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# Redwater revisited – should the buck stop here?

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## In this Update

- on April 24, 2017, the Alberta Court of Appeal affirmed the Alberta Court of Queen's Bench's decision in *Redwater Energy Corporation (Re)*, 2016 ABQB 278 (*Redwater*)
- reasons for the *Redwater* decision
- the issues in *Redwater* raise various important policy concerns regarding land owners, the public at large and the oil and gas industry
- background and significant implications of *Redwater*

## Introduction

Nearly one year ago, the Alberta Court of Queen's Bench released its eagerly awaited decision in *Redwater Energy Corporation (Re)*, 2016 ABQB 278 (*Redwater*). In that decision, Chief Justice Wittmann held that a receiver and trustee (together, a Trustee) is permitted to renounce or disclaim an insolvent debtor's interest in uneconomic licensed assets, while retaining and selling its valuable licensed assets to maximize recovery for its secured creditors (see our previous Osler Update – Implications of the Redwater decision – Where does the buck stop?).

On April 24, 2017, in a decision that underscores the significant implications of that decision for the regulation of Alberta's oil and gas resources, the Alberta Court of Appeal affirmed the lower Court's decision. Writing for the 2-1 majority, the Honourable Mr. Justice Slatter held that the provisions of Alberta's regulatory regime under the *Oil and Gas Conservation Act*[1] (OGCA) and the *Pipeline Act*[2] (PA) are inoperative to the extent such provisions require a Trustee to satisfy the liability inherent in the abandonment and remediation of an insolvent debtor's oil and gas wells in priority to the claims of its secured creditors. The majority decision determined that the obligations imposed under the OGCA and the PA on Trustees were in operational conflict with the provisions of the *Bankruptcy and Insolvency Act*[3] (BIA) and frustrated its federal purposes of winding up insolvent corporations and settling the priority of creditor claims.

Reframing the issues before the court in her dissent, the Honourable Madam Justice Martin disagreed with the majority and the lower court, holding that "there is no more important arena for co-operative federalism than the environment." Finding no conflict between the provincial regulatory regime and the BIA, and no frustrated federal purpose, Justice Martin held that: (a) the oil and gas licensing regime in Alberta creates end-of-life obligations owed

by license holders that are part of the general law of Alberta and exist outside a bankruptcy; (b) continued application of the end-of-life obligations established by the regime is not a monetary claim or an unauthorized priority in bankruptcy, nor does it reorder creditor priorities established by the BIA; and (c) a Trustee cannot, under the BIA or otherwise, renounce the end-of-life obligations of certain licensed assets in favour of transferring other, more valuable, licensed assets for the benefit of the debtor's lenders.

As Justice Martin noted in her dissent that, "The implications [of this decision] for the regulation of Alberta's publicly owned resource, and for the Alberta public, are significant." The "cradle to grave" approach adopted by the AER to the regulation of exploration and development activities has become a "cradle to insolvency" approach, foisting the "to grave" portion of a producer's obligations onto Alberta landowners, the Alberta public and the oil and gas industry. In the words of Justice Martin, such a system alters the "polluter pays" policy to a "third party pays" system. A thoughtful and broad review of the federal insolvency regime by Parliament is necessary to ensure it accounts for the distinct character of the oil and gas regulatory regime in situations of insolvency. In the meantime, the AER and provincial legislators must rethink how best to ensure the public is not left holding the proverbial bag.

## Background

The background to *Redwater* is well known in Alberta. Redwater Energy (Redwater) was a publicly listed junior oil and gas producer. When its principal secured lender, Alberta Treasury Branches, demanded repayment of its indebtedness, Grant Thornton was appointed Redwater's receiver pursuant to section 243 of the BIA.

Upon appointment, the receiver conducted an assessment of Redwater's licensed assets and advised the AER that it would only take control of approximately 20 of the 127 Redwater properties licensed by the AER. The receiver determined these 20 licensed assets held value, while the rest did not, and so were purportedly renounced or disclaimed.

In response, the AER issued closure and abandonment orders in respect of the renounced assets and filed an application to compel the receiver to comply with the orders and fulfill all statutory obligations of Redwater in relation to the abandonment, reclamation and remediation of the licensed assets.

On October 28, 2015, a bankruptcy order was issued for Redwater, appointing Grant Thornton as trustee in bankruptcy. The trustee disclaimed the assets it had renounced as Receiver and indicated that it did not intend to comply with the closure and abandonment orders.

As discussed in our previous Osler Update, the Alberta Court of Queen's Bench concluded that the claim of Redwater's secured creditor had priority over the obligation to reclaim wells, thereby determining that Trustees were permitted to renounce an insolvent debtor's interest in its licensed assets while keeping and selling valuable licensed assets to maximize recovery for secured creditors.

The AER and the Orphan Well Association (OWA) both appealed the decision of the Court of Queen's Bench.

## Decision of the majority

Writing for the majority, Mr. Justice Slatter found that the abandonment orders and, more broadly, the obligations imposed on Trustees under the OGCA and the PA to abandon and remediate licensed assets as a "licensee" created an operational conflict between the provincial regulatory scheme and the BIA and frustrated the purposes of the BIA.

In finding that an operational conflict existed between the provincial regulatory regime and the BIA, Justice Slatter considered both the effects of section 14.06 of the BIA and whether abandonment orders issued by the AER were properly construed as claims provable in bankruptcy according to the principles outlined by the Supreme Court of Canada in *Newfoundland and Labrador v AbitibiBowater Inc.*[4], 2012 SCC 67.

In reviewing section 14.06 of the BIA, Justice Slatter held that:

(a) absent the specified forms of misconduct in s. 14.06(2)(b), a Trustee is not personally liable for environmental liabilities, meaning that the obligation to remedy that type of damage is are limited to the assets available in the bankrupt estate;

(b) a Trustee can renounce property burdened with environmental liabilities pursuant to both s. 14.06(4) and the BIA more generally;

(c) funds spent remediating environmental issues are not part of the administration costs in the bankruptcy (s. 14.06(6));

(d) a claim arising from environmental damage can be a claim provable in bankruptcy (s. 14.06(8)); and

(e) section 14.06 does not alter the order of payment of claims in bankruptcy under s. 136 of the BIA which provides that all distributions are "subject to the rights of secured parties."

In determining whether the abandonment orders constituted a claim provable in bankruptcy, Justice Slatter applied the three-part test established by the Supreme Court of Canada in *AbitibiBowater* and found that, among other things, the effect of the abandonment orders was to divert value from the bankrupt estate to ensure that remediation was done, thereby upsetting "the priorities of the BIA," effectively giving environmental claims a super priority over other creditors.

Finding that the abandonment orders constituted provable claims, Justice Slatter concluded that the abandonment orders and, more broadly, the obligations imposed on Trustees under the OGCA and the PA to abandon and remediate licensed assets as a "licensee," conflicted with the provisions of the BIA that exempt a Trustee from personal liability, the provisions allowing a Trustee to disclaim assets, and the provisions respecting the priority of remediation costs. Justice Slatter also held that the obligations imposed on Trustees under the OGCA and the PA to abandon and remediate licensed assets frustrated the federal purpose of managing the winding up of insolvent corporations and settling the priority of claims against them. Accordingly, he held that such licensing obligations were unenforceable by the AER against a Trustee within an insolvency proceeding under the BIA.

## The dissent

Madam Justice Martin disagreed with the majority, finding that the framing of the issue by the chambers judge, and the majority as "whether the Regulator can effectively create a

priority for abandonment and environmental liabilities in bankruptcy" was incorrect. She found that the premise ought not to be the assumption that licence obligations are debts. Rather, such licensing obligations, including asset end-of-life obligations, are public duties, and the real issue before the Court was better posited as: whether the license obligations created by *intra vires* provincial legislation conflicted with or frustrated the BIA priority scheme. She found no such conflict or frustration and that the oil and gas licensing regime could co-exist with the BIA priority scheme.

Starting from the proposition that "there is no more important arena for co-operative federalism than the environment," Justice Martin held that "To allow trustees in bankruptcy to pick and choose when they will comply with valid and generally applicable provincial law would be a power so extraordinary that it would require clear and express articulation." Her Ladyship found no such clear and express articulation in the BIA.

Instead, Justice Martin found that licensing abandonment and remediation obligations imposed on Trustees did not constitute claims provable in bankruptcy:

There is no monetary claim that can be compromised in a bankruptcy proceeding here; what we are dealing with are public duties and regulatory obligations that survive the bankruptcy. In law, the end-of-life obligations are licence conditions which must be assumed before an entity may profit from resource extraction. These are costs to comply with generally applicable laws. Even if end-of-life obligations are seen as part of the price of obtaining the desired licence, this does not transform them into a monetary claim in bankruptcy.

Importantly, Justice Martin acknowledged that AER *Directive 006: Licensee Liability Rating (LLR) Program and Licence Transfer Process* treats all licenses held by a licensee as a "package" and the liability management ratio (LMR) of a licensee, which affects whether and how such assets may be transferred to others, is not assessed on an individual licence or segregated asset basis. She identified three difficulties with the Trustee's proposal to take possession of only 20 of Redwater's licensed assets: 1) there would be no responsible party to respond to any emerging safety or environmental issues; 2) the Trustee, in segregating some of the licensed assets and then avoiding the posting of security normally required to effect the transfer of assumed licenses directly contravened the LLR program and; 3) the debtor's full estate is considered when licenses are granted, and continues to be the guiding factor in any license transfer. Licenses are granted on the basis that the value of all of a licensee's licensed assets are available to satisfy end-of-life obligations, and lenders know this system. Justice Martin considered that, by avoiding the regulatory end-of-life obligations associated with some of a debtor's licenses, the Trustee "seeks to increase the value of the estate above what it would have been but for the bankruptcy."

Regarding section 14.06 of the BIA, Justice Martin held that:

(a) sections 14.06(2) and (4) were intended to protect Trustees in order to avoid them being saddled personally with liabilities the debtor estate could not cover. Neither section prevents the assets of the estate from being used to comply with the order;

(b) sections 14.06(4), (7) and (8) refer to "real property," and s.14.06(4) contemplates the Trustee releasing "an interest in any real property affected by the condition." Alberta's regulatory regime, however, addresses AER-issued licences, which are not real property, and therefore s.14.06(4) "does not grant [Trustees] the right to renounce end-of-life obligations imposed by the regulatory regime." With no entitlement to renounce these obligations, she concluded there is no operational conflict between the BIA and the provincial legislation; and

(c) section 14.06(7) grants the Crown a super-priority in the debtor's real property requiring remediation so that the Crown may recoup some of the costs incurred to clean up the

environmental damage on that same property. This provision, and the compromise inherent in it, is effective only in respect of the debtor's real property. It has no application to the oil and gas licensing regime in Alberta, which involves licenses, and not real property.

Finding that: (i) abandonment orders did not constitute a provable claim in bankruptcy; (ii) attempting to file abandonment orders under Alberta's oil and gas licensing regime into s. 14.06 was an "awkward shoehorning"; and (iii) section 14.06 cannot apply as broadly as submitted by the Trustee; Justice Martin held that the provincial regulatory regime did not clearly conflict with the BIA. As a result, she held that there were no grounds for a declaration that the OGCA and PA were inapplicable in bankruptcy. Trustees are not permitted, by the BIA or otherwise, to disclaim AER-issued licensed assets and avoid the associated of end-of-life obligations owed by the debtor.

## Impact

Since the lower Court's decision in *Redwater* last year, the AER has adopted increasingly proactive measures to avoid the *Redwater* situation. Effective June 20, 2016, substantive changes were made to the transfer requirements for licensees, and licensee eligibility pursuant to Bulletin 2016-16 (see our previous Osler Update – Alberta's Energy Regulator Imposes Further Restrictions on Embattled Energy Industry in Response to Redwater). The changes were designed to "minimize risks to Albertans" arising from the impact of *Redwater*, while the AER and the Government of Alberta worked to develop "appropriate regulatory measures" to more permanently address *Redwater*. That work must continue. With the release of the Court of Appeal's decision affirming the lower court's decision, the urgent need for appropriate regulatory measures has increased.

Similarly, in March 2017, the AER took the unprecedented step of seeking the appointment of a receiver to realize upon the assets of Lexin Resources Ltd. to attend to stakeholder and creditor issues and assist with the outstanding environmental and safety issues at the sites owned by Lexin in a court-supervised process.

As discussed both by Justice Slatter and Justice Martin, the issues in *Redwater* raise various important policy concerns regarding land owners, the public at large and the oil and gas industry. Justice Martin accurately observes that the current regime prescribed under section 14.06 of the BIA for addressing environmental issues does not address the distinct nature and structure of the oil and gas regulation. The complex social, financial, and environmental issues raised in this case demand a broad and thoughtful analysis by Parliament regarding the application of the federal bankruptcy regime to the unique Alberta oil and gas industry.

Interestingly, the majority decision focuses on the risk that if "inchoate environmental claims" (i.e. the AER's control of license transfers) are given a "super priority over even the claims of secured creditors" that lenders will resile from financing industry players. The amount of financing available to the oil and gas industry can only decline substantially should the "contingent risk" of the enforcement of end-of-life obligations continue through bankruptcy. In contrast, in her dissenting reasons, Justice Martin references evidence on the court record that such end-of-life obligations had been expressly considered by ATB and used in calculating the debtor's borrowing base, and acknowledged the AER's concern that permitting a Trustee to shed a debtor's end-of-life obligations would incentivize other licensees to similarly organize their affairs, resulting in more orphaned wells. "If [licensees] are allowed to avoid or evade the end-of-life responsibilities attached to their licenses, abandonment and reclamation ... would likely be among the first sacrifices made in times of fiscal difficulty."

While secured creditors may be satisfied that the buck should stop here, Madam Justice

Martin's dissent opens the door to a compelling opportunity for Parliament to resolve the debate, and for an appeal to be made to the Supreme Court of Canada. Until then, an industry still regaining its optimism from stabilizing commodity prices and growing transaction levels after having slashed costs and employees to survive the last 2.5 years, must now brace for anticipated additional economic pressure to fund the work necessary to abandon, reclaim and remediate the wells of others no longer capable of funding their share. We expect that any uncertainty created by the appeal of the lower court's decision regarding the treatment of uneconomic wells in an insolvency will dissipate, while the number of wells renounced by Trustees could increase dramatically.

Regulation of the oil and gas industry requires a careful balance of the competing interests, rights and obligations of numerous stakeholders. Achieving that balance just got more difficult as sharing the risk of development now takes on a new meaning.

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[1] *Oil and Gas Conservation Act*, RSA 2000 c. O-6.

[2] *Pipeline Act*, RSA 2000, c. P-15.

[3] *Bankruptcy and Insolvency Act*, RSC 1985 c. B-3.

[4] *Newfoundland and Labrador v AbitibiBowater Inc.*, 2012 SCC 67.