

SOME SECOND THOUGHTS ON DAMAGES FOR BREACH OF A DRILLING COMMITMENT

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The Supreme Court appears to have reinstated the cost of drilling as an appropriate measure of damages for breach of a drilling commitment.

Ever since *Cotter v. General Petroleum Limited and Superior Oils, Limited*¹ was decided some twenty years ago, a defaulting party under a drilling obligation could console himself with the thought that the plaintiff would encounter difficulty in establishing any substantial amount of damages. Subsequent decisions of the lower courts which followed *Cotter* with varying degrees of enthusiasm, reinforced this view. Having regard to the magnitude of the values and expenditures at issue, the damages awarded by the courts were almost nominal. More important, the cost of drilling, which normally would lead to very handsome damages, had been entirely discredited as a proper measure. Now the Supreme Court in *Sunshine Exploration Ltd. v. Dolly Varden Mines Ltd. (NPL)*² has severely restricted the scope of *Cotter* and endorsed the cost of doing the work as a suitable guide in computing damages.

An absolute commitment to drill a well is usually encountered in two situations; the offset drilling obligation in an oil and gas lease and a covenant in a farmout agreement.

The typical lease will contain an offset drilling clause. While the wording may vary from lease to lease, the effect is the same, with the exception of some modern forms that include the right of surrender. The effect of this modification is discussed in the closing portion of this article.

The offset clause requires the lease to drill a well, once certain conditions have been fulfilled. These pre-requisites occur if a well located on other lands in the immediate vicinity of the lease lands is placed on production. The need for such a clause is occasioned by the migratory nature of oil and gas. To varying degrees, these substances are free to move from place to place within the reservoir. They are no respecters of property lines and may flow from

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¹ [1951] S.C.R. 154.

² (1970), 8 D.L.R. 3(d) 441.

their original location under A's land to a well located on B's land and be reduced into his possession. One of the surest ways of causing the substances to migrate is to put a well on production. This creates a pressure differential and draws in the substances to replace those being produced up the well bore. There is only one way to counteract this from the point of view of the mineral owner and that is to drill a well on his lands and commence production of the underlying petroleum substances. Such then is the *raison d'être* of the offset clause. The obligation imposed by the offset clause is mandatory, provided the basic requirements are present. These requirements are:

- (a) The well which creates the obligation must have encountered "commercial production". This is normally a defined term and means the output from a well as would warrant the drilling of a like well in the vicinity thereof, after a production test of thirty days. The thirty day production test ensures that the creating well must have encountered production which was sustained during at least a thirty day trial period.
- (b) The creating well must be located on adjoining lands, almost invariably a laterally adjoining space unit, on the assumption that no significant drainage will occur over greater distances.
- (c) The creating well must be on land not owned by the lessor. Presumably, a lessor will not suffer any actual financial loss if the producing well were situated on his lands, even if not included within the particular lease.

These basic ingredients are often expressed in a clause such as the following:

In the event of commercial production being obtained from any well drilled on any spacing unit laterally adjoining the said lands and not owned by the lessor, then unless a well has been or is being drilled on the spacing units of the said lands laterally adjoining the said spacing unit on which production is being so obtained and to the horizon in the formation from which production is being so obtained, the lessee shall, within six (6) months from the date of said well being placed on production, commence or cause to be commenced within the six (6) month period aforesaid operations for the drilling of an offset well on the spacing unit of the said lands laterally adjoining the said spacing unit on which production is being so obtained, and thereafter drill the same to the horizon in the formation from which production is being obtained from the said adjoining spacing unit; PROVIDED, that if such well drilled on lands laterally adjoining the said lands is productive primarily or only of natural gas, the lessee shall not be obligated either to drill an offset well unit unless and until an adequate and commercially profitable market for natural gas which might be produced from the offset well can be previously arranged and provided.

Like the oil and gas lease itself, the farmout agreement is a basic document under which rights are acquired in the oil indus-

try. The usual structure of such an agreement is that the farmor, the lessee under an existing lease, grants to the farmee the right to earn an interest in the property by drilling a well. Sometimes the farmee is granted an option in that it does not have to drill the well, but earns an interest if the well is drilled. In other types of farmout agreement the obligation to drill is absolute. Some agreements provide that the farmee is entitled to an assignment of its interest only after the drilling has been completed, while others, primarily for United States tax considerations, assign to the farmee an interest in the drilling unit prior to any operations being commenced under the farmout agreement. As we will see later, these differences can become critical in the light of the Supreme Court's judgment in the *Sunshine* case.

It does not require much imagination to visualize circumstances under which a mineral lessee would be reluctant to perform its drilling obligations. For example, the creating well, after a satisfactory thirty day production test, may deteriorate; it might suddenly start to produce excessive volumes of water, suffer from a high gas-oil ratio, lose pressure, or cease production altogether. Additionally, other drilling in the surrounding area may result in a discouraging series of dry holes. The lessee could well conclude that any further drilling would be merely spending good money after bad and refuse to drill the offset well. Such failure usually results in the termination of the lease, but this may be of cold comfort to the lessor who finds himself restored to the possession of mineral rights whose value has been seriously undermined by the recent developments. He wants something more than the cancellation of the lease, he wants damages for the breach of an undoubted obligation. From the lessor's point of view, the cost of drilling the well would normally be a most satisfactory measure for damages since such amount is usually substantial, and if his faith in the value of his mineral rights remained unshaken, he could drill the well with the damage proceeds.

If a farmee, for any reason, decides not to proceed with the drilling, it is clear, under the terms of the farmout agreement, that it earns no interest in the lands. Is the farmee, however, liable for damages in addition to forfeiting its interest in the lands?

The *Cotter* decision, as interpreted and applied by the lower courts, virtually eliminated the cost of drilling as a measure of damages.

The drilling obligation in the *Cotter* case arose from a curious document which was not a lease, but appeared to be both an option and a covenant to exercise the option contained within the same document. The documentary structure was founded on a lease of petroleum and natural gas for a term of twenty-one years, the lessee being required by the terms of the lease to commence

within six months the drilling of a well. This drilling commitment could be extended for an additional six month period by the payment of a further sum of \$1,000.00. The original lessee assigned his interest to the plaintiff who then entered into an agreement with the defendants. In essence, this agreement granted the defendants an option to acquire a sub-lease of the lands covered by the original lease, which option was to be exercised by the defendants, "erecting upon the sub-demised lands the necessary derrick complete with rig irons, boiler and engine, and installing all drilling machinery, and actually spudding in and commencing the work of drilling a well for the discovery of petroleum on the subdemised lands". If the defendants exercised the option they would be entitled to a sub-lease in a form which was attached to the option agreement. The option agreement also contained the following clause:

3. The Optionee's covenant to exercise the option within the said period, in the manner aforesaid, and in the event of their neglect or failure so to do, the Optionor shall, despite the lapse of the said option, be entitled to exercise any remedies which may be legally available to him for the breach by the Optionees of this covenant, which the parties hereto agree is given and entered into by the Optionees as the substantial consideration for the granting of the said option.

The end result of the agreements was similar to the conventional farmout arrangement under which the farmee obligates itself to drill a well in return for an interest in the land. Bear in mind that the defendants were not to receive the sub-lease until they had exercised the option by commencing to drill the well.

The defendants' ardor was cooled by two nearby dry holes. They declined to undertake the drilling. The plaintiff paid the \$1,000.00 required to extend the drilling commitment and sued for damages.

It was admitted at trial that the cost of drilling the well would have been \$53,500.00. Expert geological evidence was to the effect that, while prospects for the area were most unfavourable, the possibility of production could not be completely ruled out.

The trial judge, McLaurin J., as he then was, held that the document should be interpreted as obliging the defendants to commence drilling by the specified date and that they were in breach of their obligation.³ Having decided that there was liability, the court was then confronted with the question of damages.

There are a number of factors, some of them highly speculative and uncertain, that enter into any determination of damages flowing from the failure to drill a well. If the covenant to drill is a binding one, the mineral owner is entitled to have a well drilled. The result of having a well drilled, however, may either bring in highly remunerative production or may establish the

³ [1949] 1 W.W.R. 193.

mineral property as having no value whatsoever. Sometimes, due to geological and well control data in the general area, it is possible to estimate that the chances of success might be minimal or substantial. The costly process of drilling a well remains, however, the only method by which the existence or non-existence of petroleum substances beneath the land can be conclusively established.

The usual starting point for a judicial enquiry of this type is the well-worn quotation from *Wertheim v. Chicoutimi Pulp Co.*:⁴

And it is the general intention of the law that, in giving damages for breach of contract, the party complaining should, so far as it can be done by money, be placed in the same position as he would have been in if the contract had been performed.

This passage is not particularly helpful since it merely restates the problem. It does not tell us what the plaintiff is entitled to, beyond declaring that he should be placed in the same position as though the contract had been performed. If this test were to be applied in the strict sense to the drilling situation, it would seem to yield the result that the plaintiff should be awarded damages based on the cost of drilling. In this way he could proceed on his own to explore his property and thus be in precisely the same position as he would have been if the defendant had carried out its obligation. The existence of persuasive geological evidence discrediting the probability of obtaining production dampens the enthusiasm of the courts to apply the test literally.

In rendering his decision in the *Cotter* case, McLaurin J. reviewed the then existing Canadian authorities in some detail. In *Kranz v. McCutcheon*⁵ the action was brought under an agreement to drill five wells. The defendant drilled only two which proved to be failures. The geological evidence was that the general reputation of the oilfield had greatly declined because of the two unsuccessful wells, although no-one "could forecast with certainty what the result of boring three more wells would be". The trial judge ordered the question of damages to be referred to the Master with a direction that substantial damages are recoverable in respect of the breach and that such damages were to be assessed on that basis. This direction was varied on appeal by striking out the words "substantial damages" and substituting the words "the damages, if any, sustained".

The Ontario Court of Appeal rang in a new concept, that of loss of a sporting or gambling chance that valuable oil or gas would be found if the additional drilling was carried out. In *Carson v. Willitts*⁶ the defendant had agreed to drill three wells;

⁴ [1911] A.C. 301, 80 L.J. P.C. 91 (P.C.).

⁵ (1920), 18 O.W.N. 395 (C.A.), 19 O.W.N. 161.

⁶ (1930), 65 O.L.R. 456.

drilled the first, then refused to continue. The matter first came before the Master who awarded damages on the basis of what it would have cost to drill the remaining two wells. This approach was rejected by the Court of Appeal which, however, indicated that compensatory damages could be awarded but on the following basis:⁷

If the wells had been bored and no oil or gas of value had been found, the effect would be that the plaintiff has lost nothing by the refusal of the defendant to go on boring. On the other hand, if valuable oil or gas had been discovered, by the boring of these two wells, he had lost substantially. It may not be easy to compute what that chance was worth to the plaintiff, but the difficulty in estimating the quantum is no reason for refusing to award any damages.

In many ways the mining and oil industries follow similar operating procedures. Both require intensive exploratory work, exploratory drilling or sinking of shafts and development work to bring the properties to an economic productive level. In *Cunningham v. Insinger*⁸ the defendant had received an option to purchase a mine and in consideration of certain extensions undertook to carry out specified additional drilling and boring. The defendant failed to make the required instalment payments, he relinquished possession of the mine and surrendered his option, but he did not carry out the required exploratory work. The trial judge held that the defendant was responsible for the cost of completing the work he had agreed to do and this approach was challenged in the Supreme Court of Canada as being the wrong principle for the ascertainment of damages. It was argued that in accordance with the settled rule the plaintiff was entitled only to recover the actual value of the advantage he would have obtained by a performance of the contract, which would be the equivalent of any increase in the value of the mine to arise therefrom. Duff J. did not quarrel with this approach. He commented that cases no doubt may arise in which this test could be the only proper one and, difficult and intricate as the enquiry might be, it would be the duty of the court to enter upon an examination of the effect of doing the work upon the value of the property. He added, however, that cases must also arise in which the plaintiff's right is plainly to recover at least the cost of doing the work. If it were conclusively made out, for example, that the work to be done formed a necessary part of some plan of exploration or development required to develop the mine and that in the event of the option lapsing the owner would, in the ordinary course, have the work completed, then the damages should include the cost of doing the work. In the *Cunningham* case there was evidence that both parties were proceeding upon the footing that this work was necessary to develop the mine.

⁷ *Ibid.*, at p. 458, per Masten J.A.

⁸ [1924] S.C.R. 8.

Accordingly, the trial judge's award based on the cost of doing the actual work was upheld.

Nominal damages only were awarded in an Alberta case, *Medalta Potteries Ltd. v. City of Medicine Hat*⁹ where a manufacturing company had contracted with the city to do certain drilling on the company's property and to put the gas resulting therefrom into the city's pipeline system. In return the company was granted the right to take a volume from the city's system equal to seventy-five per cent of the production resulting from the wells. Before the expiration of the time within which the drilling was to have been done, the city notified the company that it would not perform its part of the contract, thus renouncing the contract and creating a breach. The court found the city to be in breach and turned its attention to the question of damages. Here it should be noted that the plaintiff was itself required to do something, that is drill one or more wells before any advantage could accrue to it through the contract. The court dealt with the issue of damages in one paragraph:¹⁰

Whether or not it has really sustained any damage depends entirely upon whether or not by July 1930 it could and would have sunk a well or wells on the land described in the agreement (for its rights were confined to a specified parcel of land) and have found gas there in sufficient quantities to have justified it in carrying it to the city's main and that is something that no-one knows. It may be that the company instead of being damaged has been saved a large expenditure in a fruitless attempt to find gas and bring it to the city's main within the contract period. The plaintiff is entitled to nominal damages for this breach but no more and I fix them at \$5.

The fact that the plaintiff had to incur expenditures on its own behalf as a condition to receiving a benefit under the renounced contract severely restricts the application of this decision. In the typical oil and gas situation the plaintiff lessor, or farmor, is not required to do anything other than receive the benefit of having the well drilled on his property.

After this examination of the existing Canadian authorities, McLaurin J. turned to an extensive review of the state of American law on the subject. He found, as is quite often the case, that some state courts appeared to favor the cost theory of damages while others rejected it. Returning to the facts of the case before him, the trial judge looked at the economics of drilling. He noted that in view of the testimony of the geologists it was impossible to be too optimistic about the acreage, but that the possibility of success could not be wholly discarded. The defendants when they entered into the drilling agreement were experienced oil operators and could measure the risks undertaken by their covenant to drill. By their failure to drill, the defendants had deprived the

⁹ [1931] 1 W.W.R. 217.

¹⁰ *Ibid.*, at p. 223.

plaintiff of his "gambling chance" or "uncertain hope", as expressed in *Carson v. Willitts*, and therefore compensatory damages should be awarded. The court was clearly influenced by the fact that the plaintiff had contributed a lease which had originally cost \$70,000.00 against the defendant's promise to drill a well estimated to cost \$53,500.00. This should lead to substantial, not nominal, damages and when it came to the principle on which such damages should be measured, the judge favored the reasoning in those American cases which fixed the cost of drilling as the criterion. He conceded that there might be circumstances in which the cost of drilling might not be an appropriate basis. McLaurin J. then posed a question which lies at the very heart of the issue:¹¹

... but in territory that is untested how can a party, such as the plaintiff here, secure adequate redress for a breach of the drilling covenant, except by being put in the position to pay some other to do that which the defendants covenanted to do.

... in the result it appears to me that the logical approach is to give the plaintiff what defendant covenanted to give, a drilled well. . . .

The Alberta Appellate Division¹² held that the written agreement did not impose a binding obligation to drill and the issue of damages did not arise.

On appeal to the Supreme Court of Canada, three judgments were written.¹³ Locke J. dissented on the same grounds as the Alberta Appellate Division and found there was no binding obligation to drill. In the majority opinion, which allowed the appeal, the peculiar structure of the documentation became all-important. Kerwin J. did not agree with the trial judge that there was an actual covenant to drill a well. The document could not be treated as amounting to a simple agreement for a lease. This result would occur only if and when the option had been exercised. In the view of Kerwin J. the controversial clause 3 made certain provisions for what would happen if the optionees neglected to exercise the option. Even though the covenant might not have constituted an absolute commitment to drill a well, the plaintiff was entitled to more than nominal damages. The Supreme Court of Canada entertained a very different view on the quantum of damages from that of the trial judge. The principle that the proper measure is not the cost of performance to the respondents, but the value of performance to the appellant, was reiterated. The plaintiff's case for substantial damages really faltered on the impossibility of proving them:¹⁴

It was the appellant's business to show the damages and he cannot be permitted to recover damages on guesswork or surmise.

¹¹ *Cotter v. General Petroleum Limited*, *supra*, footnote 3, at p. 207.

¹² [1949] 2 W.W.R. 146, [1949] 3 D.L.R. 634.

¹³ *Supra*, footnote 1.

¹⁴ *Ibid.*, at p. 160.

The remote chance of success in the event of drilling removed, in the view of Kerwin J., all justification for awarding damages on the basis of drilling costs.

The proper measure of damages was held to be the \$1,000.00 that the plaintiff had paid to maintain the lease in force for an additional six month period, the learned judge stating that "the amount of that payment is the sum necessary to place the appellant in the same position as he would have been in if the covenant had been performed". This conclusion is difficult to follow since if the covenant had been performed the plaintiff would have had an interest in an abandoned unproductive well, or a completed productive one. All that the \$1,000.00 payment did was to extend the period within which the well, required to validate the head lease, could be commenced.

In the light of the subsequent comments in the *Sunshine* case, the judgment written by Cartwright J., as he then was, is of key importance. Here again the unusual nature of the documentation was emphasized.¹⁵

The underlying principle is expressed by Lord Atkinson in *Wertheim v. Chicoutimi Pulp Co.*, [1911] A.C. 301, at p. 307: "And it is the general intention of the law that, in giving damages for breach of contract, the party complaining should, so far as it can be done by money, be placed in the same position as he would have been in if the contract had been performed. That is a ruling principle. It is a just principle." In the case at bar if the respondents had carried out the contract the appellant would not have had to pay the \$1,000.00 for a six months' extension which he did in fact pay to the head-lessor. The circumstances as to the necessity of making such payment were known to the parties and I agree with the learned trial judge that that sum is recoverable. What further benefits would have resulted to the appellant from the performance of the contract? If the respondents had drilled the well to the prescribed depth and it had proved a producer, the appellant would have received, (a) his share of the proceeds and, (b) the benefit of having the head lease validated, by the performance of the lessee's covenant to drill, not only as to the 80 acres described in the sub-lease but as to the whole 160 acres described in the head lease. If, on the other hand, as, from the evidence of the geologists, would seem much more probable, the well had proved a failure the appellant would not have received benefit (a) but would have received benefit. (b) It must be remembered however that as a result of the respondents' breach the appellant holds the whole 160 acres free from any claim of the respondents. No part of the consideration which under the contract would have passed to the respondents has passed, except that from April 21, 1948 until some time in June 1948, when they repudiated the agreement, the respondents had rights in the 80 acres and the appellant was not free to deal therewith. Under these circumstances, I do not think that the cost of drilling is the proper measure of damages. Suppose that instead of the consideration set out in the contract the appellant had agreed to pay the respondents \$53,500.00 to drill the well and the respondents had repudiated the contract before the date set for the commencement of

¹⁵ *Ibid.*, at p. 174.

the work and before any moneys had been paid to them. In such a case by analogy to the rule in the case of building contracts the measure of damages would seem to be the difference (if any) between the price of the work agreed upon and the cost to which the appellant was actually put in its completion. I think it will be found that those cases in which it has been held that the cost of drilling is the proper measure of damages are cases where the consideration to be given for the drilling had actually passed to the defendant. Examples of such cases are *Cunningham v. Insinger*, [1924] S.C.R. 8 and *Pell v. Shearman* (1885), 10 Ex. 766 (a contract to sink a shaft).

Cartwright J. agreed with Kerwin J. in finding that the plaintiff had not proved substantial damages:¹⁶

The appellant did not seek to put his case on the ground that by reason of the breach he stood to lose the head lease, but rather that he intended to make and was in process of making other arrangements to have a well drilled. In my view, the proper measure of his damages under the circumstances of the case, is the difference of the value to him of the consideration for which the respondents agreed to drill the well and the value to him of the consideration which, acting reasonably, he should find it necessary to give to have the well drilled by others. I am unable to find in the record evidence on which the damages can be assessed on this basis.

Because no consideration had actually passed, the sub-lease not having been issued since the option was not exercised, the case was analogous to building contracts where no consideration had passed and the plaintiff had failed to establish the necessary evidence to assess such type of damages.

Accordingly, Cartwright J. awarded only the sum of the \$1,000.00 extension payment as damages.

Some years after the *Cotter* decision, McLaurin J. was once again faced with the issue of damages for failure to fulfil a drilling commitment. In *Prudential Trust Company Limited and Wagner v. Wagner Oils Limited*¹⁷ there was a lease of the petroleum and natural gas rights. Unlike most leases, the documents in this case required the actual commencement of drilling within nine months. This commitment makes the situation quite similar to that under an offset clause where the obligation also becomes mandatory once all the ingredients are present. Before reaching the question of damages, the trial judge had to resolve the issue of liability under a provision which is also present in the offset drilling situations. The *Wagner* lease provided that if the lessee did not commence the drilling within the required time his right to drill would terminate and all his rights under the lease agreement would be forfeited. The same result is achieved in the offset situation where a continued default and the appropriate notice by the lessor, ultimately will terminate the lease. The court held that the termination of the lease by its own default could not rid the defendant

¹⁶ *Ibid.*, at p. 175.

¹⁷ (1954), 11 W.W.R. (N.S.) 371.

of the consequences of its obligation to drill.

As in *Cotter*, the geological evidence was discouraging. On the question of damages, McLaurin J. expressed himself as follows:¹⁸

If it were not for the *Cotter* decision, I would be disposed to fix the damages at some substantial amount, probably the cost of drilling a well. I still see nothing unfair in visiting a defaulting party with damages in this amount. The whole foundation of legitimate promotional efforts in the exploitation of oil are based on the assumption that the parties will not renege on such deals. However, the *Cotter* case has established that such damages must not be awarded, but it does hold that nominal damages are recoverable even though no nominal damages were fixed in that case.

As to damages, I assume that I would be loyally following the Supreme Court of Canada by fixing some relatively inconsequential amount. I accordingly fix damages at \$500.00.

Both the *Cotter* and *Wagner* decisions were applied in *Albrecht v. Imperial Oil Limited*¹⁹ which involved the breach of an offset drilling clause in a petroleum and natural gas lease. The creating well produced satisfactorily during the thirty day period but, shortly thereafter, water began to intrude into the formation and led to the abandonment of the well within seven months after it had been placed on production. The plaintiff claimed damages for drainage of petroleum substances during the production period of the creating well. In the light of the evidence given by geological experts the trial judge found that royalty payments which the plaintiff might have received from any production that was drained from his land would not exceed the trifling sum of \$11.50. The main contention, however, arose over the claim for damages for breach of contract. Evidence at the trial indicated that the cost of drilling a well would amount to \$40,000.00 with an additional \$4,000.00 for production equipment. The court accepted geological evidence to the effect that a well on the plaintiff's land would be non-productive.

Riley J. rejected out of hand the cost of drilling the well as a basis for determining the damages, without elaboration, but citing the *Cotter* and *Wagner* decisions.

American authorities to the effect that the measure of damages for failure to drill an offset well is the amount of royalty the lessor would have received had the well been drilled, were quoted with approval. The geological evidence had, in the view of the court, affirmatively disproved that the plaintiff would have received any royalty whatsoever had the well been drilled on his land.

The plaintiff was not totally deprived of damages, however. The court correctly held that the *Cotter* case did not necessarily restrict the plaintiff to nominal damages. Once again the difficulty

¹⁸ *Ibid.*, at p. 374.

¹⁹ (1957), 21 W.W.R. (N.S.) 560.

lay in establishing damages as a matter of evidence. The plaintiff had led evidence to the effect that, prior to the creating well going to water there had been offers of substantial cash considerations plus commitments to immediately drill, that the plaintiff had gone to the defendants and offered to purchase the lease back for the sum of \$10,000.00, that they had been offered \$3,000.00 for each one point of royalty which they did not accept, and that, had the defendants spudded in the well on the plaintiff's land, each one point of the plaintiff's royalty would have increased in value to \$6,000.00. The court felt that at the material time the plaintiff possessed a valuable asset. Riley J. pointed out that the plaintiff had apparently refused the offer of \$3,000.00 a point and that there was some doubt as to whether concrete offers in the amount of \$6,000.000 per point would have been made if the well had been spudded, or accepted by the plaintiff, if made. Indeed, the spudding in of the offset well would seem to affect only the possible increase in value of the points from \$3,000.00 to \$6,000.00. Nonetheless, the plaintiff was deprived of an opportunity to sell the whole or a portion of the points at an attractive price. Without attempting any detailed mathematical analysis, the court awarded damages in the sum of \$6,000.00 for a loss of the opportunity to sell, plus \$11.50 for the drainage claim.

In the past, I have been somewhat critical of this aspect of the decision in that the plaintiff's decision not to sell his points was a business decision which he made on his own initiative, and one over which the defendants had no control.²⁰ In a sense, however, the court may have been reverting to the concept of "loss of the chance that valuable oil or gas might have been discovered", as utilized in *Carson v. Willitts*, although the geological evidence as accepted by the court disproved such chance. In any event, the *Carson v. Willitts* decision was not cited but both may represent the disposition of a court when confronted with both an undoubted breach and evidence that would make it improvident to drill the well, to award something, but of a lesser amount than the actual cost of drilling the well.

While the lower courts "loyally" applied the *Cotter* decision, its scope was severely cut back when it was relied upon before the Supreme Court of Canada. The defendant in *Sunshine Exploration Ltd. v. Dolly Varden Mines Ltd. (NPL)*²¹ cited it in support of the view that only nominal damages should be awarded for failure to carry out exploratory work. The plaintiff company, Dolly Varden, was the owner of mining properties in British Columbia and it entered into an agreement with the defendant under which the defendant was to explore and develop those

²⁰ Ballem, *Damages for Breach of Drilling Commitment* (1957), 35 Can. Bar Rev. 971.

²¹ *Supra*, footnote 2.

properties. The agreement originally contemplated four stages with certain work to be carried out in each stage. The first stage was purely exploratory and Sunshine was given the right to elect whether or not it would proceed from the first to the second stage. The agreement also provided that the plaintiff would assign and convey to the defendant one half of its interest in the mining property, such one half interest to be reconveyed if Sunshine elected not to proceed beyond the first stage. The work to be carried out in the first stage was described in considerable detail. Sunshine did perform certain exploratory work and expended \$348,000.00. However, this work was not done to the satisfaction of the plaintiff which complained that it was not being provided with proper reports on the work done and that Sunshine had changed materially the emphasis of the drilling programme.

In due course the defendant notified the plaintiff that it proposed to enter the second development period. Then the plaintiff gave notice of default to Sunshine listing a large number of points in respect of which defaults were alleged. This resulted in various meetings and ultimately in an amending agreement under which the defendant cancelled its notice of intention to enter the second period of development, the plaintiff withdrew its notice of default, the first development period was extended and Sunshine covenanted to carry out designated work. The work to be carried out by Sunshine called for the unwatering of the Torbit mine (one of the mining properties), a programme of diamond drilling, the testing of the downward plunge of the Torbit ore bodies, further testing by diamond drilling of the width of mineralization in the east end of the Torbit mine and completion of approximately 5,000 feet of diamond drilling on other properties. It is significant that the work contemplated was mainly of an exploratory nature, to determine whether ore bodies were present in commercial quantities.

In the result the work was not carried out and Sunshine shut down the operations. It was admitted that the agreement had terminated and that Sunshine was in breach of its obligations to carry out the work. The sole issue was that of damages.

Not surprisingly, the defendant found great comfort in the *Cotter* case and contended that only nominal damages should be awarded. Martland J. who delivered the unanimous judgment of the court examined the *Cotter* ratio, first noting that Kerwin J., as he then was, held that there was no covenant by the companies to drill a well, while in the Sunshine situation there was a specific agreement to perform the work and a breach of that undertaking. The judgment delivered by Cartwright J. in *Cotter* was then reviewed. Cartwright J., it will be recalled, held that there was in fact a covenant to drill a well. Martland J. quoted the passage

from the judgment written by Cartwright J. which is set out above and noted that the consideration had not passed to the defendants since they had not exercised the option nor had they been granted the sub-lease. This was the reason in Martland J.'s view for distinguishing the *Cotter* case as the defendant Sunshine had received its consideration in the form of the transfer of a one half interest in the mining properties, the withdrawal of the notice of default, waiver of performance of the originally required work, and an extension of the term of the first development period.

This distinction of the *Cotter* case renders it virtually inapplicable to the normal offset drilling requirement in the oil and gas lease. It cannot be argued that a defendant lessee has not received consideration under the lease, since upon its execution, it leases and grants substantial rights with respect to the mineral and the lessee receives the benefit of those rights; to enter upon the lands, to drill, to explore and to produce any substances, immediately. The consideration has passed in full and, moreover, the obligation under the offset clause is absolute once the conditions have been met.

The Supreme Court held that the proper measure of damages was in fact the cost of performing the work that the defendant had obligated itself to do. The work which was described in the agreement would have been of advantage to the properties and it committed itself to perform that work, obviously because it considered the results would be of value. The plaintiff had given up a half interest in the property because, if the results of the work were favourable, it would obtain further development of the property and in any event would be the recipient of useful information concerning its property. Both parties considered that the work would be worth the expense of doing it and Martland J. pointed out that the work would be of advantage to both parties. He rejected the test that seems to have been used in the oil and gas cases, namely, that a comparison be made between the value of the mining property with and without the work being done, because the result of the work would be unknown. To a somewhat lesser extent this observation would be also true with respect to the drilling of an offset well, although geological evidence may be more persuasive in convincing a court that an offset well would likely be of little value to either party.

If we no longer have *Cotter* in determining the quantum of damages for breach of a drilling obligation and, it is submitted that the Sunshine analysis effectively removes the *Cotter* case from this area, what guides do we have? At the provincial court level there are trial decisions in the *Wagner* and *Albrecht* cases, but these decisions simply applied *Cotter* and fall with it. In so far as decisions of the Supreme Court of Canada are concerned,

the two mining cases, *Cunningham v. Insinger* and *Sunshine v. Dolly Varden*, seem to afford the closest analogy to oil and gas drilling. Both decisions used the cost of performing the work as the proper measure of damages. The ground for so doing, simply put, was that at the time of entering into the obligation both parties were of the view that the work was necessary in exploring, developing and improving the property. This criterion can be applied in the usual oil and gas circumstances. When the parties entered into the lease containing an offset obligation it would be in the contemplation of both of them that the drilling of an offset well would be beneficial to the property, not only to protect it against drainage, but to explore it when the success of nearby drilling made it seem desirable. Even if the offset well turned out to be non-productive, it would nonetheless yield useful, if negative, information concerning the lessor's property. If, however, the disappointing performance of the creating well and other nearby drilling virtually established that the offset well would be foredoomed to failure, it might well be argued that at the time the obligation was created, namely, six months after the adjoining well being placed on production, the parties could not have felt that the drilling of the offset well would be of substantial value to the property. Against this there is always the argument that it is impossible to completely eliminate the prospect of a property being productive without the actual drilling of a well. A court would not be disposed, however, to award the very substantial damages that would be achieved by utilizing the cost of drilling where the geological evidence was overwhelming against any prospect of success. Under these conditions the court might be tempted to adopt the principle of awarding the lessor something for the loss of a gambling or sporting chance. If, however, the geological evidence falls short of being overwhelming, that is if there was no other drilling control or information in the immediate area and it was only the performance of the creating well that led the lessee to breach his obligation, then a court might very well apply the cost of drilling as the proper principle.

The situation under a farmout arrangement bears a striking resemblance to the facts of the two mining cases. The type of farmout agreement will be all-important. If it is cast as nothing more than an option, there will be no liability and no damages. If, however, the obligation to drill is absolute then a further distinction must be made. This agreement, which provides that the interest will not be assigned until the drilling has been completed, may still fall within the limited scope left to the *Cotter* decision. Since the consideration will not have passed to the farmee, it may be that Cartwright J.'s judgment, as refined by Martland J., could well apply. If the farmee receives an assignment of the spacing

unit immediately upon execution of the agreement, the arrangement would appear to exclude the application of the *Cotter* decision.

Unlike an offset well, the drilling to be done under a farmout will very often involve wildcat or semi-wildcat acreage since the main benefit that the farmor receives is exploration of unproved acreage. Consequently, there will be little chance of discouraging geological evidence to inhibit a court from applying the cost of performance of the work as the true measure of damage. There can be no doubt that the drilling will also meet the test of improving the property as laid down in the *Sunshine* case.

This type of farmout agreement, which is very widespread in western Canada, seems to invite the application of the cost of drilling concept for the determination of damages. If this result is not intended, the draftsman should include specific language to negative it.

While the offset clause discussed here is still commonly encountered, many current lease forms contain a provision which effectively avoids liability. It confers an option upon the lessee when an offset arises. It may drill the well, or surrender the land.

Mere termination or surrender of the lease will not relieve the lessee of liability for default. Under this type of clause, however, no default occurs, since the lessee, by surrendering the land back to the lessor, has done all it is required to do.

Conclusions

1. The *Cotter ratio* has now been distinguished almost out of existence. Its only remaining application to oil and gas situations may be a particular type of farmout agreement where the lands are not earned until the drilling is complete.

2. The actual cost of drilling or performing the exploratory work was used as the measure of damages in the two Supreme Court of Canada cases most closely analogous to the breach of a drilling commitment.

3. The type of farmout agreement which involves an immediate transfer of the land will most likely lead to the application of the cost of drilling concept for damages.

4. Courts will be reluctant to impose the cost of drilling concept in the face of geological evidence which downgrades the prospects of the well. They may be disposed to award substantial, but lesser, damages on the basis of a loss of a "sporting or gambling chance" or business opportunity in line with the *Carson v. Willitts* and the *Albrecht* approaches.

5. The fact that the interest of the lessee or the farmee in the documents and the properties is terminated by breach does not affect liability.

6. If the lease confers an option on the lessee to drill or surrender, there can be no liability. This feature makes such a clause very desirable from the point of view of the lessee, and equally undesirable to the lessor. There appears to be some merit to this approach, since a provident lessee would not surrender its interest unless the geological evidence effectively downgraded the prospects of success.
