

THE CONFLICT BETWEEN MORTGAGES AND SURFACE LEASES IN ALBERTA

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This article examines whether a landowner may be in breach of the terms of their mortgage by entering into a standard oil and gas surface lease without notification to and consent of the lender.

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TABLE OF CONTENTS

I. Introduction	3
II. Surface Leases and Right of Entry Orders	4
1. Surface Leases	4
2. Right of Entry Order	5
III. Mortgages.....	6
1. Disposing of an Interest	9
2. Reduction in Value of Land	9
3. Change, Alter, Add to the Land	13
4. Allow Hazardous Waste on the Land.....	13
IV. Conclusion	14

I. Introduction

The question for consideration in this article is whether a landowner may be in breach of their mortgage by entering into a standard oil and gas surface lease without notification to and consent of the lender. Specifically, could entering into a surface lease breach a landowner's obligation not to:

1. dispose of an interest in the land;
2. do something to reduce the value of that land;
3. change, alter or add to the land; or
4. allow hazardous waste on the land.

This issue has become problematic in the United States, where some banks have become reluctant to grant mortgages on properties leased for gas drilling.² As of 2011, at least eight U.S. banks do not issue mortgages on such properties.³ However, this issue is largely untested and unexplored in Canada. Nonetheless, landowners should be advised that by entering into a surface lease they risk breaching their mortgage conditions, in turn, risking that the mortgage may be terminated, may not be renewed, and that they may become liable to the lender for any loss of value or cost of clean-up that may be incurred by the lender in restoring the lands should they be found to be contaminated.

² "Rush to Drill for Natural Gas Creates Conflicts with Mortgages", New York Times, October 19, 2011, online <<http://www.nytimes.com>>.

³ *Ibid.* See also "Couple Denied Mortgage Because of Gas Drilling", WTAE Pittsburg, May 8, 2012, online <<http://www.wtae.com>>.

II. Surface Leases and Right of Entry Orders

The granting clause in older oil and gas leases conferred on the lessee the right to drill wells, lay pipelines, and install tanks, stations, structures, and roadways.⁴ However, these extensive powers no longer have any practical effect since “they have been displaced by provincial legislation that precludes the lessee from utilizing them”.⁵ Today, the oil and gas lease does not grant any rights to use the surface: such rights can only be created by a separate agreement with the surface owner for which compensation is paid called a surface lease, or under provincial right of entry legislation, which gives the lessee the right to use the surface for the purpose of taking and disposing of the leased substances, and which is called a right of entry order.⁶

1. Surface Leases

The surface lease is a voluntary agreement between a land owner and the holder of an oil and gas lease, the lessee, who is often a private oil and gas company (the “operator”). The surface rights that are required for oil and gas operations must be supported by consideration separate from that given for mineral rights.⁷ Consequently, express or implied rights to win and work contained in oil and gas leases are unavailable without separate consideration given for these surface rights.⁸ In Alberta, the practice is to acquire these rights by a surface lease.⁹ If a surface lease cannot be negotiated between the landowner and the operator, the necessary rights may be gained by

⁴ John Ballem, *The Oil and Gas Lease in Canada*, 4th ed. (Toronto: University of Toronto Press, 2008) at 140.

⁵ *Ibid.* See *Surface Rights Act*, RSA 2000, c S-24, s. 12. See also Saskatchewan, *Surface Rights Acquisition and Compensation Act*, RSS 1978, c S-65, s. 6(1); Manitoba, *Surface Rights Act*, CCSM c 5235; *Ontario Mining Act*, RSO 1990, c M-14; British Columbia, *Petroleum and Natural Gas Act*, RSBC 1996, c 361, s. 9(1).

⁶ Ballem, *supra* at 141.

⁷ Bennett Jones and Nigel Bankes, *Canadian Oil and Gas*, 2nd ed., (Ontario: LexisNexis, 1993) at para. 5.11

⁸ *Ibid.*

⁹ *Ibid.*

compulsory acquisition under a right of entry order.¹⁰ This right of entry order is obtained through the Alberta Surface Rights Board exercising its statutory authority to allow the holder of an oil and gas lease to access its mineral rights. Thus, mortgage conditions cannot be breached by a right of entry order because a right of entry order is statutorily authorized. However, a surface lease agreement is voluntarily entered into and therefore has the potential to breach mortgage conditions.

2. Right of Entry Order

A surface lease differs from a right of entry order. Section 12 of the Alberta *Surface Rights Act*¹¹ sets out the requirements that an operator must meet before a right of entry order is granted and sets out the rights that are bestowed upon the operator after a right of entry order is granted. The purpose of the *Surface Rights Act* is to ensure reasonable use of these rights and to provide adequate compensation to surface owners and occupants for disturbance of their surface rights.¹² This type of legislation arose in the prairie provinces because ownership of minerals was severed from ownership of land to such an extent that, without the legislation, landowners would have received no benefits or compensation for the use of their lands for the development of minerals.¹³ The effect of the legislation is to induce the operator to obtain surface rights under instruments separate from oil and gas leases.¹⁴ Thus, “express and implied rights of working for minerals are abrogated until a right of entry is secured in accordance with the legislation”.¹⁵ The right of entry order generally provides that an operator has a right of entry “for the removal of minerals and for

¹⁰ *Ibid.*

¹¹ RSA 2000, c S-24.

¹² Bennett Jones and Nigel Bankes, *supra* at para. 5.3.

¹³ *Ibid.*

¹⁴ *Ibid.*, at para. 5.4.

¹⁵ *Ibid.*

or incidental to any drilling operations...”.¹⁶ Any right of entry will be subject to compensation and other conditions imposed by the Surface Rights Board.

III. Mortgages

A mortgage is a conveyance or other disposition of an interest in property designed to secure the payment of money or the discharge of some other obligation.¹⁷ The party who conveys the property by way of security is called the mortgagor, the lender who obtains an interest in the property is called the mortgagee, and the debt for which the security is created is called the mortgage debt.¹⁸

In Alberta, most mortgages are modeled after the Alberta Standard Mortgage Terms. The standard terms were created pursuant to s. 102 of the *Land Titles Act*.¹⁹ A typical mortgage contains a number of conditions that a borrower must adhere to in order to obtain the benefit of financing for the mortgaged lands. A review of several bank mortgages in Canada²⁰ reveal some common conditions:

- The Borrower will at its expense, during the continuance of this security, maintain or cause to be maintained with financially sound and licensed insurers insurance acceptable to the Lender.
- This [insurance] policy must also include: (i) pollutant clean-up in the event of an accidental spill involving hazardous goods or wastes (IBC 2313 or its equivalent).

¹⁶ *Ibid.* at para. 5.5. See also the *Law of Property Act*, RSA 2000, c. L-7, s. 79.

¹⁷ EH Burn and J Cartwright, *Cheshire and Burn's Modern Law of Real Property*, 17th ed., (Oxford: Oxford University Press, 2006) at 717.

¹⁸ *Ibid.*

¹⁹ RSA 2000, c. L-4.

²⁰ For example, see Toronto Dominion Bank Mortgage between Toronto Dominion Bank and Cameron and Jane Kerr; See also “Set of Standard Charge Terms”, Royal Bank of Canada, 2005.

- The Borrower... will not permit or suffer the registration of any encumbrance, lien, or charge whatsoever, which could rank prior to the charge of this Mortgage.
- The Borrower will not permit or commit any act of waste on the Lands or do any other act or thing by which the value of the Lands shall... be diminished...
- The Borrower will not change the use of the Lands nor make or permit to be made any material alterations or additions to the Lands without the consent of the Lender.
- The Borrower covenants and agrees with the Lender that the Borrower... (c) on default the Lender shall have quiet possession of the Lands, free from all encumbrances... (e) has done no act to encumber the Lands other than is described on the existing Certificate of Title.
- The Borrower further covenants and agrees with the Lender to maintain the Lands in contamination free state and to indemnify and hold the Lender harmless from and against all loss, costs, charges, and expenses (including without limitation, legal fees, and cost incurred in the investigation, defence and settlement of a claim) relating to the presence of any hazardous waste or contaminants referred to in this clause.
- The Borrower will comply with all municipal zoning bylaws governing the subject site and all rezoning applications are to be submitted to the Lender for its prior written approval.
- The Mortgagor covenants and agrees with the Bank that he will not, without the prior consent in writing of the Bank, sell, transfer or otherwise dispose of the Mortgaged Property or any portion thereof or any interest therein; and, in the event of such sale, transfer or other disposition, without the consent of the Bank, the Indebtedness shall, at the option of the Bank, forthwith become due and payable.

As always, a breach of a mortgage condition can result in the termination of the mortgage or the decision not to renew the mortgage. The result of this termination is generally set out in a standard clause, similar to the following:

In the event default being made in any of the covenants, agreements, provisos, or stipulations expressed or implied herein: (a) The whole of the principal monies, interest,

and other sums secured hereby shall, at the option of the Lender, become due and payable provided, however, the Lender may elect at its option, to enforce this Mortgage or any collateral security for collection of only outstanding arrears of payments.

Furthermore, the Alberta *Land Titles Act* requires that a Borrower obtain the Lender's permission before signing a lease that will affect the property:

Requirements of lease

95(1) When land for which a certificate of title has been granted is intended to be leased or demised for a life or lives, or for a term of more than 3 years, the owner shall execute a lease, in the prescribed form.

(2) A lease made pursuant to subsection (1) shall give a description of the leased land that is sufficient to identify the land.

(3) A right for the lessee to purchase the land described in the instrument may be stipulated in the instrument, and if the lessee pays the purchase money stipulated, and otherwise observes the lessee's covenants expressed and implied in the instrument, the lessor is bound to execute a transfer to the lessee of the land, and to perform all necessary acts by this Act prescribed for the purpose of transferring the land to the purchaser.

(4) No such lease of mortgaged or encumbered land is valid and binding against the mortgagee or encumbrancee unless the mortgagee or encumbrancee has consented to the lease prior to its being registered, or subsequently adopts it.

Covenants implied in lease

96 In every lease referred to in section 95 other than a lease that is subject to the *Residential Tenancies Act* or the *Mobile Home Sites Tenancies Act*, there shall be implied the following covenants by the lessee, unless a contrary intention appears in the lease:

(a) that the lessee will pay the rent reserved by the lease at the times mentioned in the lease, and all rates and taxes that may be payable in respect of the demised land during the continuance of the lease;

(b) that the lessee will at all times during the continuance of the lease keep and at the termination of the lease yield up the demised land in good and tenantable repair, accidents and damage to buildings from fire, storm and tempest or other casualty and reasonable wear and tear excepted.

[Emphasis added]

1. Disposing of an Interest

Generally a mortgage will forbid the disposal of an interest in the property so mortgaged. Thus, does signing a surface lease constitute the disposal of an interest in the property? Framed another way, is the surface lease an “interest” in the mortgaged property?

First and foremost, the categories of interests in land are not closed, and it is not necessary that a particular interest fit into a pre-existing legal category in order to be an interest in land.²¹

Regardless, a lease is an interest in land.²² By executing a surface lease, a landowner is disposing of an interest in the mortgaged property, contrary to mortgage conditions prohibiting such an act.

A review of a standard surface lease between landowners, Jane and Cameron Kerr, and the operator, San Tan Resources Ltd., reveals the following standard renewal provision:

If the Lessee is not in default in respect of any of the covenants and conditions contained in this Surface Lease at the date of expiration of the term of 21 years hereinbefore provided, then this Surface Lease shall be automatically renewed for a further term of 21 years commencing on the day following the expiration of the aforesaid term, which renewal shall include the within automatic right of further renewal.

By effect of this clause, the lease will continue to renew every 21 years as long as the terms of the lease are not breached by the lessee. Upon executing a lease of this nature, there is a clear disposition of an interest in land contrary to mortgage requirements not to do so.

2. Reduction in Value of Land

²¹ *Scurry-Rainbow Oil Ltd. v Galloway Estate* (1993), 8 Alta LR (3d) 225 at 266 (ABQB).

²² *Remington Development Corp. v Enmax Power Corp.*, 2011 CarswellAlta 2019 (ABQB).

A mortgage generally contains a provision that forbids the owner from doing anything that would reduce the value of the land:

The Borrower will not permit or commit any act of waste on the Lands or do any other act or thing by which the value of the Lands shall... ..be diminished.²³

The question, therefore, is whether the existence of a surface lease and the resultant equipment, well site and pollution could result in a reduction of the value of the mortgaged land?

In a 2005 paper, ‘The Impact of Oil and Natural Gas Facilities on Rural Residential Property Values: A Spatial Hedonic Analysis’, the authors determined that the presence of oil and gas facilities have significant negative impacts on property value.²⁴ Similarly, a study by the Alberta Energy and Utility Board in 2003 confirmed that oil and gas facilities can seriously devalue property. This study looked at property values in three key central Alberta municipalities: Rocky View, Foothills and Mountain View. The study examined three key factors: the price impact of industrial intensity (the number of wells), industrial proximity (the distance of wells from one’s property) and the age of the industrial facilities (those prone to leakage or grand-fathered emissions requirements).²⁵

The loss of use and adverse effect on the land is commonly recognized:²⁶ land owners are compensated for the presence of operations on their land, either by agreement or by a decision of the Surface Rights Board. In Alberta, the amount of compensation paid is based upon the following criteria:

²³ See Toronto-Dominion Mortgage between Cameron and Jane Kerr and Toronto-Dominion Bank.

²⁴ Peter Boxall, Wing Chan & Melville McMillan, “The Impact of Oil and Natural Gas Facilities on Rural Residential Property Values: A Spatial Hedonic Analysis” (Waterloo: Wilfred Laurier University, 2005).

²⁵ The Land Advocate, March 2004, online < http://www.pekisko.ca/docs/nlas/LA_2004_Mar.pdf>.

²⁶ *Livingston v Siebens Oil & Gas Ltd.* (1978), 8 AR 439 (CA).

1. **Entry Fee:** The entry fee is equal to \$500 per acre of land granted to the company, to a maximum of \$5,000. For example, if the company needs a 4.25-acre site, the entry fee would be: 4.25 acres x \$500 = \$2,125. The \$5,000 maximum applies when the area is 10 acres or larger. If the area is less than one acre, then the fee is that fraction of one acre x \$500. The minimum entry fee is \$250, paid when the area is half an acre or less.
2. **Land Value:** Usually the value of the land leased to the company is determined by the price expected if the land were sold on the open market by a willing seller to a willing buyer at the time when the lease was prepared or the Right-of-Entry Order issued. The value is also based on the highest approved use (agricultural, industrial, and residential) for the land. The per acre value for the well site is determined by dividing the value of the titled unit by the number of acres required.
3. **Initial Nuisance, Inconvenience and Noise:** This payment is for nuisance during the first year of the lease. For example, in the first year you will likely have to spend time dealing with the company's representatives and surveyors, preparing documentation, negotiating with the company and/or seeking advice from government agencies or lawyers. There may also be noise and inconvenience related to construction. The company should pay reasonable compensation to you for nuisance. Keep a record of all time spent, phone calls made and expenses incurred.
4. **Loss of Use of the Land:** The company pays an annual compensation for your loss of the normal use of the well site area during the well site's life. The amount should approximate the value of the gross annual production reasonably expected from the area. To calculate the amount, you can use the greater of yield and price averages from the past five years, or today's street price. For example, assuming canola production at 35 bushels per acre on a well site and access road occupying four acres, the loss would be 4 x 35 = 140 bushels. At \$8.50 per bushel, the total annual loss would be \$1,190. Because you are asked to agree on losses for the next five years (see "Five-year Review" below), consideration should be given to future prices.
5. **Adverse Effect:** This payment is related to your inconvenience, nuisance and extra costs on the rest of the quarter section where the well site is located. For instance, farming around the well site may require constantly turning corners, which can cause overlaps, extra strain on machinery, soil compaction, loss of seed and grain, and extra field and labour costs. Other factors related to adverse effect can be noise, dust, odour, additional traffic on the land, and proximity to a residence or farm site.
6. **Other Relevant Factors:** If there are other considerations specific to your situation, include them when negotiating compensation.²⁷

However, these factors do not address the actual loss of value of the subject property.

²⁷ Government of Alberta, Department of Agriculture and Rural Development, "Negotiating Surface Rights", online <[http://www1.agric.gov.ab.ca/\\$department/deptdocs.nsf/all/agdex1126](http://www1.agric.gov.ab.ca/$department/deptdocs.nsf/all/agdex1126)>.

According to an article written by John Baen:

The short- and long-term value implications of the drilling, production, transportation, and transmission of oil and gas off property is further complicated by changes in land title (e.g., leases, easements) and the likelihood of environmental contamination. These factors may not only reduce a property's value and mortgageability, but could leave a surface owner liable for cleanup or disclosure of these activities to future buyers...

Oil and gas activities are a major disruption of the surface and have significant value implications for surface estate owners. Many landowners and appraisers are not fully aware of the full impact of oil and gas exploration and production activities to a property's present and future market value...²⁸

This implication was also discussed in *Balisky v. Canada (Minister of Natural Resources)*,²⁹ where the appellants argued that the requirement to obtain leave of the National Energy Board to excavate using power-operated equipment or explosives in the controlled area might diminish the value of the controlled area and adjacent land. Potential purchasers may see the requirement that landowners must obtain leave from the Board as a regulatory risk with which they would rather not have to contend. This regulatory risk might, therefore, diminish the value of the owners' land. The respondents had no answer to this concern. The Federal Court of Appeal held that a potential limitation on excavating close to a pipeline may have been a factor for consideration in the awarding of compensation in respect of the taking of land for, or the construction and operation of a pipeline. At paragraphs 39-40, the Court stated:

It may be that the reduction in land value resulting from the controlled area is slight or indeed non-existent. However, as I have said, that is a matter of appraisal or other evidence to be brought before an Arbitration Committee. I can see no reason, based upon the scheme of Part V, to deny the landowners the opportunity to bring such a matter before the Arbitration Committee.

²⁸ John Baen, "The Impact of Mineral Rights and Oil and Gas Activities on Agricultural Land Values" (January 1996) LXIV *The Appraisal Journal* 67.

²⁹ 2003 FCA 104.

For these reasons, I am on the opinion that the Minister was in error when he found that compensation for the controlled area did not fit within the statutory scheme and that the learned judicial review Judge should have granted the appellants' application for judicial review.

Therefore, given the commentary on this issue, the existence of a surface lease and the resultant equipment and pollution could result in a reduction of the value of the mortgaged land.

3. Change, Alter or Add to the Land

A borrower is generally prohibited from:

...chang[ing] the use of the Lands [or] mak[ing] or permit[ting] to be made any material alterations or additions to the Lands without the consent of the Lender.³⁰

For instance, section 7(1) of the Ontario *Land Registration Reform Act*³¹ states that:

1. In a charge of freehold or leasehold land by the beneficial owner:
 - ...
 - iii. That the charger has not done, omitted or permitted anything whereby the land is or may be encumbered, except as the records of the land registry office disclose.

By entering into a surface lease, a borrower is changing the use of the mortgaged property and permitting an alteration or addition to the land.

4. Allow Hazardous Waste on the Land

Homeowners and farmers who have mortgaged property should consider mortgage default risks before entering into oil and gas leases on their mortgaged property. Mortgages routinely contain clauses prohibiting hazardous activity or substances on the property, the storage of hazardous waste, and activities that may devalue the property.³²

³⁰ See Toronto-Dominion mortgage between Cameron and Jane Kerr and Toronto-Dominion Bank.

³¹ RSO 1990, c. L-4.

³² "Natural Resources/Consumer Blog: Homeowners and Farmers with Mortgaged Property Should be Aware of Default Risks Before Entering into Oil and Gas Leases", Kravitz Law Office, January 25, 2012, online <<http://kravitz-lawoffice.com>>.

All residential mortgage lenders require homeowner's insurance from their borrowers. Even the most comprehensive homeowner's coverage, known as "broad risk form" or "special form" insurance excludes the types of property damage associated with oil and gas development. Most, if not all, insurance companies will not insure pollution costs, expenses, loss or damage.³³

In Alberta, the Surface Rights Board takes the position that physical damage to lands adjoining the well site is not covered by the *Surface Rights Act*.³⁴ However, the Board can make an award for "damage to the land in the area granted to the operator that might be caused by the operations of the operator."³⁵ Thus, it is recognized by both insurance companies and oil and gas legislation, that damage to land, which can include the release of hazardous substances, is a possible result from surface lease activities.

IV. Conclusion

This issue has become problematic in the United States, where some banks have become reluctant to grant mortgages on properties leased for gas drilling.³⁶ As of 2011, at least eight U.S. banks do not issue mortgages on such properties.³⁷ However, this issue is largely untested and unexplored in Canada. Nonetheless, landowners should be advised that by entering into a surface lease they risk breaching their mortgage conditions, in turn, risking that the mortgage may be terminated, may not be renewed, and that they may become liable to the lender for any loss of value or cost of clean-up that may be incurred by the lender in restoring the lands should they be found to be contaminated.

³³ For example, see "Core Property Protection Insuring Agreement", St. Paul Fire and Marine Insurance Company.

³⁴ *Twin Oils Ltd. v. Schmidt* (1968), 74 WWR 647.

³⁵ *Surface Rights Act*, s. 25(1)(e).

³⁶ "Rush to Drill for Natural Gas Creates Conflicts with Mortgages", *supra*.

³⁷ *Ibid*. See also "Couple Denied Mortgage Because of Gas Drilling", *supra*.