PETROLEUM ACCOUNTANTS SOCIETY OF CANADA

Commentary on the New Limitations Clause for the Oil & Gas Industry and the Industry Agreement regarding Limitations

The purpose of this commentary is to:

(a) explain the changes resulting from the new *Limitations Act*, particularly as they relate to the oil and gas industry,

(b) describe a proposed new limitations clause for use in future oil & gas agreements, and

(c) introduce an agreement, the "Industry Agreement regarding Limitations", that amends existing industry agreements to adopt the new limitations clause.

The New *Limitations Act* (Alberta)

Until recently, the time period in Alberta by which a court action must be commenced for a particular claim depended upon the type of the claim. A person wishing to sue a doctor for medical malpractice was required to do so within 12 months of the date that the medical service was completed. An action in tort (meaning a civil wrong, such as driving a car negligently and causing an accident) must be commenced within two years of the knowledge of the wrongful act. An action for breach of contract must be commenced within six years of the date of the breach. An action for the recovery of property must be filed within ten years of when the right to do so first accrued. If the claim is for breach of trust, there is no limitation period.

On March 1, 1999, the new *Limitations Act* came into force in Alberta. This Act changed the law in Alberta so now there is only one limitation period for all types of actions. Under the new *Act*, all actions must be commenced *within two years of when the claimant knew or ought to have known of its claim*. For the two-year period between March 1, 1999 and February 28, 2001, certain transition rules apply, so that claimants are in effect entitled to the shorter of two years from March 1, 1999 and the remainder of the period under the old Limitation of Actions Act. On March 1, 2001, the new *Act* is fully in effect.

The advantage of this new *Act* is that there is no longer a question of determining the type of claim in order to know what limitation period applies. There have been situations in which claims for breach of contract would be characterized as breaches of trust in order to permit the longer trust limitation period to apply- or more importantly, situations where persons who thought they had a claim in trust discovered that their action was statute-barred because it was determined to be a claim in contract. Another advantage is that the limitation period now runs from when the claimant *knew or ought to have known* of its claim. Previously, certain types of

actions, such as medical malpractice claims or breach of contract, could expire without the claimant even knowing that it had a claim.

However, there are disadvantages. A two-year limitation period is shorter than most oil and gas companies are used to dealing with; it is not uncommon to find that oil and gas companies are still negotiating over matters which are more than two years old. The industry will need to bear in mind this new, shorter limitation period when dealing with potential claims. This is not to say that industry disputes cannot still be resolved amicably; however, if a dispute has not been resolved by agreement before the two-year limitation deadline, the claimant will need to file a statement of claim in order to protect its rights.

"Ought to Have Known"

Another disadvantage is the uncertainty associated with knowing when the limitation period begins to run, because of the *Act*'s reference to the limitation period commencing when the claimant "knew or *ought to have known*" of its claim. Specifically when ought a person to have known of a claim?

The case law in this area is sparse. However, there may be cause to be conservative about this matter. In the case Norcen & Luscar v. Pembina, the Alberta Court of Appeal considered a case where a purported breach of an area of mutual interest was not identified until well after the six year contract limitation period. The plaintiffs, Norcen and Luscar, claimed that Pembina had not notified them of its acquisition of AMI lands, and that as a result Pembina held the lands in trust. The Alberta Court of Appeal rejected this claim, saying that Norcen and Luscar had a remedy in contract, and they should not look to the court to save them by pursuing a claim of breach of trust in such circumstances. However, Norcen and Luscar had not brought an action in contract within the relevant limitation period, so their claim was lost.

The Court noted that Norcen and Luscar *could have known* about Pembina's activities because they subscribed to Nickle's Daily Oil Bulletin, and the fact that Pembina was drilling a well in the AMI area was published in the drilling reports at the back of the Bulletin. The court made this comment notwithstanding that oil & gas law expert John Ballem QC had provided testimony at trial that studying the Daily Oil Bulletin drilling reports to determine partners' compliance with AMI obligations was beyond the standard of practice in the oil and gas industry generally.

The remarks of the Court of Appeal in the Norcen & Luscar v. Pembina case were not directed specifically to the new *Limitations Act*, and in fact were comments made in passing that did not bear directly on the case (lawyers call such comments "*obiter dicta*"). However, it raises the possibility that the Court could hold parties to a fairly high standard when determining when they "ought to have known" of a claim.

The Problem for the Oil and Gas Industry

In light of this potential interpretation of when a party ought to have known of its claim, the oil and gas industry will have a special problem with the new *Limitations Act*. It is traditional in the oil and gas industry to include an audit provision in industry agreements which allows an audit in

respect of a particular year to be conducted as late as 24 months after the particular year has finished. If an auditing party ought to have known of a claim at the time it arose, the audit may well be conducted after the limitation period has already expired!

This point may be easier to understand with an example. Let's say that an operator submits an invoice for a charge to the joint account on February 25, 2000 relating to an operation that occurred in January. The invoice is in error because it relates to a different joint venture on other lands, but the joint operator pays it (or the operator deducts it from revenue otherwise payable to the joint operator). The joint operator is unaware of the error on the face of the invoice, or if it suspects an error, simply ignores the issue pending an audit that it knows will be conducted later.

The joint venture agreement governing the joint operation contains the industry-standard provision that allows audits to be conducted for a period of twenty-four months after the end of a calendar year. In December, 2002 (24 months after the end of the calendar year 2000, and 34 months after the invoice), an audit is conducted. The audit covers the two year period from January 1, 2000 to December 31, 2001. The auditor notes that the February invoice appears to relate to activities on other lands, and tenders an audit query in January, 2003- "this invoice does not appear to relate to the joint lands- please explain/reverse." However, the operator refuses to refund the money, so the joint operator files a statement of claim. However, the joint operator's action to recover this amount fails because the limitation date for its claim passed on February 26, 2002, which is two years from when the joint operator received the erroneous invoice and arguably "ought" to have known of the existence of its claim.

The problem, then, is that industry standard auditing procedures and industry agreements establish a process for the conduct of audits which might result in claims becoming statute-barred before the audit occurs.

The Solution for the Oil and Gas Industry

One solution for this problem would be to conduct audits more frequently, such as on an annual basis. However, the two-year audit process is well entrenched in the industry, and this solution would require almost doubling the industry audit staff. The Petroleum Accountants Society of Canada ("PASC") instigated a survey that collected industry views on the limitations problems. This survey unanimously rejected more frequent audits as a solution to dealing with the limitations problem.

Another solution is offered by the *Limitations Act*. The *Act* allows the parties to an agreement to extend the limitation period for actions arising under the agreement. In fact, many oil and gas companies have been putting such provisions into their agreements since the new *Limitations Act* has come into effect. However, these new provisions, individually negotiated for each agreement, have varied widely in their effect: limitation periods under different agreements have been extended to three, four, five, six or ten years. And these new provisions have done nothing to deal with the problems under the thousands of agreements that were entered into before the new *Limitations Act* was passed.

The PASC survey led to the conclusion that there was unanimous support to find an industry-wide solution to the limitations problem. This has resulted in the formation of the Limitations Task Force, which is a group of individuals representing a number of key oil and gas companies, and certain industry associations such as PASC, CAPL, CAPLA and PJVA.

The Limitations Task Force has worked on developing a standard provision to be included in future industry agreements to address the limitations issue. The new limitation provision that resulted from the work of the Limitations Task Force, and which has been approved by PASC and is proposed as the industry standard for future agreements, is as follows:

If the agreement provides for audits to be performed during a specified period:

> "The two-year period for seeking a remedial order under section 3(1)(a) of the *Limitations Act*, S.A. 1996 c. L-15.1, as amended, for any claim (as defined in that *Act*) arising in connection with this agreement is extended to:
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> (a) for claims disclosed by an audit, two years after the time this agreement permitted that audit to be performed; or
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> (b) for all other claims, four years."

If the agreement does not contain such a provision:

> "The two-year period for seeking a remedial order under section 3(1)(a) of the *Limitations Act*, S.A. 1996 c. L-15.1, as amended, for any claim (as defined in that *Act*) arising in connection with this agreement is extended to four years."

Generally, the new language extends the limitation period from two years to four years. The first option, for industry agreements that contain an audit provision requiring audits to be completed by a specified time, also addresses the question of when a party is treated as having "ought to have known" of a claim by providing that the limitations "clock" begins to run at the end of the period by which an audit was allowed by the agreement to have been performed.

Industry Agreement regarding Limitations

If this provision becomes widely adopted in the industry, it will have the beneficial effect of creating a single limitation period that would be well known within industry.

However, the new standard clause on limitations that is adopted in new agreements will do nothing with respect to the practice for existing agreements. The Limitations Task Force has chosen to address this in a manner similar to the land profession's approach to revising novation practice in 1993: an "Industry Agreement regarding Limitations" has been developed that would have the new limitation language adopted in all oil and gas agreements where the parties to those agreements sign the Industry Agreement regarding Limitations.

The Industry Agreement regarding Limitations is basically an amending agreement that would have the effect of amending all agreements of a certain class. In order for a particular agreement

of that class to be amended, all of the parties to that agreement must sign a counterpart of the Industry Agreement regarding Limitations. If this occurs, the new limitations clause described above will be adopted for that agreement.

The agreements which would be amended by the Industry Agreement regarding Limitations are defined as follows:

"**Agreement**" means any agreement which:

(i) is effective before February 15, 2001; and

(ii) relates to exploration, development, production, gathering, processing, compression, construction, ownership, operation, transportation, marketing or storage of oil, natural gas, related hydrocarbons or substances produced in association with them; or grants subsurface or surface rights; or is an overriding royalty agreement; and

(iii) is governed by Alberta law, or applies to a claim which may be brought before the courts of the Province of Alberta.

This is a broad definition intended to capture a large class of oil & gas industry agreements. PASC's objective in undertaking this initiative is to attain wide approval within industry for the Industry Agreement regarding Limitations, and thereby amend many agreements. The Industry Agreement regarding Novations was signed by 2400 companies, and is estimated to have amended over 90,000 industry agreements.

PASC has circulated the Industry Agreement regarding Limitations to industry, and the process of obtaining execution of the document is now underway. If your company has not received the Industry Agreement, you will be able to find it at the PASC web site, "www.petroleumaccountants.com".

Frequently Asked Questions

In the course of developing the new limitations clause and the Industry Agreement regarding Limitations, the Limitations Task Force and PASC have responded to many questions. These have been collected in a "Frequently Asked Questions" memo, which is also available at the PASC web site, "www.petroleumaccountants.com". The FAQ memo will be updated as additional topical questions are identified.

Next Steps

The next step involves the oil and gas industry signing the Industry Agreement regarding Limitations by its deadline date of February 15, 2001. PASC encourages all oil & gas companies with operations in Alberta to do so. Companies should also ensure that *all of their relevant subsidiaries and affiliates* also sign the Industry Agreement.

As was the case with the Industry Agreement regarding Novations, it will not be enough for a particular company to sign the Industry Agreement regarding Limitations; it will only be effective to amend a particular agreement if all of the parties to that agreement also sign the Industry Agreement. For this reason, all industry members are being urged to both sign the agreement *and encourage their partners to do so as well*.

PASC also encourages members of the oil and gas industry to incorporate the appropriate form of the new limitations clause in all agreements they enter into in the future. If this can be achieved, then industry will have a widely-accepted and well-known practice with respect to limitations.

For up-to-date news about this initiative, including a list of companies that have signed the Industry Agreement, check the PASC website ("www.petroleumaccountants.com") regularly.

Should you have any further questions or comments about the new limitations clause or the Industry Agreement regarding Limitations, please contact the Petroleum Accountants Society of Canada:

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