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April 2019

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Redwater

The SCC Decision and Go Forward Thoughts

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The Supreme Court of Canada (SCC) decision in *Redwater* was finally released in late January 2019 as *Orphan Well Association v. Grant Thornton Ltd., 2019 SCC 5*. The case caused a mild media stir as reporters loudly proclaimed that oil and gas companies were

Bam. Mic drop. This one sentence is a simple, and powerful, way to cut through all the baloney and understand the decision from a pure public policy point of view. If you hold an oil and gas licence, you are responsible for the ARO that flows from that grant.

now responsible for cleaning up old oil and gas wells. Like we weren't responsible before the case came down. Anyway, media interest was, as always, short lived.

The real impact of *Redwater* is far less dramatic. The case did not change the world, but it does provide important guidance with respect to the asset retirement obligations (ARO) of insolvent companies.

ORPHANS AND ARO

There are many ways to summarize the Court's decision, but my favourite comes from the affidavit of CAPP, filed way back when this Court proceeding started in late 2015:

> The orphan fund is designed to deal with orphans, not children that the parent wishes to disown.

Bam. Mic drop. This one sentence is a simple, and powerful, way to cut through all the baloney and understand the decision from a pure public policy point of view. If you hold an oil and gas licence, you are responsible for the ARO that flows from that grant.

Sadly, the nub of the problem is in deciding whom the parents are. Not a sentence you want to hear too often when you are the father of 3 boys, but bear with me. Clearly the oil and gas company which holds the licence is a parent. No one disputes that. The difficult question is deciding whether the secured party (in this case the Alberta Treasury Branch) is also a parent, such that the bank cannot orphan the ARO via an insolvency claim as a secured creditor. This losing viewpoint was summed up nicely by the Alberta Court of Queen's Bench decision:

> [173] ...The creditors deprived of the usual order of priority in bankruptcy will be subject to a "third-party-pay" principle in place of the "polluter pay" principle.

The secured creditor argument was successful at trial, and at the Alberta Court of Appeal. However, due to the artful and compelling dissent of Justice Sheilah Martin at the Court of Appeal, the matter went to the SCC. *Spoiler alert* - the decision was overturned and we found more parents for the orphans.

REDWATER AT THE SCC

The SCC in *Redwater* confirms the oil and gas industry status quo: bankruptcy is not a licence to disregard environmental rules.

Disclaimer - To avoid more nasty allegations of plagiarism, be advised that the following discussion is a blatant rip off of the excellent Lawson Lundell LLP blog written by Lewis Manning and Toby Kruger (who appeared for CAPP at the SCC). Work smart, not hard, that's my motto. Plus, writing for *The Negotiator* pays like… I will be back at the end of the article to provide my Go Forward Thoughts on the decision.

Summary

In a case that pitted the federal *Bankruptcy and Insolvency Act* (BIA) against Alberta's constitutional rights to legislate in relation to property and civil rights in the Province, the SCC has determined that the AER has been and continues to act lawfully in accordance with the statutory framework established under Alberta's valid constitutional authority to oversee and manage the oil and gas industry in Alberta.

Specifically, in *Redwater*, Chief Justice Wagner reaffirmed the AER, the Orphan Well Association (OWA) and industry position that end of life obligations to properly clean-up wells and facilities and remediate the land on which such facilities are located—are attached to and form part of an oil and gas company's licence to produce hydrocarbons in Alberta. Without licences, which are issued pursuant to the Alberta statutory framework under the *Oil and Gas Conservation Act* and administered by

the AER, oil and gas companies' right to produce, market and sell oil and gas (*profits à prendre*) are of limited value at best, because production cannot take place without them. All licences held by an oil and gas company in Alberta, such as Redwater, are received by it subject to the end-of-life obligations that could one day arise. These end-of-life obligations form a fundamental part of the value of the licenced assets, the same as if the associated costs had been paid up front.

Having received the benefit of the "Renounced Assets" (now unproductive wells) during the productive period of their life cycles, the Court held that the lender and the receiver appointed to administer the estate on its behalf could not now disclaim and avoid the associated liabilities that were attached to the licence from the outset. The result is that even in the event of bankruptcy, the law requires the trustee in bankruptcy to use the bankrupt's assets to abandon and reclaim wells and facilities.

Background

Redwater dealt with an attempt by the receiver, Grant Thornton Limited (GTL), to pick only the valuable assets out of a bankrupt oil and gas operator's estate and renounce and disclaim the rest, leaving the liabilities in the estate. Liabilities left in the estate could become "orphaned wells" potentially subject to clean up at some point in the indeterminate future by the OWA, which is largely funded by industry.

The AER ordered GTL to properly abandon the Renounced Assets pursuant to the AER's established policies, and refused to allow the transfer of licences for productive wells out of the estate until the AER's *Directive 006 Licensee Liability Rating Program* requirements were met (the program establishes a ratio of assets to liabilities that the AER requires licensees to maintain, known as the Liability Management Rating or "LMR"). GTL disagreed and applied to the Alberta Court of Queen's Bench for an order approving the sale process and directing that the AER could not prevent the transfer of the licences, on the basis that the BIA is paramount over the provincial regulatory scheme.

...the provincial and federal legislation both dealt with separate and different things and could co-exist without the need to consider whether the obligation to make a well site environmentally safe interfered with the scheme of distribution under the BIA.

The SCC Decision

GTL argued first that the provision in the BIA limiting trustees' liability for environmental conditions released it from all environmental liability associated with the Renounced Assets. Second, GTL argued that the AER's use of its statutory powers unconstitutionally reordered the priorities in the BIA. GTL failed on both arguments.

On the first point, GTL argued that the AER's interpretation would frustrate the purpose of the BIA, and that if environmental claims are binding on estates, trustees would refuse to accept appointments. The Court rejected this argument, noting, in part: "...there is nothing to suggest that this well-established state of affairs [*the status quo before the Redwater QB decision*] has led insolvency professionals to refuse to accept appointments or has increased the number of orphaned sites. There is no reason why the Regulator and trustees cannot continue to work together collaboratively, as they have for many years, to ensure that end-of-life obligations are satisfied, while at same time maximizing recovery for creditors." The Court held there is nothing in the BIA that relieves the estate (as opposed to the trustee) from liability, and as a result the licensee (in this case GTL) must expend estate assets on abandonment.

On the second point, the Court held that the provincial legislation could potentially be inoperative to the extent it reorders BIA priorities. But that was not the case here, and the SCC overruled the courts below, stating that the federal BIA and the provincial regulatory scheme governing oil and gas development were not in operational conflict. To the contrary, the provincial and federal legislation both dealt with separate and different things and could co-exist without the need to consider whether the obligation to make a well site environmentally safe interfered with the scheme of distribution under the BIA.

Central to the Court's reasoning here was that in order to fall within the BIA scheme, a claim must be provable in bankruptcy. The Court reaffirmed that whether a claim is provable in bankruptcy in this context is determined

by the three-part test in the SCC's 2012 decision in *Newfoundland and Labrador v. AbitibiBowater Inc.*, and significantly, *Abitibi's* application to a regulatory agency acting in the public interest.

The *Abitibi* test states first that there must be a debt, a liability or an obligation to a *creditor*. Second, the debt, liability or obligation must be incurred *before the debtor becomes bankrupt*. Third, it must be possible to attach a *monetary value* to the debt, liability or obligation.

On the first part of the test, the AER argued that it was not asserting any claims provable in the bankruptcy, so GTL must comply with the Redwater estate's environmental obligations to the extent that assets are available to do so. The SCC agreed that the AER was *not* a creditor when it was acting in its *bona fide* regulatory capacity, in the public interest and for the public good is enforcing environmental obligations.

In doing so the SCC also reaffirmed the Alberta Court of Appeal's 1991 decision in *Northern Badger*, which established that a regulator enforcing a public duty by way of non-monetary order is not a creditor.

In holding that the third part of the test was not satisfied either, the SCC noted that the AER is not in the business of performing abandonments, noting that remains the responsibility of the licensee. The Court accepted the AER's evidence that it had no intention of performing the abandonment, and also indicated that the OWA's involvement is not sufficiently certain to satisfy the test either. The Court noted that the OWA is an independent organization that has its own priorities as to how it chooses to prioritize environmental work, and that the work could take years in any event. As noted by the Court, "Much could change within the next decade, both in terms of government policy and in terms of the willingness of those in the Alberta oil and gas industry to discharge environmental liabilities."

The largest practical impact of Redwater could be an increased role of the AER as "creditor" of record in insolvency proceedings. This will occur where the AER ARO is greater than the anticipated proceeds of sale of the valuable assets of the insolvent company.

Conclusion

Overall, Chief Justice Wagner reaffirmed that compliance with the LMR conditions prior to the transfer of licences reflects the inherent value of the assets held by the bankrupt estate. The SCC ordered the proceeds from GTL's sale of the Redwater assets (which were being held in trust), to be used to address Redwater's end-of-life obligations. In short, bankruptcy does not amount to a licence to disregard environmental rules set by the AER, Northern Badger remains good law, and practically speaking the industry can continue to operate as it has successfully prior to the proceedings.

GO FORWARD THOUGHTS

End of plagiarism part. Now back to Paul.

Redwater Didn't Cause the OWF Avalanche

Redwater did not cause, and is not the silver bullet to fix, the avalanche of wells, facilities and pipelines going into the OWF. The economic collapse of the oil and gas industry did that. Well that, together with a bit of hubris on our part in believing that $100 oil and $10 gas would never end. Had we addressed 20-year-old standing wells in the boom, we could have possibly lessened the impact on the OWF today. I expect new legislation is coming, but whether that is before or after the pending provincial election is anyone's guess.

Closed Deals Stay Closed

Redwater does not impact completed transactions. Sales completed under a Vesting Order, or a receiver general sale power, are done. *Redwater* does not unwind these deals as they closed under valid law at the time of the transaction. Unclear what happens to prior disclaiming letters, but the licences still end up in the OWF anyway, and there is no money left, so the result is the same.

WIPs and the OWF

Redwater creates benefits for the OWF, but these benefits do not flow to Working Interest Participants (WIPs) in as direct a manner as you may hope. As always, the licensee must pay 100% of the upfront ARO costs and apply to the OWF for reimbursement of the delinquent party's share. This can

be absolutely terrifying for a small company with no free cash to pay extra ARO costs.

Disclaiming Is So Over

The largest procedural impact of *Redwater* is that receiver disclaiming letters are done. Small victories. Not to be an Eeyore, but remember that the lack of a disclaiming letter does not, in any way, mean that an AER WIP abandonment order will still not arrive in the mail.

AER May Appoint More Receivers

The largest practical impact of *Redwater* could be an increased role of the AER as "creditor" of record in insolvency proceedings. This will occur where the AER ARO is greater than the anticipated proceeds of sale of the valuable assets of the insolvent company. A bank, quite rightly, may choose to simply let the company die, rather than appoint a receiver, where there is no money for the bank at the end of the day. The AER has already taken on this role in Lexin, due to care and custody concerns after Lexin advised the AER that it could no longer safely manage its sour gas properties, including the Mazeppa sour gas plant. If this occurs, the hope is that the AER steps in quickly and acts proactively to sell the remaining valuable assets to create some AER ARO funds. Time will tell.

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AER ARO Cash Calls?

The most intriguing impact of *Redwater* is the possible capture of an insolvent licensee's security deposit funds by the AER before it goes to the OWF. If I am reading *Redwater* correctly, these monies are to be used by the AER *exclusively* towards the outstanding ARO of the insolvent licensee, not as a pot of money to go into the OWF for general industry ARO.

If this is correct, it may be possible to create cash calls to the AER to pay for WIP ARO in certain circumstances. Think of all the Lexin Resources sour gas wells in the OWF. If Lexin has assets of value, and they are to be sold, couldn't a smart buyer offer to acquire those Lexin wells in which it is a WIP and offer as consideration the abandonment of other Lexin WIP wells or facilities, rather than cash?

In my view, this is the best use of any Redwater AER acquired funds in such circumstances. Use the recovered funds for direct and immediate licensee ARO reduction. It will take a brave and creative purchaser and a willing AER to make this happen. I hope someone makes this work.

Financing Impacts

Lastly, my thoughts on the impact of Redwater on bank lines and credit facilities available to oil and gas companies. *Caution* – I am really, really bad at math, so take my thoughts with a grain of salt. My view is that banks began to fear and notice ARO at least 10 years ago. Your borrowing base is likely already discounted for full ARO risk, which incidentally, is much greater than the limited scope of ARO recovery under a LMR system. So, despite much gnashing of teeth, I don't think Redwater will have a material effect on new financing or existing borrowing base.

Lack of pipeline capacity is doing a great job of destroying financing all by itself. ♦

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