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on record

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What Is Meant by “Producible”?

A Look at *Bearspaw Petroleum Ltd. v. Encana Corporation*

by Justin Jensen, Student-at-Law

Introduction

For the first time in a reported decision, a Canadian appellate court has defined the term “producible” as it has been used in the context of the habendum of a freehold petroleum and natural gas lease. By defining the term “producible”, the Alberta Court of Appeal (the “ABCA”) in *Bearspaw Petroleum Ltd. v. Encana Corporation*¹ (“*Bearspaw*”) provides a degree of clarity for the interpretation of freehold petroleum and natural gas leases. This decision might also have an impact on how the courts interpret other similar phrases, such as “capable of producing” which is at issue in the as yet to be heard appeal of the Energy Resources Conservation Board (the “ERCB”) decision in *Omers Energy Inc.*²

Facts and Timeline

Bearspaw Petroleum Ltd. (“Bearspaw”), as lessee, and Encana Corporation (“Encana”), as lessor, were the successors to a freehold petroleum and natural lease dated Nov. 7, 1960, originally entered into between the Canadian Pacific Railway Company and the British American Oil Company. The habendum stated that the lease was granted for a term of 10 years and for “so long thereafter as the leased substances or any of them are *producible* from the leased area.”³ Additionally, the lease stated that if reserves were found in commercial quantities, the lessee was required to “...continue with due diligence to drill for and develop the property so as to produce the leased substances in paying quantities upon the entire tract, having regard at all times to existing geological and marketing conditions...”⁴

The basic history of this case is as follows:

November 7, 1960 – Petroleum and Natural Gas lease was granted between the original parties.

January 1962 – First well drilled in the leased area which produced for a short period of time.

August 1962 – Second well drilled in the leased area which produced oil between 1973 and 1995 and from 2003 until it was abandoned in December, 2005.

October 1999 – Third well drilled on pooled lands. Commercial quantities of natural gas were discovered in the Belly River formation. The well was never tied-in and did not produce.

December 2000 – Fourth well drilled in leased area. Natural gas was discovered, but, as with the third well, this well was not tied-in to a pipeline and never produced.

March 2005 – Encana served Bearspaw a termination notice based on its view that the lease had terminated according to its terms. Encana argued that the lease had terminated because the leased substances on the applicable lands were not producible. Bearspaw brought action seeking a declaration that its lease interest continued to be valid. Encana counterclaimed for a declaration that the lease had expired and for an order discharging Bearspaw’s caveat.

The ABCA's definition of "producible" in *Bears paw* could play an important role in how other similar and more frequently used phrases are interpreted, such as the phrase "capable of producing".

Issues on Appeal

The Alberta Court of Appeal considered two issues:

1. Does the lease term continue because the wells are "producible" even though production has not commenced on account of the wells not yet being tied into a pipeline?
2. If the lease term does continue, has the lease nonetheless terminated for breach of an implied covenant to market the natural gas which the wells would produce?

What does it mean for substances to be "producible"?

The ABCA's decision on the first issue turned on the meaning of the word "producible". Encana argued at trial and on appeal, that producible means "...to be capable, without more, of immediately being put into production in commercial quantities."⁵ That is, that because the wells were not connected to a pipeline, and were not, therefore, capable of immediate production in commercial quantities, the lease had terminated. Bears paw argued a more lenient interpretation of "producible". Bears paw argued that producible means "...to be capable of being put into production in commercial quantities upon certain other steps being taken ...".⁶ In order to determine the meaning of the word "producible", the ABCA noted that "[t]his term "producible" does not appear to have been used in other oil and gas leases that have been the subject of reported Canadian litigation."⁷

At trial⁸, Justice McMahon held that "producible" should be given its plain and literal meaning. Quoting the Webster's dictionary, he held that "producible" means "capable of being produced or brought forth or forward."⁹ Justice McMahon held that "producible" contemplates a future occurrence not a present occurrence.¹⁰ In response to Justice McMahon's statement, and after distinguishing American jurisprudence, the ABCA decided that:

"... the plain and ordinary meaning of the word "producible" and past relevant applications of the term each support the trial judge's conclusion that the lease continued because "**producible**" means **something less than capable of immediate production, with no more to be done than turning on a valve.**"¹¹ (Emphasis Added)

The ABCA upheld the trial court decision that the lease had not terminated either at the end of its initial 10 year term or subsequently, notwithstanding that the natural gas found on the property was not in production and not capable of immediate production on account of the wells not being tied-in to a pipeline. The ABCA did not find reason within the provisions of the lease, or the commercial intentions of parties, to require immediate production. The lease had not been terminated because the leased substances were "producible" once Bears paw took steps to build a pipeline and tie in the wells.

Was there an implied covenant to market the natural gas?

The ABCA held that it was not necessary to imply a covenant to market the leased natural gas because Clause 4 of the lease, "... expressly provides a timeline for [production and marketing] which is not immediate and has

regard for the manner best suited to the recovery of the greatest quantity of leased substances at the least cost."¹² The lease contained a "reasonable diligence" standard that was intended to reflect existing market conditions and the "orderly development of the lease."¹³ According to the ABCA, Bears paw's intention to build a pipeline and tie-in the wells when it was economical to do so, met the reasonable diligence standard. Since there was no evidence that the natural gas pool was being drained by any other wells, it was reasonable for Bears paw to wait for more favourable economic conditions before continuing the project.

Conclusion

Though the wording in the *Bears paw* lease is not common in freehold petroleum and natural gas leases, industry participants should be aware of the interpretation made by the ABCA. If the habendum or shut-in provision of a lease contains the term "producible", parties need to know that this means something less than "capable of immediate production". "Producible" signifies that a lease can be continued despite the fact that there are major steps, including the construction of a pipeline and tying-in a well, that may need to be taken before production can occur. This is potentially problematic for lessors who wish to expeditiously produce and market leased substances and should be avoided in leases where this is the goal. The use of the term "producible" has the potential to enable a lessee to continue its rights in a lease while indefinitely postponing production from the applicable well(s) until a future, more economically beneficial time.

The ABCA's definition of "producible" in *Bears paw* could play an important role in how other similar and more frequently used phrases are interpreted, such as the phrase "capable of producing". If "producible" allows a future ability to produce, does "capable of producing" require a present ability to produce? For further discussion on this issue please see the next article in this publication—that of *What is Meant by "Capable of Producing" Leased Substances—the Pending Omers Appeal*.

Footnotes

¹ *Bears paw Petroleum Ltd. v. Encana Corporation*, 2011 ABCA 7

² ERCB decision 2009-037

³ *Supra* Note 1 at para. 12

⁴ *Supra* Note 1 at para. 20

⁵ *Supra* Note 1 at para. 2

⁶ *Ibid*

⁷ *Supra* Note 1 at para. 14

⁸ *Bears paw Petroleum Ltd. v. Encana Corporation*, 2010 ABQB 225

⁹ *Supra* Note 1 at para. 13

¹⁰ *Ibid*

¹¹ *Supra* Note 1 at para. 17

¹² *Supra* Note 1 at para. 38

¹³ *Ibid*

What is Meant by “Capable of Producing” Leased Substances?

The Pending *Omers* Appeal

By Alicia Quesnel and John Lowe



The Question

Under a freehold oil and gas lease, if, as the Court of Appeal held in *Bearspaw Petroleum Ltd. v. Encana Corporation*¹, (“Bearspaw”) “producible” speaks to a future ability to produce, does “capable of producing” require a present ability to produce? Must that production be “immediate”?

This is a question that the Alberta Court of Appeal will be addressing in *Omers Energy Inc. v. Alberta (Energy Resources Conservation Board)*². In this case, the Alberta Court of Appeal will consider whether the Energy Resources Conservation Board (“ERCB”) erred in its interpretation of the phrase “capable of producing the leased substances”. The hearing has been scheduled for May of 2011 and industry is anxiously awaiting this decision.

The ERCB Decisions in *Omers* and *Desoto*

A review of some background to this appeal will demonstrate how significant this determination could be.

In two recent decisions, *Omers Energy Inc. Section 39 Review of Well Licenses No. 0336235 and No. 0392996 Warwick Field*³ (“*Omers*”) and *Desoto Resources Limited Section 40 Review of Well Licence No. 0365128 Joffre Field*⁴ (“*Desoto*”), the ERCB has made some very significant and far-reaching pronouncements on the meaning of “capable of producing” in the context of the suspended well and habendum provisions of freehold oil and gas leases.

According to these ERCB decisions a well is not “capable of producing” leased substances if:

- (a) the well is not able to flow the leased substances when it is turned “on” because additional equipment or repair is required;
- (b) the well is not tied-into a pipeline; or
- (c) the well is unable to produce a “meaningful volume of production.”

The ERCB's suggestion that a well is capable of producing only if it is able to produce a "meaningful quantity" of petroleum substances immediately upon completion goes beyond the generally accepted understanding of industry and is not supported by Canadian case law.

In other words, the ERCB has determined that to be "capable of producing" there must be a demonstrated, present ability of a well to produce leased substances in a meaningful quantity. If a well cannot simply be "turned on" without further work required for the well to attain or maintain the ability to produce leased substances in a meaningful quantity, it is not a well "capable of producing" leased substances.

In *Omers* the ERCB suspended certain well licenses held by Omers Energy Inc. ("Omers") on the basis that Omers had no right to produce leased substances from its wells. Its lease had terminated in accordance with its terms on May 10, 2006 as there was no well on the lands "capable of producing" the leased substances for the purposes of continuation under the suspended well provisions of the applicable leases. The ERCB did not cite any case law or other authority for its determination in *Omers*; however, the decision came shortly after the decision of the ERCB in *Desoto*.

In *Desoto*, the ERCB suspended certain well licenses held by Desoto Resources Ltd. ("Desoto") on the basis that Desoto had no right to produce leased substances from its wells. Its lease had terminated in accordance with its terms as there was no well on the lands "capable of production" in paying quantities for the purposes of continuation under the habendum provisions of the applicable leases. Citing U.S. case authority, the ERCB determined that the lease held by Desoto had terminated for want of production. Although U.S. case law authority can be persuasive in the Canadian context, reliance is cautioned. Both of the U.S. decisions cited by the ERCB in support of its decision were premised on the fact that there existed at law in those U.S. jurisdictions an implied duty on the part of the lessor to develop the lease and produce and market the leased substances. As such, in those U.S. jurisdictions, a failure to develop the lease and produce and market the leased substances can result in damages for breach and/or termination. However in Canada, the courts have expressly held that there is no

implied duty on the part of a lessee to develop the lease and produce and market the leased substances. And more significantly, one of the U.S. cases cited by the ERCB as standing for the proposition that a well that is not tied into a pipeline is not a well "capable of producing" does not, in our view, stand for that proposition.

The ERCB Pro-Development Mandate and the Common Law

Normally, freehold lease continuation and termination issues are questions for the courts to decide. However, the role of the ERCB is to ensure economic and efficient development of Alberta's resources and sometimes this role requires the ERCB to go further. There are times when it conducts a full inquiry into ownership, for example, because there is a primary title issue restricting production or a title dispute which must be efficiently resolved to allow a significant amount of extraction to occur.

In making a legal determination of "entitlement", the ERCB must give due consideration to principles of common law applicable to the resolution of the question in the same manner as a court, and "legally" must "get it right." That said, the ERCB is a statutory body whose decisions are necessarily informed by its public interest mandate, which favours development over sterilization. When the ERCB "rolls up its sleeves" and takes a hard look at legal ownership of the mineral, the Board tends to favour outcomes which will maximize resource recovery.

In our view, both *Desoto* and *Omers* highlight the fact that the pro-development mandate of the ERCB, as applied to an oil and gas lease, may not be entirely consistent with the application of the common law. Although the specific phrase "capable of producing" has not been definitively determined by Canadian courts, there is support in the case law for the proposition that drill stem tests that establish the underlying reservoir's potential, even before the well is tied-in or even completed, may be sufficient to establish that a well is "capable of producing." The ERCB's

suggestion that a well is capable of producing only if it is able to produce a "meaningful quantity" of petroleum substances immediately upon completion goes beyond the generally accepted understanding of industry and is not supported by Canadian case law. Indeed, a number of Canadian cases have made findings of fact that suggest a contrary view.

Concern Over Potential Pending Precedent

We are concerned that the way in which the Alberta Court of Appeal framed its decision in *Bears paw* could impact its resolution of the question posed in the *Omers* appeal. As we note in the *What is Meant by "Producible"* article in this issue, the Alberta Court of Appeal in *Bears paw* addressed the meaning of the term "producible" in a manner that speaks to a future ability to produce in purported contrast to the phrase "capable of producing". This could lead the Court of Appeal to concur, in whole or part, with the ERCB that "capable of producing" requires a demonstrated present and immediate ability to produce leased substances. In our view, this would be an unfortunate result.

Given the very significant implications of these issues to the industry, what is required here is a thorough examination of the relevant Canadian case law. We hope that occurs. If the Court of Appeal concurs with the ERCB that a well is not "capable of producing" if: (i) the well is not able to flow the leased substances when it is turned "on" because additional equipment or repair is required; (ii) the well is not tied-into a pipeline; or (iii) the well is unable to produce a "meaningful volume of production," the continuation and validity of a significant number of freehold leases in Alberta will become open to challenge.

Footnotes

¹2011 ABCA 7

²leave to appeal granted in 209 ABCA 273

³ERCB Decision 2008-037

⁴ERCB Decision 2008-047

Last Chance: Drilling Royalty Credits

By Mike Gilchrist

The last opportunity to utilize drilling royalty credits is fast approaching. The cut-off point for the credits to be allocated and then applied to Crown royalties is the end of the month in which royalty obligations are determined for the March 2011 production month.

The Program

Just under two years ago, the Province of Alberta created a program of royalty credits in order to stimulate drilling activity. The credit is worth up to \$200 per metre for eligible wells drilled where the Crown holds the entire mineral interest. What is an “eligible well”? The Regulation¹ states that an “eligible well” is one that:

- a. is spudded on or after April 1, 2009 but before April 1, 2011,
- b. has a finished drilling date on or after April 1, 2009 but before April 1, 2011,
- c. is drilled for the purpose of recovering crude oil or gas according to the records of the Board,
- d. has a Crown interest greater than 0%, and
- e. is subject to royalty under the *Petroleum Royalty Regulation, 2009*, the *Natural Gas Royalty Regulation, 2009* or section 27 of the *Oil Sands Royalty Regulation*.

In addition to the preceding, a well does not qualify as an “eligible well” if the well:

- a. is part of a Project under the *Oil Sands Royalty Regulation, 2009*,
- b. was not drilled for the recovery of oil or gas,
- c. is a re-entry well where the original well does not meet the above stated requirements, or
- d. contains a well event in respect of which the Minister has prescribed a quantity of conservation gas.

The Deadline

Credits established between April 1, 2009 and April 1, 2010 can only be applied against royalty obligations for the production months of April 2009 through March 2011. Those credits established after April 1, 2010 but before April 1, 2011 may only be applied against royalty obligations for the production months of April 2010 through March 2011. Any remaining credits not allocated and applied against royalties arising from these months will be forfeited.

If a royalty payer is unable to utilize the extent of the credit which it has earned, it remains possible to allocate the credits to another royalty payer in exchange for consideration such as a negotiated price per dollar of credit or even a working interest. This assignee can then apply the credits towards its royalty obligations arising up to the March 2011 production month.

Footnotes

¹ Drilling Royalty Credit Regulation, Alta. Reg. 245/2009



Bill 26 – Clarifying Ownership of Coalbed Methane on Split Title Freehold Lands in Alberta

by Jonathan Selnes, Student-at-Law

Background

On December 2, 2010 the *Mines and Minerals (Coalbed Methane) Amendment Act, 2010*¹ (“Bill 26”) was passed into law in Alberta. Bill 26 clarifies the uncertainty over who owns the rights to coalbed methane (“CBM”) on split title freehold lands in Alberta. It does so by declaring CBM “to be and at all times to have been natural gas”, thereby assigning the ownership of CBM to natural gas rights holders. By clarifying coalbed methane ownership, Energy Minister Ron Liepert believes this “will clear the way for coalbed methane development and continue the efficient and responsible development of Alberta’s abundant mineral resources.”² By assigning natural gas rights holders ownership of CBM on split title freehold land, Bill 26 addresses three major areas of uncertainty:

1. ownership of CBM
2. preservation of previous arrangements entered into by the natural gas rights holders or their lessee and the coal rights holders or their lessee covering ownership of CBM. Any existing agreements entered into prior to the passage of Bill 26 will not be affected; and
3. protection of coal rights holders or their lessee, surface rights holders and the government from being sued by the natural gas rights holder or their lessee for past extraction, production or removal of CBM prior to the passage of Bill 26.

What is CBM and why is its ownership an issue?

CBM is natural gas, composed primarily of methane, that is producible from coal seams.

CBM ownership is an issue because of the large remaining reserves of CBM in Alberta, which were estimated in 2005 to be 20.9 billion cubic metres. The Energy & Utilities Board (“EUB”) estimated that production of CBM will increase from 2.9 billion cubic meters in 2005 to 19.6 billion cubic meters in 2015, an increase from less than 2% in 2005 to about 16% in 2015 of total Alberta marketable gas production.³

Who owns the land where CBM is located in Alberta?

The Province of Alberta owns approximately 81%, private companies and individuals own approximately 10% and the Federal Government (National Park, Indian Reserves) owns approximately 9% of the province’s mineral rights by land area.⁴

Ownership of CBM

The ownership of CBM has been a key area of uncertainty that has hampered development of this resource in Alberta.

Subsection 10.1(1) of Bill 26 declares CBM “to be and at all times to have been natural gas”. This is consistent with s. 61(1) of the *Mines and Minerals Act*⁵, which assigned natural gas rights holders or their lessee the rights to CBM on Crown land in Alberta.

Furthermore, Bill 26 follows the lead of other jurisdictions such as the United States of America⁶ and British Columbia⁷, where CBM is owned by natural gas rights holders.

Upholding previous arrangements covering CBM

Bill 26 is retroactive in effect and declares CBM “to be and at all times to have been natural gas”. Notwithstanding this, certain agreements between the holders of natural gas rights and the holders of coal rights are grandfathered. Subsection 10.1(2) states that:

(2) Subsection (1) does not affect any conveyance, agreement, agreement for sale, lease, joint venture, or any other contract that specifically grants, leases, excludes, excepts or reserves rights in land in respect of coalbed methane and that was entered into before the coming into force of this section by

- (a) the owner of the title to the natural gas in the land, or any person holding natural gas rights through that owner, and
- (b) the owner of title to coal in the land, or any person holding coal rights through that owner.

While the intention of Section 10.1(2) is clear, the clause itself is confusing and further amendments may be required to achieve the intended effect. The clause could be construed in two ways:

- (a) conjunctively, so that the agreement in question must be between a person holding natural gas rights and a person holding coal rights (whether as owner or lessee); or
- (b) disjunctively, so that:
 - (i) any agreement pertaining to CBM that is entered into by a holder of natural gas rights is grandfathered; or
 - (ii) any agreement pertaining to CBM that is entered into by a holder of coal rights is grandfathered.

In our view, based upon the original language proposed for this section, the first interpretation is the correct one. Persons holding coal rights, however, may differ on that analysis.

Protection of past activities from future legal action

Bill 26, like other legislation having retroactive effect, also protects the government, the owners of title to the surface of lands, the owners of coal and persons holding coal rights through owners from being sued by holders of natural gas rights for damages or compensation for past extraction, production or removal of CBM (or in the case of the government, for enacting legislation precluding such claims) prior to the Bill coming into effect. Finally, Bill 26 protects the government from any takings or expropriation claims by coal rights holders others by expressly deeming, for all purposes, including the purposes of the *Expropriation Act*, that no expropriation has occurred as a result of the enactment of the legislation.

Conclusion

By clarifying CBM ownership, Bill 26 will hopefully encourage more CBM development throughout the province.

Footnotes

¹ Amends R.S.A. 2000, c. M-17.

² Government of Alberta “Amendments clarify coalbed methane ownership” News Release (October 27, 2010) <http://alberta.ca/acrv/201010/29405EF2B3C31-E004-0161-1A15908EB871FFA4.html>

³ EUB Decision 2007-024 (March 28, 2007) at pg. 1.

⁴ Ibid.

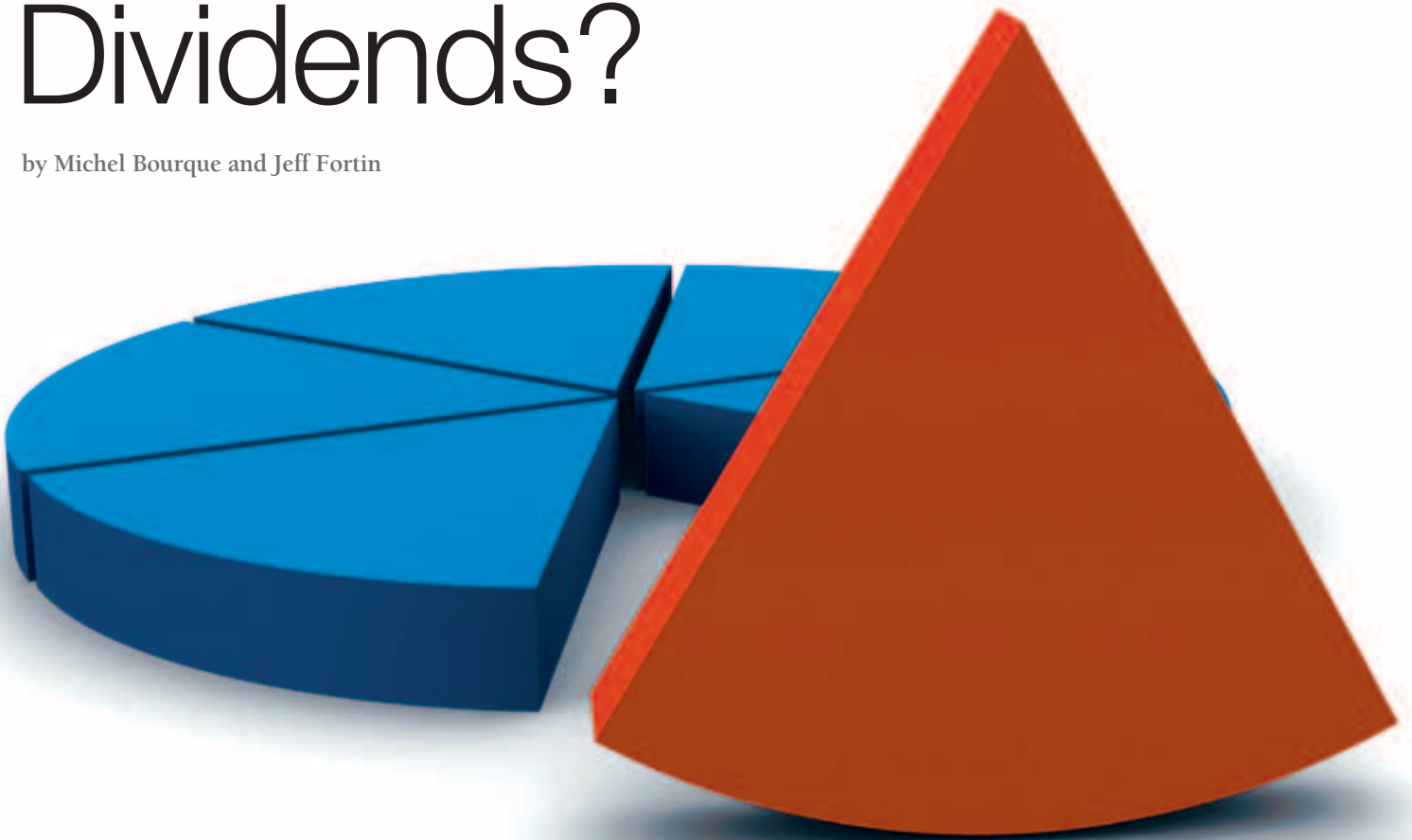
⁵ R.S.A. 2000 c. M-17.

⁶ *Amoco Production Co. v. Southern Ute Indian Tribe* 526 U.S. 865 (1999) (U.S.S.C.)

⁷ Coalbed Gas Act, S.B.C. 2003, c. 18.

Paying Eligible Dividends?

by Michel Bourque and Jeff Fortin



In order for a dividend to be an *eligible dividend* for purposes of the enhanced gross-up and dividend tax credit regime, the paying corporation must notify the shareholder recipients at the time the dividend is paid that it is an eligible dividend.

For public corporations, Canada Revenue Agency accepts that notification has been made if, before or at the time the dividends are paid, a designation is made stating that all dividends are eligible dividends unless indicated otherwise. Acceptable methods of making a designation are posting a notice on the corporation's website, and in corporate quarterly or annual reports or shareholder publications. The CRA also considers that a notice posted on a corporate website is notification that an eligible dividend is paid to shareholders until the notice is removed.

It is suggested that public corporations do all the following:

1. Post a general notice on the corporation's website stating that all dividends are eligible dividends unless indicated otherwise;
2. Make a statement in the AIFs, quarterly reports and annual reports that all dividends are eligible dividends unless indicated otherwise; and
3. Indicate in the press release announcing the declaration of the dividend that the dividend is an eligible dividend.

For private corporations, notification may be made by identifying eligible dividends through letters to shareholders and dividend cheque stubs, or where all the shareholders are directors of the corporation, by a notation in the director's resolutions or meeting minutes.

New Thresholds

Competition Act 2011 Transaction Size Thresholds for Notification

The transaction-size threshold for 2011 has increased from \$70 million to \$73 million. As a result, advance notice of proposed transactions will generally be required when the assets in Canada or revenues of the target firm generated in or from those assets exceed \$73 million and when the combined Canadian assets or revenues of the parties and their respective affiliates in, from or into Canada, exceed \$400 million.

Investment Canada Act 2011 Thresholds for Review

For investors from countries that are members of the World Trade Organization (WTO), the acquisition of control by a non-Canadian of a Canadian Business with gross assets of \$312 million or more is subject to review (up from \$299 million in 2010).

Women Build 2011

BD&P is pleased to be presenting sponsor of a new initiative of Habitat for Humanity Calgary — that of Women Build 2011. The Women Build program is an international movement that helps bring women together for a common purpose: to change the lives of families in their communities. Women of all ages and backgrounds are encouraged to volunteer in a non-traditional capacity — that of construction! It allows participants to learn new skills while contributing at the same time to the provision of safe, comfortable homes in which families can grow and prosper.

The Women Build Program will be focused during the week of May 2nd to 7th with the building of a 5-plex in Cochrane which will ultimately house 5 families. BD&P female lawyers and clients will attend a unique kick-off party on April 19, 2011 designed to launch the All Women Build Program in Calgary and some of those same lawyers and clients will be onsite in Cochrane to take part in the all women build on Saturday, May 7. It promises to be an exciting day! A number of our female lawyers and staff were involved in an all women build in November 2010 and couldn't say enough about the positive experience they had working side by side with their colleagues in furtherance of the dream of a young family previously residing in less than ideal circumstances.



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