June 17, 2016

The Power of a Trustee in Bankruptcy to Disclaim Unproductive Oil and Gas Properties and the Implications for the AER's Liability Management Program

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Case Commented On: *Redwater Energy Corporation (Re)*, 2016 ABQB 278

In a much anticipated decision Chief Justice Neil Wittmann has concluded that there is an operational conflict between the abandonment and reclamation provisions of the province's *Oil and Gas Conservation Act*, RSA 2000, c O-6 (OGCA) and *Pipeline Act*, RSA 2000, c P-15 and the federal *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 (BIA). Thus, a trustee in bankruptcy is free to pick and choose from amongst the assets in the estate of the bankrupt by disclaiming unproductive oil and gas assets even where (and especially so) those assets are subject to abandonment orders from Alberta's oil and gas energy regulator, the Alberta Energy Regulator (AER). As a result, the value of the bankrupt's *productive* assets is preserved for the benefit of secured creditors. AER abandonment orders do not bind a trustee with respect to the disclaimed properties and do not constitute costs of administration of the bankrupt's estate. Since the trustee has no responsibility for disclaimed assets, the trustee should be in a position to transfer non-disclaimed producing assets to a third party purchaser without objection from the AER on the basis of any deterioration in the liability rating associated with the unsold non-producing assets. If either the AER or the Orphan Well Association (OWA) carries out the abandonment of the disclaimed assets such costs may constitute a provable claim in bankruptcy but, as a general creditor, the AER/OWA would likely only recover cents on the dollar.

The practical effect of this decision is that the AER's authority to enforce abandonment orders at the cost of the licensee is unenforceable at precisely the time when the AER most needs to be able to exercise that power i.e. when the licensee is insolvent. Furthermore, one of the AER's principal mechanisms to ensure that a licensee has assets on hand to cover its liabilities (its authority to withhold consent to the transfer of assets which result in the deterioration of a licensee's ability to discharge its obligations) is no longer available. Thus, the entire provincial scheme for protecting Albertans from the abandonment costs in relation to non-productive wells is seriously compromised, and, as a result, in the case of a bankrupt licensee the costs of abandonment will necessarily be assumed by the Orphan Well Fund or the province. If the costs are assumed by the Fund this means that the industry as a whole bears the burden; if the costs are assumed by the province (perhaps by a cash infusion into the Fund) this means that all Alberta taxpayers bear the burden of discharging these abandonment and reclamation obligations. While this result flies in the face of any conception of the polluter pays principle it is, according to Chief Justice Wittmann, the necessary result of the interpretation of the relevant statutes and the application of the constitutional doctrine of paramountcy.

Any effort to restore the pre-eminence of the polluter pays principle will require statutory amendments or changes in regulatory practice. The most obvious candidate for amendment is the BIA itself but this may well prove to be an immovable object given the desire to protect the

interests of secured creditors and to avoid a "third party pays" scenario. Any changes to provincial laws will have to be carefully crafted to remain onside the federal scheme. Much however might be achieved through changes in AER practice so as to prevent "producers" from carrying so many unproductive properties and inventories of suspended wells. Although this is akin to closing the stable door once the horse has already escaped given the number of companies likely facing financial difficulties as a result of low oil prices, it is still a task that needs to be undertaken on a go-forward basis. It will also be necessary to consider significant increases to the annual levy if the AER and the province are serious about making sure that the industry covers its costs.

The balance of this post proceeds as follows. The next section presents the AER's liability management regime and the following sections discuss the inconsistencies between the provincial regime and the BIA as identified by Chief Justice Wittmann.

The AER's Liability Management Regime

The AER maintains a liability management regime which is designed (at para 26) "to prevent costs associated with suspension, abandonment, remediation and reclamation of AER licensed properties (well, facility or pipeline) … from being borne by the public of Alberta should a licensee become defunct … [and] to minimize the risk to the Orphan Fund administered by the OWA [Orphan Well Association]." The regime is based on a number of AER Directives and the Oil and Gas Conservation Rules, Alta Reg 151/1971, Part 1.1 (OGCR); while the details are complex the underlying concepts are fairly straightforward. The basic proposition is that a licensee must maintain a positive liability management ratio (LMR) in relation to its assets. The LMR is the ratio of a licensee's deemed assets (e.g. producing wells) and its deemed liabilities (e.g. suspended wells). If a licensee's LMR falls below 1.0 the AER will require the licensee to post increased security to cover the difference. Similarly, if a licensee is proposing to transfer assets and the result of the transfer will reduce the LMR of either the transferor or the transferee below 1.0, the AER may require the relevant licensee to provide additional security before it will approve the transfer.

The AER may direct a licensee to abandon a well or facility in a number of circumstances and in particular may do so, as here, where "in the opinion of the Regulator the well or facility may constitute an environmental or a safety hazard" (OGCR s. 3.012). Where a licensee (or other working interest participants (WIPs) in the well) fail to do so the AER may carry out the abandonment itself or may declare the well or facility to be an orphan, at which point the OWA assumes responsibility for the abandonment and reclamation of the property. The financial resources available to the OWA include the Orphan Fund Levy funds (an annual levy on all licensees) and any security deposit made by that licensee.

There are a number of premises that underlie the efficacy of this scheme. The first is that the deeming rules that underlie the calculation of the ratio are realistic. To the extent that the deeming rules overestimate assets or underestimate actual liabilities then the assets on hand to cover liabilities will be inadequate. The AER's concerns in relation to this scheme led it to tighten the rules of the program significantly in 2013 with a roll out of the new rules over a three year period. The new rules *inter alia* increased the deemed costs and also reduced deemed revenues by shortening the period for averaging industry netbacks. These changes led to LMRs below 1.0 for some companies, which required them to make additional security payments. While these requirements undoubtedly increased the financial pressure on junior oil and gas

companies and may contribute to their insolvency, these tightened rules do provide some assurance with respect to the first premise, and as well shall see, also the second major premise.

The second premise is that the licensee's assets will actually be available to fund the licensee's abandonment and reclamation activities at the relevant time. The result of the decision in *Redwater* is that in the case of a bankruptcy, the assets will not be available or certainly not on a preferential basis. The assets will first be used to satisfy the rights of secured creditors. Thus the second major premise underlying the AER's liability management scheme is fundamentally flawed. The only assets that we can be assured will be available in an insolvency are those security deposits held by the AER.

The second major premise is flawed because the provincial rules that assume the availability of the assets are unconstitutional. They are unconstitutional because of an operational conflict with the BIA.

There is of course no doubt about the validity of the provincial laws that make up the AER's liability management scheme (see para 93). The question for present purposes is whether elements of those rules are inoperable by virtue of the doctrine of paramountcy. There are two branches of the paramountcy test. The Supreme Court of Canada put the test this way in *Alberta (Attorney General) v Maloney*, 2015 3 SCR 327, 2015 SCC 51, at para. 18:

> A conflict is said to arise in one of two situations, which form the two branches of the paramountcy test: (1) there is an operational conflict because it is impossible to comply with both laws, or (2) although it is possible to comply with both laws, the operation of the provincial law frustrates the purpose of the federal enactment.

In his judgement, Chief Justice Wittmann canvassed three possible conflicts. (1) Is there a conflict between the trustee's power to renounce and continuing liability under provincial legislation? (2) Is there a conflict between the distributional scheme mandated by the BIA and the allocation of resources required by provincial legislation? (3) Is there a conflict between the scheme of the BIA and the AER's rules and practices with respect to the approval of licence transfers?

Is there a conflict between the trustee's power to renounce and continuing liability under provincial legislation?

Section 14.06 of the BIA allows a trustee to renounce or disclaim any interest in real property that is affected by an environmental clean-up order. There is no similar opportunity to disclaim under the provincial legislation. A licensee has a continuing liability under the provincial rules and a licensee is defined to include "a trustee or receiver-manager of property of a licensee" (OGCA, s 1). Accordingly, there is an operational conflict between the BIA and the provincial statutes insofar as the trustee would remain liable notwithstanding its renouncement. Chief Justice Wittman summarized his conclusion as follows (at para 156):

> In the result, the Trustee is not a licensee of the renounced assets, ought not to be required to assume any liabilities, and is not bound by the Abandonment Orders relating to the renounced assets in seeking approval of the sales process to market and sell the assets remaining under its possession and control of. In other words, so long as the Trustee renounces the affected property in accordance with section 14.06(4), the AER cannot attempt to impose on the Trustee the obligation to

> remediate the renounced property by performance or posting security. In addition, the effect of section 1 of the *OGCA* and the *Pipeline Act* is to remove the benefits otherwise available in a renunciation and thus frustrates the purpose of section 14.06 of the *BIA*. Despite renouncing, a receiver would have to assume control of the remediation activities and incur the very risks that section 14.06 of the *BIA* is designed to avoid, which may lead to trustees refusing mandates where there are potential liabilities if they have to comply with abandonment orders.

Is there a conflict between the distributional scheme mandated by the BIA and the allocation of resources required by provincial legislation?

If given full effect, the provincial laws would require the trustee to carry out the abandonment operations in priority to satisfying the claims of secured creditors. In order to determine whether that gives rise to a conflict it is first necessary, as the majority of the Supreme Court of Canada put it in *Newfoundland and Labrador v AbitibiBowater Inc*, 2012 SCC 67 (CanLII) (at para 17), "to determine whether an environmental order [the abandonment order in this case] that is not framed in monetary terms is in fact a monetary claim." It is only if the order is a monetary claim that there is a conflict.

Justice Deschamps on *AbitibiBowater* suggested that the provisions of the BIA offered a three part test for determining whether an environmental order should be so treated (at para 26, emphasis in the original): "First, 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." Chief Justice Wittmann applied that test here, noting that both the AER and the OWA conceded (at para 164) that the first two elements of the test were satisfied.

As for the third element, the record was somewhat mixed. Indeed Chief Justice Wittmann suggested that "The answer is no in a narrow and technical sense, since it is unclear whether the AER will perform the work itself or if it will deem the properties subject to the orders, orphans. If so, the OWA will probably perform the work, although not necessarily within a definite timeframe." However he went on to conclude that the orders should be treated as monetary claims since:

> [173] ... the situation does meet, in my opinion, what was intended by the majority of the Court in *AbitibiBowater*. Compliance with the orders would require the Trustee and Receiver to expend funds by way of security that would be used to perform the abandonment work. The effect is that if the obligations to remediate property are fully complied with by the Trustee within this bankruptcy context, the claim of the Province for remediation costs will be given a super priority not provided for under section 14.06. 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 history of amendments to the *BIA* in this case shows that Parliament intended that the priority of creditors as provided under section 14.06, and thus the distribution of funds, ought not to be disturbed by provincial legislation. In the result, I find that although not expressed in monetary terms, the AER orders are in this case intrinsically financial.

> [174] In this case, the obligation to comply with the orders directly affects Redwater's estate. Indeed, the obligation to comply with the orders requires payment of or the posting of security for, the abandonment costs to the AER in priority to all other creditors. Those actions frustrate the primary purposes of the *BIA*. These costs are not a sanction of regulatory nature, but would have a direct effect on the scheme of distribution provided under the *BIA*.

It is worth observing that Chief Justice Wittmann has effectively concluded here that an abandonment order *ought* to be treated a monetary claim so as not to undermine the scheme of the BIA. It is very much an example of result-oriented or consequentialist reasoning.
Once it is determined that an order is a monetary claim, then it follows that the AER's efforts to enforce that claim in priority to the claims of secured creditors frustrates the scheme of s 14.06 of the BIA, both generally, as well as several of its specific provisions. At the general level Chief Justice Wittmann observed that Parliament had addressed its mind to the priority to be accorded to environmental orders. The specific provisions designed to give effect to that ordering of priority were inconsistent with the provincial rules. For example, s 14.06(6) provides that once a trustee has disclaimed property, any costs associated with remedying the condition of the disclaimed property cannot rank as costs of administration. Instead, Parliament had decided (s 14.06(7) & (8)) that the monetary claim of a provincial regulator such as AER/OWA would be entitled to security, but only as against the particular property and not more generally against the assets of the bankrupt.

Is there a conflict between the scheme of the BIA and the AER's rules and practices with respect to the approval of licence transfers?

It followed from the above that any scheme adopted by the AER which allowed it to continue to take into account disclaimed properties in deciding whether to consent to the transfer of licences is also inconsistent with and frustrates the purposes of the BIA. Such a scheme (at para 178):

> ... has a direct financial impact on all creditors. Under the guise of simply exercising its regulatory powers, the AER is ensuring that the polluter or its licensee will pay for the environmental damages, which is certainly a very important concern. In other words, if the property is found to include that which was renounced by the receiver, *Directive 006* still frustrates the purpose of section 14.06 of the *BIA* by including renounced assets in its calculation for determining the approval of a sale. The effect of section 14.06 is that renunciation is possible, with the purpose of protecting the trustee and receiver with the ultimate goal of equitable distribution, and as such, provincial legislation that interferes with this purpose amounts to frustration of intent.

Conclusion

The decision is under appeal. I understand that the parties have been able to secure a September date for a hearing in the Court of Appeal and it is reasonable therefore to think that we might have a decision by the end of the year. The AER and the OWA will face an uphill battle since they will need to succeed on all three of the adverse rulings outlined above. While Chief Justice Wittmann may have equivocated on the question of whether an abandonment order in Alberta is

a regulatory requirement or a monetary claim, and while his reasoning on that point may be open to question, success on this issue alone will not be enough to save the integrity of the AER's liability management scheme, which has clearly been badly compromised and needs an overhaul. And this time the overhaul should not be some behind-the-doors deal between the AER and representatives of the oil and gas industry but should be subject to rigorous public scrutiny.

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