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Lessons from *Redwater*: Discard the *AbitibiBowater* Test and Legislate Super Priority for the Regulator

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Case Commented On: *Orphan Well Association v Grant Thornton Ltd*, 2019 SCC 5 (CanLII)

Environmental cleanup costs are a natural consequence of operating in the oil and gas industry. Provincial regulations ensure these costs are borne by the company responsible for them, and these regulations work if that company is solvent. An insolvent company, however, cannot bear the costs of outstanding environmental orders, which leaves those costs to the company's creditors or to the public.

The goal should be, and fairness dictates, that the debtor always covers the cost, regardless of its solvency, but that requires amending the governing legislation, preferably to give the regulator (in this case, the Alberta Energy Regulator (Regulator), and the equivalent regulators in other provinces) a super priority. Knowing the Regulator has a super priority in a bankruptcy will compel the adjusting creditors to modify their agreements *ex ante*, ensuring, in turn, that companies comply with regulations and have enough capital to cover environmental costs as they arise. This solution is better than our current system, in which creditors must wait for a court to apply the three-part test from *Newfoundland and Labrador v AbitibiBowater Inc*, 2012 SCC 67 (CanLII) (*AbitibiBowater* test) to determine who has priority, potentially leaving them to deal with the consequences *ex post*.

On a matter this important and this costly, a matter that has notable public policy considerations and far-reaching implications for private parties, both sufficient environmental protection as well as certainty in adherence to the legislated priorities, must be the ultimate goals. The *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 ("BIA") does not currently provide enough environmental protection, which may compel courts to compensate through the *AbitibiBowater* test. It is hard to predict the outcome of the test and, depending on its application to a given set of facts, it undermines the BIA priority scheme. Throughout the proceedings of *Orphan Well Association v Grant Thornton Ltd*, 2019 SCC 5 (CanLII) (commonly known as the *Redwater* case), in three levels of court, there were five judgments. Eleven judges applied the same test and six of them ruled in favour of the Regulator, while five ruled in favor of the secured creditor. This much disagreement over one set of facts should indicate that these issues should not be handled by the courts through the application of the *AbitibiBowater* test. The required certainty in this area must come from Parliament by way of legislative amendment to clarify a super priority charge in favour of the Regulator in the BIA.

Facts

Redwater Energy Corporation was a publicly traded oil and gas company. It carried oil and gas licenses granted by the Alberta Energy Regulator. In 2013, Alberta Treasury Branches (ATB) advanced funding to Redwater, and in return, took a security interest in Redwater's present and after-acquired property. Redwater started to experience financial difficulty in 2014. In 2015, ATB appointed a receiver, Grant Thornton Limited (GTL), for Redwater. At the time of the appointment, Redwater owed ATB approximately $5.1 million.

At the time of GTL's appointment, Redwater had licensed assets (comprising of wells, facilities and pipelines), some that were revenue producing, and some, not. The value of its non-producing assets was higher than the value of its valuable assets. Under the provincial regulations, Redwater was required to "abandon" its non-producing assets, which meant it needed to render them environmentally safe.

After GTL determined it could not meet the Regulator's requirements, as the cost needed to abandon Redwater's spent wells would likely have exceeded the sale proceeds for the productive wells (para 50), it disclaimed ownership of the non-revenue producing assets. This meant GTL walked away from Redwater's end-of-life obligations for the non-valuable assets and attempted to sell its valuable assets separately. However, the Regulator maintained that, in spite of the receivership, GTL needed to fulfill the regulatory obligations before it distributed funds from the estate to any of the creditors.

Redwater went into bankruptcy and GTL was appointed as trustee. The legal proceedings that ensued focused on the interaction between the provincial regulatory requirements and the distribution scheme in the BIA. The Supreme Court of Canada (SCC) considered how these end-of-life obligations are resolved when the trustee is distributing the bankrupt's assets among its creditors.

The issues were two-fold. First, the Court considered whether there is a conflict between the Alberta regulatory scheme and section14.06 of the BIA. Second, it considered whether the Regulator is asserting claims provable in bankruptcy.

Applicable Legislation

Liability of trustee

GTL disclaimed the non-revenue producing assets in order to sell the valuable assets separately. The provincial *Oil and Gas Conservation Act*, RSA 2000, c O-6 and the *Pipeline Act*, RSA 2000, c P-15, do not recognize that disclaimer as enforceable, and require the licensee to fulfill its abandonment obligation or face liability. In the provincial legislation, the definition of "licensee" includes a receiver and a trustee, meaning the provincial legislation subjects GTL to the same liabilities as Redwater.

Under section14.06(4) of the BIA, a trustee is not personally liable for failing to comply with an environmental order that affects property involved in the bankruptcy if the trustee had abandoned or disclaimed any interest in the property before the order was made. Under section14.06(2) of the BIA, a trustee is also not personally liable for any environmental condition that occurred before the trustee's appointment, or after, unless the condition occurred as a result of the trustee's gross negligence or willful misconduct. Neither provision mentions the liability of the bankrupt.

Distribution scheme

The provincial legislation requires GTL to satisfy Redwater's environmental obligations before any other creditor. However, upon bankruptcy, every creditor, except secured creditors, is stayed, meaning creditors cannot pursue remedies or commence any action against the bankrupt or the bankrupt's property (BIA, s 69.3). Once the trustee realizes the proceeds from the bankrupt's estate, he must pay creditors according to the priority scheme set out in section136 of the BIA. Pursuant to section 121(1) of the BIA, all debts and liabilities to which the bankrupt is subject are deemed to be "claims provable" under the BIA and the trustee must determine whether a contingent claim is a provable one (ss 121(2) & 135(1)).

If the order is a "provable claim", a conflict arises between federal and provincial law, and the federal law will prevail under the doctrine of federal paramountcy. The result casts the Regulator as an unsecured creditor, subjecting it to the stay imposed in bankruptcy proceedings and slotting it into the BIA priority scheme. If the order is not a provable claim, the two schemes can continue operating together, meaning the Regulator can enforce the order during the bankruptcy. Since the latter finding requires the trustee in bankruptcy to use the assets of the estate to pay for the remediation work, that finding effectively gives the Regulator a super priority, meaning a priority over every other creditor.

Determining whether the regulatory order is a provable claim requires the courts to apply the *AbitibiBowater* test. The BIA does not give super priority to environmental orders, and yet, if the regulatory order is not a provable claim upon the application of the *AbitibiBowater* test, that result arises.

SCC Majority Decision

Effect of disclaimer on the bankrupt

The majority decision found that the BIA and provincial regulations could co-exist harmoniously. Under the BIA, the trustee is not personally liable upon disclaimer, but the bankrupt remains liable. This means the trustee is not entitled to walk away from obligations with regard to disclaimed assets.

Under the provincial regulations, a "licensee", which includes the trustee, can be required to satisfy all its environmental liabilities.

The operation of both schemes together allow the trustee, a "licensee" under the provincial legislation, to expend estate assets on the bankrupt estate's environmental liabilities.

Provable claim in bankruptcy

To determine whether the environmental liabilities were "claims provable in bankruptcy", the SCC applied a three-part test outlined in *AbitibiBowater*. Finding a "claim provable in bankruptcy" requires meeting all three parts. The test is:

> 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. (emphasis in original at para 26).

Under the first step, the majority determined that the Regulator was not a creditor of Redwater, rather, it was, "a regulator exercising a power to enforce a public duty" (para 124). Relying on *Panamericana de Bienes y Servicios SA v. Northern Badger Oil & Gas Ltd*, 1991 ABCA 181 (CanLII), the Court concluded that payment of the environmental obligation did not benefit the Regulator financially. Rather, the Regulator's goal was to have the environmental work performed for the benefit of third-party landowners and the public. As the duties were owed to citizens, not to a creditor (para 135), the Regulator was not recovering a debt (para 128).

The court went on to analyze step three, even though it was not necessary given its findings on the step one. Step three requires that a contingent debt or liability owed by a bankrupt to the creditor must be sufficiently certain, as in, capable of valuation, in order to constitute a provable claim (para 138). There were two contingent debts or liabilities here – the abandonment of the assets and the conditions imposed before the Regulator would approve the transfer of the licenses. Neither were not found to be sufficiently certain in value, nor was it sufficiently certain that the Regulator would perform the abandonments and advance a claim for reimbursements, such that the third step could be met.

Having found that the Regulator was not a creditor, the majority concluded that Redwater must comply with its obligations arising under provincial law. These obligations were not provable claims, and as such, did not conflict with the BIA, regardless of the consequences that would inevitably arise for the secured creditors (para 160).

SCC Dissenting Judgment

Effect of disclaimer on the bankrupt

The dissent took a different view of section14.06 of the BIA. It agreed that the BIA relieves the trustee of personal liability for disclaimed assets, but it went further than the majority by finding that the provision also relieves the bankrupt company of the liabilities. Finding that the purpose of this provision is to allow the trustee to dispose of assets that work against maximizing the value of the estate, it follows that the trustee can walk away from the asset and the associated liabilities after disclaimer (para 196). Under provincial law, the matter is entirely different. Provincially, receivers and trustees are liable as "licensees" in relation to distressed assets (para 227), meaning GTL's disclaimer of its non-revenue producing assets did not mean it was relieved of the associated environmental liabilities. Given the operational conflict between the provincial legislation and the BIA, the doctrine of paramountcy applied, rendering the provincial legislation unenforceable.

Provable claim in bankruptcy

Following the majority's reasoning, the dissent also analyzed steps one and three of the *AbitibiBowater* test. With regard to step one, the dissent found that the Regulator was a creditor because it had exercised its enforcement power against the debtor (para 238). Acting in the public interest, which, arguably, will always be the case for regulators, did not necessarily negate the Regulator's position as a creditor (para 248). On the third prong, the dissent found it was sufficiently certain that the Regulator would ultimately perform the abandonment work and assert a monetary claim for reimbursement (para 255).

Analysis

Problems with current structure and legal test & Solution to these problems

When there are environmental orders against an insolvent company, two problems arise under the current legislative schemes. First, the legislation does not provide for enough environmental protection if the company goes bankrupt. Second, the BIA distribution scheme is subject to change depending on the courts' application of the *AbitibiBowater* test, leading to much uncertainty as to who pays for the remediation costs. Both problems are discussed below.

The first problem is that the environmental protections in the BIA do not go far enough. The BIA gives the Regulator a secured charge on contaminated real property and other related property (BIA, s 14.06(7)) and a provable claim for the costs of remedying environmental damage on real property (BIA, s 14.06(8)). A secured charge on contaminated real property does not matter if the contaminated property is without value. And a provable claim for the costs of remedying the environmental condition is an unsecured claim, meaning very little, if anything, will be left to the Regulator under section14.06(8) of the BIA. The Court of Appeal judgment (*Orphan Well Association v Grant Thornton Limited*, 2017 ABCA 124 (CanLII) at para 56) commented on the current protections:

> Section 14.06(7) will rarely, if ever, have any practical application to oil and gas wells. If a government (directly, or through an agency like the Orphan Well Association) remediates an abandoned well, there is usually nothing of value left. The oil well itself is cemented-in at various underground formations, and becomes nothing more than a plugged hole in the ground. The well is shut-in at the surface, and the surface remediated. At that point the surface rights terminate, and there is no property interest of value left. Thus, the security interest created by s. 14.06(7) is of no real value, subject to two possible exceptions. It is possible that in the future someone might drill a new well, parallel to the shut-in well, and again seek to exploit the oil and gas deposit. This assumes, however, that the deposit has not been depleted, but that it has insufficient present economic value to be marketable by the trustee, assumptions that have no air of reality to them. The second

possible exception is that the security interest created by s. 14.06(7) also attaches to “contiguous” properties with value.

The second problem is that the *AbitibiBowater* test is uncertain. Courts agree on the test itself but there is little agreement on how it applies to the facts. As Anna Lund says, “[a]ssessing whether or not a regulatory claim is provable is an unpredictable and fact-specific enterprise” (A Lund, “Lousy Dentists, Bad Drivers, and Abandoned Oil Wells: A New Approach to Reconciling Provincial Regulatory Regimes with Federal Insolvency Law”, 80 Sask L Rev 157 (2017) at 165 (Lund)).

In addition to the uncertainty over how the test will play out in any given set of facts, the outcomes of different applications are vastly different, with notable consequences on the parties. One application of the test pays the Regulator first, out of the assets of the estate; the other application pays the Regulator near the end, when the assets have been depleted. It is not good law when an unpredictable test leads to these types of consequences. One only has to look at the different applications and interpretations by the majority and dissenting judgments in this case alone to see the problems arising from applying the test.

When it comes to environmental protection, an insolvency scheme must have two goals. First, there must be enough environmental protection in bankruptcy to cover the cost of environmental remediation work. Second, the scheme must be certain and predictable, as in, the priorities for which the creditors bargained, which are the legislated priorities, must be preserved.

The system we currently have achieves neither of those goals. The legislation, as it is currently drafted, does not provide enough protection for the costs of environmental remediation work. In fact, the lack of sufficient protections in the BIA may have been the reason the majority decision interpreted the *AbitibiBowater* test to give the Regulator super priority over the assets of the estate. The dissent argued that the majority’s decision had been made on the basis of policy, not law, choosing as it did to avoid leaving the public with the cost of remediation (para 289). The dissent went on to note that, while these are compelling policy reasons, policy is not a reason to disrupt the legislated priority scheme in the BIA, and that these problems must be resolved by the legislature, not the courts (para 290). While we do not know whether policy determined the majority’s position, we do know that policy weighed heavily in this decision and that a finding against the Regulator would have left the public bearing the costs for environmental remediation. Regardless, the lesson from this is that failure to meet the first goal will likely lead to a failure to meet the second. Without proper environmental protections, courts may compensate by applying the *AbitibiBowater* test in favour of the Regulator, disrupting the legislated priorities and undermining the collective scheme that binds all creditors in a bankruptcy.

Allowing the Regulator to take first from the assets of the estate would meet the environmental protection goal, and, as there would be no need to resort to the *AbitibiBowater* test if the Regulator’s priority is legislated, creditors would go into a bankruptcy knowing the priority scheme would be upheld. That way, rather than have their priority unexpectedly subverted in favour of the Regulator *ex post*, they can bargain for protection *ex ante*.

Certainty and predictability are the goals of every market economy, as without them, the economy stagnates. Fundamental to business transactions is the knowledge that parties' legal rights and obligations will be preserved, and when the outcome of transactions becomes unpredictable, parties do not transact. In this case, the secured creditors bargained with the debtor for a priority position and structured their dealings on that basis, but they ended up bearing a significant cost by losing that priority.

The problem with super priority is that it typically elicits a negative reaction, as many understand it to establish a "third-party-pay" system, rather than one in which the polluter pays. In other words, super priority for the Regulator is seen as transferring the cost of remediation from the debtor to the creditors. The SCC understood this to be the case in *AbitibiBowater*, where Justice Marie Dechamps maintained (para 40):

> Moreover, full compliance with orders that are found to be monetary in nature would shift the costs of remediation to third-party creditors, including involuntary creditors, such as those whose claims lie in tort or in the law of extra-contractual liability. In the insolvency context, the Province's position would result not only in a super-priority, but in the acceptance of a "third-party-pay" principle in place of the polluter-pay principle.

This argument is based on an erroneous premise, as it fails to take into account the effect of super priority on the parties' behavior well before insolvency. Super priority internalizes the cost of environmental cleanup by the debtor by altering its behavior throughout its operations. By knowing about the Regulator's super priority position *ex ante*, secured creditors will be more particular about lending money and if they do lend, they will ensure their lending agreements have the appropriate protections. Debtors will be required to show they are able to bear the costs of environmental remediation before the secured lenders extend credit, and, once credit is extended, creditors can ensure debtors operate responsibly and clean up as they go by monitoring the debtor's activities. In other words, bargaining for the ability to oversee and monitor the debtor's operations will allow secured lenders to police the debtor to ensure it adheres to environmental regulations. If the increased policing results in the debtor running an environmentally clean operation, it will result in positive externalities, as in, all the creditors will benefit, not just the secured creditors. And if the debtor does become insolvent, the monitoring will continue to lead to positive externalities. It will have ensured the debtor enters insolvency with less buildup of environmental costs, and, given that insolvency is a time during which debtors are more likely to engage in risky behavior, the monitoring will allow the secured creditors to act faster, before the liabilities skyrocket.

The *AbitibiBowater* test creates much uncertainty in these cases, as its application can lead to vastly different consequences for creditors. As Anna Lund aptly says, after analyzing how various decisions have applied the *AbitibiBowater* test, "[a] small factual difference resulted in completely opposite legal outcomes, a state of affairs that creates uncertainty" (Lund at 166). The uncertainty as to whether the secured creditors are paid before or after the Regulator, combined with the significant amount of money it costs to fulfill environmental remediation orders, means it is an area desperately in need of change. That change should come in the form of imposing super priority for the environmental orders. The idea of super priority is not new; it has been suggested before (see, for example, Alexander Clarkson, “In the Red: Towards a Complete Regime for Cleaning up Environmental Messes in the Face of Bankruptcy”, 69 UT Fac L Rev 31 (2011)). We should seriously consider it now.

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