras 40–46.
[30] *Saskatchewan Minerals v Keyes*, [1972] SCR 703, 23 DLR (3d) 573 [*Keyes*].
[31] *Ibid* at paras 1, 23.
[32] *Ibid* at para 30.

> This is not to say that every reservation or grant of a royalty creates an interest in land. The words in which it is couched may show that only a contractual right to money or other benefit is prescribed. However, if the analogy is to rent, then the fact that the royalty is fixed and calculable as a money payment based on production or as a share of production, or of production and sale, cannot alone be enough to establish it as merely a contractual interest.[33]

In three sentences, Laskin J deftly affirmed the possibility that a royalty can be an interest in land, that the words evidencing an intention to create an interest in land must be construed against the terms of the agreement as a whole, and rejected Martland J's position on behalf of the majority in both *Keyes* and *St Lawrence Petroleum* that a royalty payable on the net proceeds of production could not be an interest in land.[34] Finally, the *Keyes* dissent suggests the formulation of the language that actually creates the interest in land is an important consideration in identifying its character, particularly where it "accords with language that has been held sufficient for the creation of an interest in land…".[35]

Multiple courts later found Laskin J's dissenting reasons to be persuasive.[36] His contribution to the development of this area of law is therefore instructive. Not only did his judgment lend further support to the idea that a grantor's intentions can only be determined in the context of the entire agreement, but he refused to blindly follow the Supreme Court's previous technical rejection of a royalty payable on production. In addition, he affirmed a new indicium for courts to look to in ascertaining whether a royalty is an interest in land: the presence of granting language.

3. The Common Law Continues to Evolve: the Emphasis Remains on the Entire Agreement

In *Bensette v Reece*,[37] the Saskatchewan Court of Appeal began its analysis of a disputed royalty with the observation that a royalty's "meaning must be deduced from the circumstances surrounding its use".[38] Considered in the context of *St Lawrence Petroleum* and *Keyes*, this suggests that the target of the inquiry remains the parties' intentions as revealed by the entire agreement, and, arguably, the circumstances surrounding its formation.

Having established its starting point, the *Reece* Court relied on the granting language in the royalty agreement to support its determination that the disputed royalty was an interest in land, holding, just as Laskin J had written in *Keyes*, that the language "to give, grant, bargain, sell, assign and transfer…a royalty in all the minerals…which may be found in, under or upon the said lands" displayed an intention to create an interest in the land.[39]

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[33] *Ibid* at para 50.
[34] *Ibid* at para 12.
[35] *Ibid* at para 49.
[36] *Scurry-Rainbow Oil Ltd v Galloway Estate* (1993), 8 Alta LR (3d) 225, 138 AR 321 (Alta QB) [*Scurry-Rainbow*], aff'd 1994 ABCA 313; *Canco Oil & Gas Ltd v Saskatchewan* (1991), 89 Sask R 37 (Sask QB) [*Canco*].
[37] *Bensette v Reece* (1973), 34 DLR (3d) 723 (Sask CA) [*Reece*].
[38] *Ibid* at para 6.
[39] *Ibid* at para 7.

Beyond the granting language, the Court sought to ascertain the intentions of the parties by inquiring into the language "couching" the royalty. Specifically, the Court was concerned with the meaning of the phrase, "a royalty *in* the minerals".[40] Perhaps logically, the Court held that a royalty *in* the minerals is an interest that inheres in the minerals; a royalty *on* the minerals, on the other hand, would have indicated the parties merely intended to create a commission or some other executory interest (the "in/on" distinction).[41] This distinction persisted in the common law for some time.

In *Vanguard Petroleums Ltd v Vermont Oil & Gas Ltd*, the Alberta Supreme Court substantially agreed with the reasoning in *Reece*, concluding that courts must consider the facts of the parties' relationship and "examine the language under particular sets of circumstances to determine the nature of [the] royalty".[42] The Court also found the "in/on" distinction persuasive;[43] however, it declined to accept Laskin J's characterization of a royalty as something akin to rent. Unlike a royalty, rent is a payment in consideration of or as compensation for the use and occupation of another's property.[44] In this way, it is intrinsically tied to the underlying property right. By contrast, a GORR in the oil and gas and mining sectors is a covenant to pay a third party a percentage share upon the production of the subject substance or mineral.

4. An Attempt at Simplification

As the number of royalty cases before the courts grew, the number of considerations that courts felt obliged to consider grew in step. The *Guaranty Trust Co of Canada v Hetherington* decision is a good example of this complexity.[45] In *Hetherington*, the Court surveyed the existing case law on royalties, developing the following list of factors to consider when attempting to characterize a royalty:

1. the intention of the parties;[46]
2. the presence of granting language;[47]
3. the manner in which the interest is described;[48]
4. the words in which the royalty is couched (the "in/on" distinction);[49] and
5. the operation of the entire agreement.[50]

Arguably, the latter four indicia flow from the first—the parties' intentions. By considering these specific factors, courts could seek to ascertain the intention motivating the creation of the

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[40] *Ibid* at para 8.
[41] *Ibid* at para 9.
[42] *Vanguard Petroleums Ltd v Vermont Oil & Gas Ltd* (1977), 72 DLR (3d) 734, 4 AR 251 (Alta SC) at paras 27, 31 [*Vanguard*].
[43] *Ibid* at para 28.
[44] *Ibid* at paras 29–30.
[45] *Guaranty Trust Co of Canada v Hetherington* (1987), 50 Alta LR (2d) 193, 77 AR 104 (Alta QB) [*Hetherington*], aff'd (1989) 67 Alta LR (2d), 95 AR 261 (Alta CA).
[46] *Ibid* at paras 91, 94, 100.
[47] *Ibid* at para 94.
[48] *Ibid* at paras 96, 100.
[49] *Ibid* at para 97.
[50] *Ibid* at para 104.

royalty, even if that intention was not expressly stated in the agreement. Though not discussed in *Hetherington*, an additional factor from *St Lawrence Petroleum* should be added to this list:

6. the degree of control the grantor retains over the royalty lands.

In an apparent effort to simplify this inquiry, the Alberta Court of Queen's Bench in *Vandergrift v Coseka Resources Ltd*[51] proposed a two-step test to apply to royalty agreements. It was this test that the Supreme Court ultimately endorsed in *Dynex*.[52] In its analysis, however, the *Vandergrift* Court continued to follow the lead of the earlier decisions, examining the agreement as a whole and relying on the "in/on" distinction to determine that the disputed royalty was not an interest in land.

Thus, by 1993 there were at least six indicia a court could refer to in determining whether a royalty was an interest in land. The purpose of this approach was to identify the intentions of the parties where they were not clearly stated, and to ensure that the agreement actually gave effect to those intentions. But there was a problem: how were the various factors to be weighed against each other? Moreover, how should a court weigh these factors against each other when the parties that attempted to create the interest in the first place may have done so before the indicia the courts developed had found their way into the common law?

In *Scurry-Rainbow*,[53] Hunt J narrowed this list, rejecting the "in/on" distinction relied upon in *Vanguard* and *Vandergrift* on the basis that fine technical distinctions such as this are not reflective of commercial reality.[54] Rather than relying on overly technical and legalistic modes of reasoning, Hunt J instead urged courts to direct their analysis to the "substance of the transaction", focusing the inquiry on identifying what the parties were actually trying to achieve.[55] Following *Scurry-Rainbow*, it appears the common law had jettisoned one technical indicia of an interest in land and redirected its focus to what the parties actually intended, rather than what the terms of the agreement accomplished in a vacuum.[56]

5. Is This More Substantive Approach in Conflict with Prior Jurisprudence?

Hunt J's focus on actual intention appears to confirm an earlier decision from the Saskatchewan Court of Queen's Bench, *Canco Oil & Gas Ltd v Saskatchewan*,[57] which asked if a royalty agreement should be interpreted in light of the intentions of the parties, or whether it should be construed more conservatively, giving effect only to what the terms of the agreement actually accomplish in light of the various factors courts should consider. In other words, should a court look only at what the mechanics of the agreement achieve, or should it also consider what the parties intended to create?

The answer to this question appears to be both. The most important questions in characterizing royalty interests are: i) whether the grantor is capable of granting the interest; ii)

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[51] *Vandergrift v Coseka Resources Limited* (1989), 67 Alta LR (2d) 17, 95 AR 372 (ABQB) [*Vandergrift*].
[52] *Ibid* at paras 31–33.
[53] *Scurry-Rainbow*, *supra* note 36.
[54] *Ibid* at para 58.
[55] *Ibid* at para 59.
[56] While the royalties at issue in *Scurry-Rainbow* were Gross Royalty Trust Agreements, Hunt J's discussion of the law on royalties has been more recently cited in relation to gross overriding royalties as well. See: *Dynex* CA, *supra* note 4; *Dynex* SCC, *supra* note 4; *Re Walter*, *supra* note 17; *Dianor*, *supra* note 10; *Manitok*, *supra* note 11.
[57] *Canco*, *supra* note 36.

whether the grantor intended to grant an interest in the land; and iii) whether the grantor accomplished its intention.[58] Of these three questions, the Court's comments suggest the second question—the intentions of the parties—is the main point of inquiry. The mere fact that the grantor failed to use the precise wording previous courts have considered essential to the creation of interests in land cannot detract from a clearly manifested intention to create that interest.[59]

But a consistent theme of Canadian royalty cases has been that it is not enough to simply call something an interest in land. It has to actually be an interest in land. Importantly, it appears the *Canco* Court was alive to the fact that the expressed intentions of the parties could provide important context to the effect of the royalty agreement. As long as a royalty grantor has an interest in the underlying estate, its intention to alienate part of it in favour of another should be given effect to where possible. In *Canco*, for example, the agreement expressly stated that the parties intended the royalty would run with the land.[60] This clearly expressed intention likely allowed the Court to overlook other deficiencies in the rest of the agreement, or construe them in the context of the commercial circumstances and the parties' intentions. While it is unlikely that a clearly stated intention would have been determinative at the time, the Court's reasoning in *Canco* is consistent with the earlier tests, while also affording Hunt J the space to redirect the inquiry to the substance of the parties' intentions in *Scurry-Rainbow*.

6. *Dynex*

Conducting a thorough assessment of the law of royalties in *Dynex* CA, the Alberta Court of Appeal acknowledged that the pivotal question a court must ask in determining whether a royalty runs with the land is whether the parties intended to convey such an interest.[61] Importantly, however, the Court held that simply stating the interest is an interest in land is insufficient;[62] rather, the interest can only be properly characterized by "interpreting the agreement as a whole and within its context."[63]

As developed in *Canco* and *Scurry-Rainbow*, the proper approach is to examine the parties' intentions from the agreement as a whole, along with a proper consideration of the surrounding circumstances.[64] That said, this approach should not be overly literal, particularly if it leads to an unrealistic result that the parties would not themselves have contemplated at the time of contract.[65] Accordingly, the Court concluded that parties can create royalties that are interests in land if their intentions to do so are clear.[66] In ascertaining their intentions, the following indicia are relevant:

1. the underlying interest is an interest in land;
2. the intentions of the parties, as evidenced by the language of the grant and any admissible evidence of the surrounding circumstances or behaviour, indicate that it was understood that an interest in land was created/conveyed;

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[58] *Ibid* at para 58.
[59] *Ibid*.
[60] *Ibid* at para 9; John Bishop Ballem, *The Oil and Gas Lease in Canada*, 4th ed (Canada: University of Toronto Press, 2008) at 183.
[61] *Dynex* CA, *supra* note 4 at paras 32–33, citing *St Lawrence Petroleum*, *supra* note 24.
[62] *Ibid* at para 73.
[63] *Ibid* at para 33.
[64] *Ibid* at para 73.
[65] *Ibid* at paras 68–69, citing *Scurry-Rainbow*, *supra* note 36 at para 100.
[66] *Ibid* at para 82.

3. the interest is capable of lasting for the duration of the underlying estate.[67]

Other possible signposts include:

4. a reservation of an interest in the petroleum substances by the farmor/royalty holder in the working interest to be earned by the farmee/royalty grantor;
5. whether the farmee/royalty grantor is agent of the farmor/grantee for the farmor's/grantee's share of petroleum production;
6. the existence of remedies against the interest of the farmee/royalty grantor through a proprietary remedy such as a lien.[68]

On appeal to the Supreme Court, Major J agreed with the appellate decision "for substantially the same reasons".[69] However, instead of adopting the indicia suggested by the Court of Appeal (as set out above), he cited the "sufficiently-stated" two-part *Vandergrift* test:

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.[70]

It is interesting to note that, as originally set out in *Vandergrift*, the *Dynex* SCC test closely, but not exactly, tracks the first two indicia contained in the *Dynex* CA test. It is arguable that the Court's reference to a similar but different articulation of the test set out by the lower court suggests a desire to depart from that aspect of its decision—the accompanying indicia, in particular—emphasizing the clear intentions of the parties. In doing so, the Supreme Court appears to have collapsed the inquiry to focusing almost exclusively on the intentions of the parties as disclosed by the language of the agreement. A minor caveat on this point: despite adopting the approach taken in *Vandergrift*, it is important to note that the Court did not endorse Virtue J's analysis, nor did it endorse the specific factors relied on in the *Vandergrift* analysis.[71]

When the *Dynex* dispute was re-heard at trial, Hawco J referred to the indicia set out by the Court of Appeal,[72] but only applied one of them in his reasons. He expressly referred to the fact that: i) the royalty was expressed to be a percentage of the proceeds of sale of petroleum substances produced from the lands;[73] ii) unlike in *Canco*, there was no clear expression of intent;[74] and iii) the royalty holder had failed to register a caveat to protect the interest.[75] Despite relying on the *Dynex* test and referring to the indicia in *Dynex* CA, it is notable that Hawco J relied on altogether different factors in determining that the royalty was not an interest in land.

The decision in *Dynex* QBII highlights the difficulties that courts have had in applying the *Dynex* test, and calls into question the steps that a court should follow in conducting the inquiry.

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[67] *Ibid* at para 84.
[68] *Ibid*.
[69] *Dynex* SCC, *supra* note 4 at para 6.
[70] *Ibid* at para 22.
[71] *Dianor*, *supra* note 10 at para 73.
[72] *Bank of Montreal v Dynex Petroleum Ltd*, 2003 ABQB 243 at para 39 [*Dynex* QBII].
[73] *Ibid* at para 52.
[74] *Ibid* at para 53.
[75] *Ibid* at para 55.

Should a court rely solely on the intentions of the parties? Should it consider the mechanics of the agreement as set out in previous case law? Should it do both? It is unfortunate that the first post-*Dynex* SCC case to interpret a royalty agreement was not entirely clear in its approach. Similarly, the decisions that followed are equally inconsistent.

7. Post-*Dynex* Treatment of Royalties

The foregoing review of the pre-*Dynex* royalty case law illustrates the confused evolution this area of law has experienced. Not only was it unclear whether the common law would even recognize a real property right arising from an incorporeal hereditament, but those courts that elected to consider the matter in spite of this uncertainty adopted idiosyncratic approaches. The indicia that courts developed and applied was in a constant state of flux: it was common for judges to consider new factors, or ignore factors previously relied upon. Meanwhile, commercial lawyers assisting parties in drafting royalty agreements were left to discern which language and provisions would best establish an interest in land as determined by the shifting common law.

Though courts had previously recognized that GORRs *could* be interests in land, it was not until *Dynex* that Canadian law affirmatively recognized the validity of this proposition. In recognizing the viability of creating such interests, the Alberta Court of Appeal and Supreme Court of Canada both responded, in large part, to the needs of industry. Because the investment structure in the oil and gas and mining industries relied so heavily on the creation of royalties that could "run with the land" regardless of which company owned the relevant mineral lease, the courts understood the need to protect them from commercial uncertainty.[76]

Given the *sui generis* nature of the property right and the clear policy motivations underlying both the *Dynex* CA and *Dynex* SCC judgments, it is certainly arguable that the Supreme Court of Canada sought to reorient the inquiry to focus primarily on the intentions of the parties. If the underlying hereditament is capable of supporting a royalty interest in the land and the parties intend to create one, why is that intention not enough?

As history shows, courts did not respond to *Dynex* SCC this way. Instead, they continued to apply the pre-*Dynex* indicia. As was the case before *Dynex*, industry participants in the oil and gas and mining sectors continued to grapple with the uncertainty created by the inconsistent development and application of the pre-*Dynex* indicia. Indeed, royalty agreements that complied with the indicia in existence at the time they were drafted may not have been compliant with the law at the time they were later litigated. One example of this is the *San Juan Resources* royalty dispute.[77]

The overriding royalty at issue in *San Juan* was created in 1952—one decade before Martland J suggested that overriding royalties on production could be interests in land if the parties so intended. However, it did not appear before a court for another five decades. In the intervening period, the law of royalties underwent enormous change. It could not have been possible for the original drafters of the agreement to anticipate what a court would find relevant some 50 years later.

Tasked with determining whether the royalty was an interest in land, LoVecchio J attempted to discern the original parties' intentions. To that end, he determined it was not enough

[76] *Dynex* CA, supra note 4 at paras 39–40, 45.
[77] *James H Meek Trust v San Juan Resources Inc*, 2003 ABQB 1053 [*San Juan*], rev'd on other grounds, 2005 ABCA 448.

that the *San Juan* royalty contained the appropriate granting language.[78] Whatever degree of intention the granting language illustrated was outweighed by the fact that: i) the royalty was a payment obligation "payable out of production";[79] ii) the grantee did not reserve a right to take the royalty in kind—their interest in the royalty was passive;[80] and iii) the royalty holders did not attempt to register a caveat against title.[81]

It is unknown whether a statement that the parties intended the royalty to be an interest in land would have bolstered the applicants' position in light of the *Dynex* decision. What is clear, however, is that relying on an evolving list of indicia to determine whether royalty agreements drafted years earlier were interests in land creates a great deal of commercial uncertainty. Not only that, but such uncertainty seems contrary to the express policy reasons that motivated the *Dynex* decisions in the first place.

Viewed along this historical continuum, the law of royalties remains unclear. In 2018, the Ontario and Alberta courts delivered a sequence of decisions suggesting that the post-*Dynex* courts have missed the mark in their deference to the pre-*Dynex* case law. Consistent with the *Dynex* test, the principal point of inquiry ought to be the expressly stated intentions of the parties. As well, the Ontario case, *Dianor*, has given rise to an incredibly troubling question: even if a royalty is a valid interest in land, does a superior court judge retain the inherent jurisdiction to transfer the underlying property "free and clear" of the royalty in the course of insolvency proceedings? If the Ontario Court of Appeal ultimately decides that courts do have this jurisdiction, the policy and commercial realities motivating the *Dynex* decisions will be completely undermined.

IV. *DIANOR* AND *MANITOK*: A NEW PATH FORWARD?

1. *Dianor* SCJ

In 2016, Newbould J released his decision in *Dianor* SCJ[82]—a decision that immediately attracted the interest of Canadian insolvency, energy, and mining lawyers. After Dianor Resources Inc ("Dianor") entered insolvency proceedings in August 2015, its receiver sought an order approving the sale of certain assets to Third Eye Capital Corporation ("Third Eye") free and clear of all encumbrances. A third party, 2350614 Ontario Inc ("235"), did not oppose the sale, but argued that the transfer was subject to royalty rights that attached to the land.

Though the decision does not cite the legal authority for the position, Third Eye argued that the royalty could be cancelled through a vesting order and the payment of fair compensation to 235.[83] Newbould J's analysis began with an acknowledgment of the *Dynex* test and a consideration of the language that created 235's gross overriding royalties.

The royalty was payable in respect of diamonds and all other metals and minerals produced from the lands.[84] Importantly, the diamond royalty was calculated in respect of the average appraised value of all diamonds recovered or produced from the lands; the metals and minerals

[78] *Ibid* at para 36.
[79] *Ibid* at paras 37–38.
[80] *Ibid* at para 39.
[81] *Ibid* at para 43.
[82] *Dianor* SCJ, *supra* note 19.
[83] *Ibid* at para 15.
[84] *Ibid* at para 18.

royalty was calculated in respect of Dianor's realized gross revenue.[85] In other words, the royalty applied to the products after they had been either recovered, or recovered and sold, respectively. However, similar to the royalty agreement in *Canco*, the royalty agreement in *Dianor* contained a clause expressly stating that the parties intended the royalty to be an interest in land, running with the royalty lands and binding all successor parties.[86] Newbould J's view, however, was that this expression of intent was just that—an expression of intent. The agreement failed to give effect to that intention and actually convey an interest in land.[87] In other words, the key to identifying its true character was to determine whether the agreement *carried out* the intent, not whether the intent was clearly expressed.

Relying on cases that looked to the nature of royalty-granting covenants, Newbould J identified two factors that rendered the royalty a contractual interest, not an interest in land:

1. the agreement failed to extend to 235 a right to enter and "enjoy" the lands;[88] and
2. the description of the royalty was couched in language suggesting it applied either to minerals produced from the lands or revenues derived therefrom.[89]

The Court also relied on case law that appears to have found the "in/on" distinction persuasive.[90] Given his finding that the royalty was not an interest in land, Newbould J concluded that he had the jurisdiction to grant the proposed vesting order, selling the lands to Third Eye free and clear of 235's royalty. This decision appears to have been consistent with the approach Canadian courts had historically taken to the royalty question, though it could be said that the reasoning adopted a fairly conservative approach to identifying and weighing the parties' intentions. Problematically, Newbould J then declared in *obiter* that he could "see no reason in logic…why the jurisdiction would not be the same whether the royalty rights were or were not an interest in land."[91] Respectfully, such a fundamental change in the perceived boundaries of a court's jurisdiction must be grounded in law, not logic.

2. A Return to Basics: The Ontario Court of Appeal's Recalibrated Approach to Royalties

With the exception of his comments as to the court's inherent jurisdiction to vest off interests in land, Newbould J's decision was not entirely surprising: it was a technical application of fairly well-established case law. On appeal, however, the Ontario Court of Appeal took a different approach, signalling a preference for a more straightforward and practical analysis. As the Court recognized, the uncertainty surrounding the nature of gross overriding royalties prior to *Dynex* was due to the fact that the common law viewed the right to take resources from another's

[85] *Ibid* at paras 18–20.
[86] *Ibid* at para 22.
[87] *Ibid* at para 23.
[88] *Ibid* at para 24. The authors note that Newbould J appears to have viewed the right to "enter and enjoy" as functionally equivalent to certain civil law rights to enter, use, profit from, and dispose of the lands (*usus*, *fructus*, *abusus*). These rights are much more closely related to the bundle of rights that a working interest partner would require to benefit from its interest, not a royalty holder.
[89] *Ibid* at paras 25–26.
[90] *Ibid* at para 26, citing *St Andrew Goldfields Ltd v Newmont Canada Ltd*, [2009] OJ No 3266 at paras 101–103 (Ont SCJ), aff'd 2011 ONCA 377.
[91] *Ibid* at para 40.

land to be an interest in land, but it did not extend the same consideration to the right to a payment of profits.[92] The Supreme Court of Canada's decision in *Dynex* officially scrapped this old rule of the common law, creating a *sui generis* property interest to keep the law in step with modern commercial practices.[93]

Because commercial practices in the oil and gas and mining industries evolved under the assumption that GORRs could be interests in land, the Court in *Dianor* noted that the Supreme Court of Canada in *Dynex* SCC elected to change the common law solely on policy grounds to "permit a royalty interest, including a [GORR], to become an interest in land, consistent with industry practice."[94] The Court in *Dianor* noted that it was to accommodate these practices that the Supreme Court "quite deliberately changed the common law",[95] expressly predicating the creation of the interest on the parties' intentions.

In arriving at its decision, the Court of Appeal in *Dianor* appears to have been heavily persuaded by the fact that: i) the *Dynex* CA decision responded to industry practice and the intentions underlying that practice; and ii) the Supreme Court of Canada endorsed that approach. The implication is that, as expressed in *Dianor*, a court must "examine the parties' intentions from the agreement as a whole, along with the surrounding circumstances, as opposed to searching for some magic words."[96] This approach, however, should be tempered by Major J's approval of Laskin J's comments in *Keyes*: "[T]he intentions of the parties judged by the language creating the royalty would determine whether the parties intended to create an interest in land or to create contractual rights only." The Ontario Court of Appeal's decision in *Dianor* indicates that this was the Supreme Court's ultimate holding in *Dynex*.[97]

With respect to 235's royalty, the Court applied the *Dynex* test to conclude that it was an interest in land: the royalty was itself carved out of an interest in land and the parties expressly stated in plain language that they intended the royalty to be an interest in land. Confirming this intention was the fact that the royalty holder subsequently registered its interest on title.[98] The Court's decision to focus its inquiry on the express intentions of the parties is made clear at paragraph 65 of the decision:

> The contractual terms are not necessarily determinative of whether an interest in land was intended; the language does not require magic words to demonstrate the parties' intention. However, these words were present in the Agreements. In my view, the appellant's [GORRs] constitute interests in land that run with the land and are capable of binding the claims in the hands of a purchaser.

While not decisive, the fact that language clearly setting out the express intentions of the parties is present in the agreement is highly persuasive as to the manner in which the interest should be construed. To further substantiate its position, the Court reconsidered Newbould J's reasons with an emphasis on the express intentions of the parties. In failing to interpret the agreement with

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[92] *Dianor*, *supra* note 10 at para 36.
[93] *Ibid* at paras 38–42; *Dynex* SCC, *supra* note 4 at paras 17–20; *Dynex* CA, *supra* note 4 at paras 29, 34–45.
[94] *Dianor*, *supra* note 10 at para 44.
[95] *Ibid* at para 43.
[96] *Ibid* at para 54.
[97] *Ibid* at para 55, citing *Dynex* SCC, *supra* note 4 at para 12.
[98] *Ibid* at paras 62–64.

that perspective in mind, the Court concluded that Newbould J erred in treating the fact that 235 did not retain a right to enter the lands and explore for minerals as anathema to an interest in land.[99] In addition, the fact that the royalty was a right to share in the proceeds of production does not mean that it cannot be an interest in land.[100]

The purpose of a royalty that runs with the land is to allow a passive interest holder to protect its economic interests. Demanding that the royalty holder retain a right to enter the lands before its royalty will be an interest in land fails to align with the intentions of the parties to a royalty agreement.[101] With respect to the character of the royalty, the Court of Appeal simply relied on Laskin J's judgment in *Keyes* to conclude that the mere fact that a royalty is to be calculated with respect to production cannot, by itself, defeat the clear intentions of the parties.[102]

3. *Manitok*: An Apparent Endorsement of the *Dianor* Approach

Less than two months after the Ontario Court of Appeal delivered its judgment in *Dianor*, Horner J of the Alberta Court of Queen's bench heard submissions concerning a similar application in *Manitok.*[103] In this case, an insolvent energy company, Manitok Energy Inc ("Manitok"), informed its receiver that it did not believe a producing royalty held by Freehold Royalties Partnership ("Freehold") was an interest in land. After reviewing the royalty agreements, the receiver revoked Freehold's take-in-kind rights, which Freehold had been exercising for six months prior to the receivership order. Freehold contested Manitok's position, applying to the Court for a declaration that the royalty was an interest in land, and that it was entitled to take-in-kind all oil volumes corresponding to its royalty interest.

The royalty itself was created and defined across two related agreements—a Production Volume Acquisition Agreement (the "Acquisition Agreement") and a Production Volume Royalty Agreement (the "Royalty Agreement"). Both Agreements expressly stated that the royalty was intended to be an interest in land.[104] Moreover, Schedule B of the Royalty Agreement contained abbreviated granting language, but reiterated that the royalty was an interest in land that would "run with the land" in respect of all oil volumes "within, upon or under the…[lands]".[105] The Agreements clearly set out that Manitok could not contest the character of the royalty and that Freehold retained a first-priority right to receive the royalty,[106] as well as a right to take the royalty in kind. [107]

Notwithstanding the stated intentions of the parties and the presence of some language to suggest the royalty was an interest in land, a number of provisions appear to have run contrary to that intention. The scheme of the Royalty Agreement routinely defined the royalty in terms of produced volumes, and was expressed to be "in respect of" produced oil volumes, rather than an interest in the oil volumes *in situ*.[108] The royalty was not fixed, but set to decline over time.[109] This

[99] *Ibid* at para 67.
[100] *Ibid* at para 67.
[101] *Ibid* at paras 71–72.
[102] *Ibid* at paras 76–77.
[103] *Manitok*, *supra* note 11.
[104] *Ibid* at paras 5–6.
[105] *Ibid* at para 7.
[106] *Ibid* at para 7.
[107] *Ibid* at para 8.
[108] *Ibid*.
[109] *Ibid* at para 10.

could suggest that it was not an immutable interest in the minerals themselves, but a contractual right to share in the profits of production with reference to a sliding scale. Finally, and perhaps most problematic, was the fact that Manitok could assign the royalty lands on notice to Freehold, but was obliged to offer a substitute property in which Freehold's royalty interest would continue.[110] How could it be said that the interest was in the land, if the land itself could change?

Freehold argued that the *Dynex* test had been misconstrued by Canadian courts over the past 15 years. Relying on the two-part *Dynex* test, Freehold's position was that it is enough that those two requirements are satisfied. If the parties clearly state their intention to create an interest in land out of a *profit a prendre*, the courts should recognize it. As a result, there is no need to go beyond the clearly stated intentions of the parties and inquire into the indicia set out by the pre-*Dynex* courts.

Without so stating, Horner J appears to have accepted this argument—particularly in light of the *Dianor* decision:[111]

> 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.
>
> The other factors cited…are also not sufficient to defeat what appears to have been the clear intention of Freehold and Manitok to create an interest in land.[112]

If we consider the *Manitok* decision in the context of *Dianor*, so long as it is clear that the parties intended to create an interest in the land, courts should defer to that intention. This can generally be accomplished through the use of an express acknowledgment that the parties intend to create an interest in land. It is only where the agreement is otherwise silent that the pre-*Dynex* indicia are necessary to identify the parties' intention.

4. Is This New Approach Too Broad?

Is this recent shift in the way that courts weigh the clearly expressed intentions of the parties a cause for concern? Not necessarily.

It seems counterintuitive to adopt the view that simply calling something an interest in land makes it an interest in land. One cannot point to a dog, call it a cat, and have it be so. In a sense then, this new approach opens the law of royalties up to abuse. However, overriding royalties as interests in land are unique. The Supreme Court clearly departed from common law principles of property law to recognize that they can be interests in land where the parties so intend. It is therefore arguable that the pre-*Dynex* indicia are not necessary features of royalties that are also interests in land. They are incidents of ownership that courts historically relied on to work around

[110] *Ibid* at para 11.
[111] *Ibid* at para 21.
[112] *Ibid* at paras 22–23.

the common law prohibition on creating an interest in land out of an incorporeal hereditament. Overriding royalties that incorporate all of the indicia are not royalties at all: they are working interest rights that are accompanied by a percentage payment on production.

We recognize that an overly broad approach gives rise to certain concerns. That said, viewed as the product of an organic and constantly evolving legal process, there are strong reasons to believe that the courts in *Dianor* and *Manitok* got it right. The clearly stated intentions of the parties should be guiding and, if not determinative, at least highly persuasive.

V. THE UNANSWERED, LOOMING QUESTION IN *DIANOR*

Though *Manitok* was appealed to the Court of Appeal of Alberta by the receiver, the appeal has now been abandoned. Therefore, *Manitok* is the most recent Alberta pronouncement on these issues. However, the 'royalty question' remains alive in the courts, and will remain so until the issues discussed herein are again addressed by either the Supreme Court of Canada or other appellate courts. There is potential for this to occur soon.

Dianor has been appealed to the Supreme Court of Canada, however the leave application submissions are on hold pending the parties returning to the Ontario Court of Appeal and making further arguments on the contentious issue of the Court's ability to convey the underlying mineral interest free and clear of royalties irrespective of whether they are interests in land. The Ontario Court of Appeal indicated that this question was not adequately addressed in the facta or oral argument. Due to this, the Court directed further submissions on issues "of considerable importance to the insolvency practice".[113] Any natural resources lawyer or industry participant would assert that this issue is certainly one of considerable importance for their practice and business as well.

It is clear from the decision of the Court of Appeal (and on a plain reading) that the particular provisions of the *Courts of Justice Act*[114] and the *Bankruptcy and Insolvency Act*[115] raised in respect of the vesting off issue "do not expressly authorize a court to take real property out of the hands of a third party".[116] If a 3% GORR that is an interest in land is truly to be considered an "ownership" interest in the minerals *in situ*, then the debtor in possession, or the receiver stepping into the shoes of the debtor, should not be able to sell a 100% interest in the property free and clear of the GORR. Such a sale would be contrary to the principle of *nemo dat quod non habet*, meaning "no one can give that which he does not have".[117] Vesting off an interest in land of this nature would be a form of expropriation not provided for in either current insolvency legislation or the common law. However, despite authorities that bar a court from vesting off proprietary interests, the Court of Appeal considered whether there are situations that may warrant such action and requested additional arguments from the parties on the following question:

> Whether and under what circumstances and limitations […] a Superior Court judge has jurisdiction to extinguish a third party's

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[113] *Dianor, supra* note 10 at para 13.
[114] *Courts of Justice Act*, RSO 1990, c C.43, ss 100, 101.
[115] *Bankruptcy and Insolvency Act*, RSC 1985, c B-3, s 243.
[116] *Dianor*, *supra* note 10 at para 107.
[117] The Canadian Abridgment: Words & Phrases Judicially Defined in Canadian Courts and Tribunals (online), "*nemo dat quod non habet*" (Westlaw W&P 19641) citing *Barberree v Bilo* (1991), 3 CPC (3d) 96, 126 AR 121 (Alta QB) at para 12.

> interest in land using a vesting order, under s. 100 of the CJA and s. 243 of the BIA, where s. 65.13(7) of the BIA; s. 36(6) of the CCAA; ss. 66(1.1) and 84.1 of the BIA; or s. 11.3 of the CCAA do not apply?[118]

The comeback hearing took place in September 2018;[119] however, the Court has yet to release its decision, leaving insolvency and natural resources practitioners in suspense. Commercial lawyers are left to draft royalty agreements designed to protect their clients' interests without certainty as to the true state of the law. Insolvency practitioners are left to continue managing the estates of insolvent natural resources entities without clear common law direction as to what they can and cannot do. Interestingly, we note that since the Ontario Court of Appeal released its decision in *Dianor*, some recent Ontario decisions have already cited it for the proposition that an interest in land *cannot* be vested off the underlying mineral interest in an insolvency process.[120]

VI. JUST HOW SECURE ARE ROYALTIES?

Despite the authors' view that Canadian courts lack the jurisdiction to wipe an underlying mineral interest clean of any pre-existing royalty interests in the land, such royalties are not entirely secure—and never have been. To begin, the royalty will only survive for so long as the underlying interest survives. While freehold lessor royalties are likely secure in this respect (the fee interest lasts into perpetuity), freehold GORRs can terminate if the underlying lease terminates. This puts the GORR-holder in a precarious position: the continued existence of their royalty interest is entirely dependent on the actions of the grantor or their successors in interest. If the grantor fails to produce in accordance with the terms of the lease (or improperly shuts in production), the GORR might terminate. Similarly, if the GORR is granted out of a Crown lease, it is important to keep in mind that, if the lease terminates (or is cancelled or surrendered), the underlying interest reverts back to the Crown free and clear of all pre-existing encumbrances.[121] Again, notwithstanding the nature of the royalty, the GORR-holder is left in a precarious position and may lose their royalty interest through no fault of their own. Contractual provisions can provide some protection for royalty holders, such as agreeing that, notwithstanding the surrender or expiry of a lease, the royalty lands will remain subject to the royalty if the grantor or its affiliates re-acquire the royalty lands within a set period of time. However, the fate of the royalty is ultimately tied to the providence of the underlying interest.

The fact that GORRs that are interests in land can terminate notwithstanding their proper creation takes on even greater significance in the insolvency context. Because GORRs are encumbrances that diminish the value of the interest to which they attach, the desirability of the underlying leasehold interest will vary with prevailing market conditions. Thus, if the grantor of a GORR enters insolvency or bankruptcy proceedings, their receiver or trustee may not be able to sell the encumbered interest. In these circumstances, otherwise viable royalty generating wells can

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[118] *Dianor*, *supra* note 10 at para 121.
[119] Ontario Courts, "Court of Appeals Monthly Case List" (last visited 14 August 2018), online: *Court of Appeal for Ontario* <www.ontariocourts.ca/coa/en/caselist/monthlylist.htm>
[120] *American Iron v 1340923 Ontario*, 2018 ONSC 2810 at para 25; *Krates v Crate*, 2018 ONSC 2399 at para 23.
[121] *Mines and Minerals Act*, RSA 2000, c M-17, s 32(1).

end up in the Orphan Well Fund, in part because the attached royalty is an obligation that purchasers were not willing to assume. This is an unfortunate consequence of the 'royalty as interest in land' characterization and may motivate collaborative and other negotiated solutions among receivers or trustees, royalty holders, and prospective purchasers.

As a consequence of the current economic climate, royalty interests are no longer a passive investment. GORR holders should keep a close eye on their royalty grantors and successors in interest. Where formal insolvency proceedings are initiated, GORR holders should ensure that a representative is added to the service list and remains apprised of developments in the sales process and the licensed insolvency professional's management of the estate. Active participation in the insolvency process is important for all GORR holders regardless of whether their royalties can be characterized as interests in land or not. While an interest in land is afforded more protections than a contractual interest, the viability of such an interest is still at risk if the underlying leasehold estate is jeopardized, the possibility of which increases during insolvencies.

VII. CONCLUSION

A close review of the Canadian jurisprudence on the nature of royalty interests and the threshold for a finding of an interest in land reveals that the case law is rife with inconsistencies and nuances which have led to an unclear understanding and inconsistent application of the *Dynex* test. What is clear, in an otherwise confusing area of the law, is the dire need for the Supreme Court of Canada to re-visit its comments in *Dynex* and clarify its position definitively. Absent clarification, the commercial certainty that industry participants and insolvency practitioners seek will remain elusive. However, it is the authors' view that *Dianor* and *Manitok* signal a sensible path forward and, should the Supreme Court ultimately deny leave to appeal, represent a point from which the common law can evolve in a manner that enhances commercial certainty, reduces unnecessary disputes, and better captures the Supreme Court of Canada's intent in *Dynex*.

With respect to the outstanding vesting off issue raised in *Dianor*, the scope of the court's equitable jurisdiction is a matter of primary importance in the insolvency context and also demands clarification. Royalties that are interests in land do not enjoy absolute protection, but a finding that the court can extinguish such royalties to enhance the saleability of the underlying asset will negate the protections and benefits afforded to interests of this nature and have profound commercial implications. Although a court's discretion to vest off third party property rights would likely be limited to narrow circumstances, such a finding would disregard the express intentions of the granting party and undermine the express policy reasons that informed the Supreme Court of Canada's decision in *Dynex*.