Will the Redwater Decision Encourage Reckless Abandon(ment) of Oil and Gas Wells in Alberta?

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On May 19, 2016, the Alberta Court of Queen's Bench released its decision in *Redwater Energy Corporation (Re)*.[1] The issues at hand were whether the receiver and trustee is required to take possession and control of all licensed assets of a company and fulfil provincial statutory obligations to abandon, reclaim and remediate same. The Court also considered whether the Alberta Energy Regulator (AER) can refuse applications to transfer licenses of the retained assets by relying on the provincial regime in the bankruptcy context. The Court held that proceeds from the sale of assets will prioritize secured creditors over cleaning up the company's abandoned oil and gas wells.

The Court applied the doctrine of paramountcy and found that certain trustee obligations set out in Alberta's *Oil and Gas Conservation Act*[2] and *Pipeline Act*[3] operationally conflicted with or frustrated the purposes of Canada's *Bankruptcy and Insolvency Act*.[4] Accordingly, the BIA prevailed where provincial and federal laws conflicted.

The Court held that so long as a trustee renounces or disclaims the affected property in accordance with the BIA provisions, AER cannot impose on the trustee the obligation to remediate the renounced property by either performance or posting security for the reclamation obligation.

While the decision provides transactional certainty for oil and gas lenders, it increases the risk that more abandoned wells in Alberta will end up being the responsibility of the Orphan Well Association (OWA), and will ultimately fall on industry and tax payers.

On May 27, 2016, AER and OWA filed notices of appeal to Alberta's Court of Appeal.

Background

In May 2015, junior energy producer Redwater Energy Corporation's (Redwater) filed for bankruptcy. Grant Thornton Limited (GTL), Redwater's court appointed receiver and bankruptcy trustee, took possession of some Redwater oil and gas properties, and renounced others as having little or no value. In insolvency proceedings, a receiver typically formulates a process to sell an insolvent entity's assets to satisfy debt obligations to creditors. GTL assessed the economic marketability of Redwater's assets and chose to take possession of only producing licensed assets, including wells, facilities and pipelines. GTL renounced any interest in the remaining non-producing licensed assets pursuant to section 14.06(4) of the BIA.

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1 2016 ABQB 278 [*Redwater*].
2 RSA 2000, c O-6 (OGCA).
3 RSA 2000, c P-15 (PA).
4 RSC 1985, c B-3 (BIA).

The renounced assets, including about 70 non-operative wells, had outstanding and unfunded environmental and abandonment liability estimated at over $5 million. GTL compared deemed values and associated deemed liabilities and reasoned that the negative value, lack of possibility of future production, and the significant liabilities of the renounced assets meant that including such assets would compromise the sales process. GTL planned to exclude the renounced properties from the receivership assets, effectively releasing both GTL and the Redwater estate from having to fund remediation and abandonment costs for the renounced properties.

AER had issued abandonment orders for some of the wells. It argued that the sale should not advance unless proceeds went first to decommissioning all Redwater licensed properties. AER and OWA[5] relied on obligations imposed by AER's closure and abandonment orders and provincial legislation to advance its application. AER took issue with GTL's decision to pick and choose realizable property from Redwater assets.

GTL argued that AER's position on its claims would create a super priority ranking before all other claims. GTL sought court approval of Redwater's asset sales process.

Licensee Liability Rating Program

Alberta operates a Licensee Liability Rating Program[6] (LLR) to ensure that energy companies or the Province has sufficient funds to pay for abandoned wells. A company is required to pay a security deposit to AER where its Liability Management Rating (LMR) is below 1.[7]

In *Redwater*, AER claimed that GTL must post security, abandon and reclaim some licensed properties and/or transfer some of the licensed property liabilities to ensure the LMR was above 1. GTL and the Alberta Treasury Branches, Redwater's principal secured lender, argued that the money had to be used to remit receivership fees and Redwater's debts as prescribed by the BIA.

Paramountcy Argument

GTL relied on the doctrine of paramountcy to assert that it could not effectively comply with both section 14.06 of the BIA and the obligations and resulting personal liability arising from provincial legislation in deeming a trustee as "licensee".[8] GTL argued that the provincial legislation conflicts with or in the alternative frustrates the purpose of the BIA, which offers an option to renounce and protects from exposure to personal liability.

The doctrine of paramountcy establishes that where there is a conflict between valid provincial and federal laws, the federal law will prevail and the provincial law will be inoperative to the extent that it conflicts with the federal law. Paramountcy applies:

- where there is an operational conflict and it is impossible to abide by both laws, or
- if dual compliance is possible, where the operation of the provincial law frustrates the purpose of the federal law.

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5 AER, the regulator of all upstream oil and gas activities in Alberta, oversees OWA. OWA is funded by the energy industry and is responsible for cleaning up orphaned wells that have no owners.

6 AER *Directive 006* and *Directive 011*.

7 This LMR is calculated as the ratio of a company's "eligible deemed" assets under certain programs over the "deemed liabilities" in these programs.

8 "Licensee" is defined in both s 1(1) of the OGCA and s 1(1) of the PA to include a trustee or receiver-manager of the property of a licensee.

While the paramountcy test has two parts, a finding of operational conflict concludes the paramountcy inquiry. The party seeking relief from a provincial law is thus released from the burden of proving that the law frustrates the purpose of the federal law.

The Court recognized the inherent conflict:

> [O]n the one hand the BIA allows the Trustee to renounce and not be liable for the costs of abandonment remediation and reclamation, but on the other hand the Trustee remains liable for the same obligations under the provincial legislation.[9]

The Court concluded that dual compliance with both federal and provincial regimes was impossible and that the BIA prevailed where there was conflict. The upshot was that GTL could renounce certain assets in the insolvency process, even if doing so left reclamation and abandonment obligations on outstanding and unfunded assets.

The Court also considered the second branch of the paramountcy test. The Court first applied the principles set out in *AbitibiBowater*[10] and subsequent cases to find that the abandonment orders constituted provable claims within the meaning of the BIA and subject to federal insolvency legislation. Thus, AER ranked as an unsecured creditor.

The Court found that the provincial regulatory scheme frustrated the purposes of the BIA in the following instances:

- the definition of "licensee" pursuant to the OGCA and PA and the resulting requirement to pay security deposits and comply with the abandonment orders created a super-priority and frustrated the distribution scheme set out in the BIA

- prohibiting the renouncement of certain assets created the potential for personal liability for receivers and trustees, an effect precluded by section 14.06 of the BIA

- requiring compliance with the abandonment orders or payment of security deposits in order for AER to approve license transfer applications frustrated the legislative purpose of section 14.06 of the BIA, which permits renouncing non-producing assets.

Implications of the Redwater decision

If energy prices and profits remain low, junior energy companies facing bankruptcy may choose to abandon worthless oil and gas wells. The result may be an even greater number of renounced and orphaned wells.

In addition to funding their own well abandonment and remediation costs, Alberta energy producers pay orphan fund levies to OWA for orphan well costs. Allowing a receiver to "cherry pick" among an insolvent producer's assets will push obligations and liability to OWA. Ultimately, the oil and gas industry would be on the hook for unfunded well abandonment costs that a producer fails to carry out.

On May 27, 2016, AER and OWA filed notices of appeal to Alberta's Court of Appeal. AER warns that it can also pursue directors and officers of the insolvent companies.

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[9] *Redwater* at para 151.

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

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