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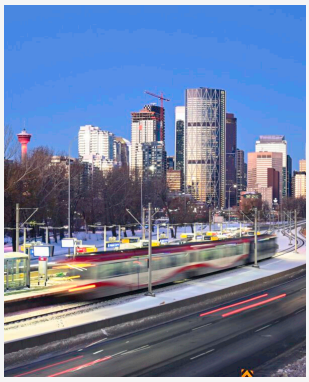
Joint operations and insolvent operators: Change of operatorship during a receivership



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Background

On February 21, 2018, the Alberta Court of Queen's Bench released its decision in *Firenze Energy Ltd. v. Scollard Energy Ltd.*, 2018 ABQB 126 (*Scollard*)[1]. This case considered the effect of an operator's formal insolvency proceedings (and the stay that typically arises in such proceedings) on the non-operating working interest owners' rights under the relevant joint operating agreement to assume operatorship, or appoint a new operator.

The Court's decision in *Scollard* follows in a long, though somewhat sparse, line of cases considering the contractual rights granted to non-operators under the CAPL Operating Agreement to replace the operator upon its insolvency – the most recent such case being the 2016 decision of Justice Macleod in *Bank of Montreal v. Bumper Development Corp.*, 2016 ABQB 363 (*Bumper*). Importantly, *Scollard* differs from *Bumper* and the other cases which preceded it because, for the first time, the Court was asked to consider the lifting of the stay and the enforcement of sections 2.02 and 2.06 of the 2007 CAPL Operating Agreement (2007 CAPL) during a receivership, at a time when the receiver was still in possession of the assets and before the assets were sold.

Facts

Scollard Energy Ltd. (Scollard) and Firenze Energy Ltd. (Firenze) were party to a *Joint Operating, Farm-Out and Royalty Agreement* (the JOA), dated November 6, 2014, pursuant to which the parties jointly owned and operated various wells and facilities. The JOA incorporated the terms of the 2007 CAPL. Scollard was the operator of the jointly owned properties under the JOA.

On September 1, 2017, a Receivership Order was granted against Scollard. As is typical, the Receivership Order stayed the exercise of "all rights and remedies" against Scollard. Shortly thereafter, Firenze applied to the Alberta Court of Queen's Bench for an order lifting the stay to permit it to serve notice that it would replace Scollard as operator of the jointly owned assets pursuant to section 2.02A(a) of the 2007 CAPL. The receiver objected to the lifting of the stay on the basis that that such a step would seriously prejudice the Scollard estate and Scollard's creditors.

Immediate replacement of operator – insolvency

Section 2.02A(a) of the 2007 CAPL provides that the operator shall be replaced immediately after service of notice from any non-operator if the operator, among other things, becomes bankrupt or insolvent, is placed in receivership, or seeks debtor relief protection under the *Bankruptcy and Insolvency Act* or the *Companies' Creditors Arrangement Act*. Firenze asserted that pursuant to this section, it had the right to replace Scollard as operator due to Scollard's insolvency and asked the Court to lift the stay to permit it to serve the required notice. In advancing this position, Firenze relied on the Court's decision in *Bumper*.

The Court distinguished *Bumper* on its facts on the basis that, in *Bumper*, the receiver was no longer involved, and the contest was between two working interest owners (i.e., the purchaser of the operator's interest from the receiver, and the non-operating working interest owner). In contrast, Firenze's application in *Scollard* sought to lift the stay at a time when the receiver was in possession of the assets and prior to the assets being sold. Unlike in *Bumper*, the proposed lifting of the stay in *Scollard* directly impacted the estate of Scollard and the ability of the receiver to perform its duties under the Receivership Order – including the marketing and the sale of the affected assets.

After distinguishing *Bumper* on its facts, the Court considered whether Firenze met the test for a lifting of the stay based on the test articulated by the Court in *Alignvest Private Debt Ltd. v. Surefire Industries Ltd*., 2015 ABQB 148 (*Alignvest*) (i.e., the stay can be lifted where a party is likely to be materially prejudiced by the stay or it would be equitable to lift the stay on other grounds). Considering the foregoing test (and echoing the words of Justice Romaine in *Alignvest*), the Court held that the fact that Firenze was prevented from exercising a contractual right for which it had bargained (i.e., replacement of the operator where a receiver is appointed) was not a sufficient reason to lift the stay. Accordingly, the Court dismissed Firenze's application for a lifting of the stay in respect of section 2.02A(a) of the 2007 CAPL.

Given that Firenze's application was only to allow it to exercise its rights under section 2.02A(a) of the 2007 CAPL, this should have been the end of the matter. However, the Court went on – on its own motion – to make several other findings regarding section 2.02A(g) of the 2007 CAPL.

Immediate replacement of operator – assignment

Pursuant to section 2.02A(g) of the 2007 CAPL, replacement of the operator is automatic (once the required notice is provided) if the operator assigns or attempts to assign its general powers and responsibilities of supervision.

The Court in *Scollard* decided to lift the stay in respect of this provision to permit Firenze to serve the requisite notice on Scollard and replace Scollard as operator of those assets in which it held more than a 40% interest (see discussion below). In our view, the Court's holding on this point is curious because: (a) Firenze's application did not make any reference to this clause, (b) the parties did not argue the point, and (c) there was no evidence that the operator (or the receiver standing in its shoes) had "assigned or attempted to assign" the powers in respect of operatorship. Accordingly, the triggering event which would permit the exercise of 2.02A(g) had not occurred.

The Court appears to have come to this conclusion on the basis that it believed that the receiver was "marketing the operatorship" and that Scollard's working interests had been "marketed in a manner that suggests that the right of operatorship would flow to the

purchaser . . .” The Court concluded that the mere fact that the assets were being marketed for sale subject to all of the contractual rights and obligations which the debtor had was sufficient basis for concluding that the receiver was “attempting to assign” operatorship to a third party, thereby justifying the lifting of the stay so as to permit the enforcement of clauses 2.02A(g).

Based on the Court’s finding that the Receiver was assigning or attempting to assign Scollard’s interest merely by marketing the assets for sale, the Court then looked to section 2.06 of the 2007 CAPL for the process required to effect a change of operatorship when the operator is disposing of its working interest (other than to an affiliate) and wishes the purchaser to become the operator. Section 2.06 provides that, in such a scenario, the working interest owners have the right to vote on who will become operator, subject to (among other things), the right of the non-selling owner to become operator if there are only two joint owners and the non-selling owner holds more than a 40% working interest. Based on this language, the Court concluded that Firenze had the right to become operator of the assets in which it owned more than a 40% interest.

In our view, the Court’s holding on this point is curious. First, there was no evidence before the Court to suggest that the receiver was assigning or attempting to assign operatorship (which is the triggering event for the application of section 2.02A(g)). Second, prior to section 2.06 applying, the operator (or presumably the receiver in its shoes) must provide notice indicating its intention to resign because of a disposition of its interest. Here, no such notice had been issued as Firenze’s interest in the jointly owned assets had not been disposed of by the receiver – again, the triggering event under section 2.06. Nevertheless, the Court held that Firenze had the right to become operator under these sections of the 2007 CAPL and lifted the stay to permit Firenze to serve the requisite notice under these sections.

Going forward

While (in our view), the Court’s holding in *Scollard* is curious, it does provide authority for future non-operating working interest owners who are faced with operators being placed into receivership and who wish to take over operatorship. The case provides authority for the proposition that the marketing of the operator’s interests in jointly owned property triggers rights under 2.02A(g) and section 2.06 of the 2007 CAPL to permit non-operating working interest owners to effect immediate replacement of the operator.

For receivers and their counsel, in future similar cases (and assuming there is no intention to try and assign rights of operatorship to a third-party purchaser against the wishes of the non-operating working interest owners), the evidence filed on such an application should be very clear that: (1) the receiver is only marketing the operator’s interests in the property; (2) those interests include all of the contractual rights and obligations that the operator has under the applicable JOA and any other contracts to which the operator is a party; and (3) the receiver is not marketing or attempting to assign any rights that the operator does not have. It will be interesting to see in future cases what use is made of the decision in *Scollard* if the evidence is clear that the receiver has not (to use the language from the 2007 CAPL) “assigned or attempted to assign its general powers and responsibilities of supervision and management as operator” under the JOA to a third-party purchaser.

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[1] The authors were counsel to FTI Consulting Canada Inc. in its capacity as Court-appointed

Receiver of Scollard.