

on

Insolvency Law

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The logo for Fraser Milner Casgrain LLP, consisting of the letters 'FMC' in white on a dark blue square background.

FRASER MILNER CASGRAIN LLP

THE PRIORITY OF THE OPERATOR'S LIEN

In *Brookfield Bridge Lending Fund Inc. v. Vanquish Oil & Gas Corp.*, the Alberta Court of Queen's Bench found that the trust created pursuant to section 507 of the 1990 Canadian Association of Petroleum Landman Operating Procedure ("1990 CAPL Operating Procedure") created a trust in favour of the joint operator that went beyond funds held in the insolvent operator's account at the date a receiver was appointed to cover all assets of the debtor's estate, including the net proceeds of the sale of the insolvent operator's interest in that property, in priority to the operator's secured lender.

The insolvent operator had granted a general security interest in all of its property. Its lender subsequently applied for, and obtained, an order appointing a receiver over all of its property. At the time of the appointment of the receiver, the joint operators were owed approximately \$320,000 in respect of non-payment of certain net production revenues not remitted by the insolvent operator, Vanquish.

The receiver sold the operator's interest in the property and ultimately maintained the amount of \$320,539 in reserve pending the outcome of the dispute between the non-operator beneficiaries of the trust and the insolvent operator's lender.

In applying the case law surrounding the trust created by the 1990 CAPL Operating Procedure, the Court reviewed the *Société Générale/Sorrel Resources Ltd.* case, along with a general overview of the hallmarks of a constructive trust set forth in the decision of *Soulos v. Korkontzilas*, namely that:

- (1) the defendant must have been under an equitable obligation, that is, an obligation of the type that courts of equity have enforced, in relation to the activities giving rise to the assets in his hand;
- (2) the assets in the hand of the defendant must be shown

to have resulted from deemed or actual agency activities of the defendant in breach of his equitable obligation to the plaintiff;

- (3) the plaintiff must show a legitimate reason for seeking a proprietary remedy, either personal or related to the need to ensure that others like the defendant remain faithful to their duties; and

- (4) there must be no factors which would render imposition of a constructive trust unjust in all the circumstances of the case; e.g., the interests of intervening creditors must be protected.

In applying the *Soulos* test to the *Vanquish* case, the Court found that the insolvent operator's breach of trust "sufficed to engage the conscience of this Court in support of finding a constructive trust for the following reasons:

- (1) Section 507 of the 1990 CAPL Operating Procedure clearly imposed a trust upon Vanquish over the net production revenues in favour of the non-operator working interest owner.

- (2) With respect to the second condition, there is no direct evidence before this Court as to the ultimate disposition of the net production revenues apart from the \$58,487.86 that remained on deposit at the time of the receivership. Indeed, this is the nub of the issue in this case. However, there is a high probability that the net asset base of Vanquish was unjustly enriched by Vanquish's breach of trust as argued by counsel for Karl and referred to in para. 44 above.

- (3) With respect to the third condition, the claimant does have a legitimate reason for seeking a proprietary remedy to ensure that Vanquish, and parties similarly situated, adhere faithfully to the trust imposed upon them by virtue

of Section 507 of the 1990 CAPL Operating Procedure and indeed the law as previously enunciated by the Alberta Court of Appeal in *Société Générale*.

(4) Finally, the imposition of a constructive trust in the circumstances of this case is not unjust having regard to the interests of the secured lender (as opposed to a bona fide purchaser or other parties such as a landlord). After all, the secured lender is in a strong position to ensure that its customer adhere to its obligations by employing such things as borrower's covenants, reporting procedures, etc.”

Accordingly, the Court found the trust to have priority to the security agreement granted in favour of Vanquish's lender.

The decision is under appeal by the secured lender.

For further information please contact David Mann at 403 268-7097 or David LeGeyt at 403 268-3075, or visit our website www.fmc-law.com/insolvency.