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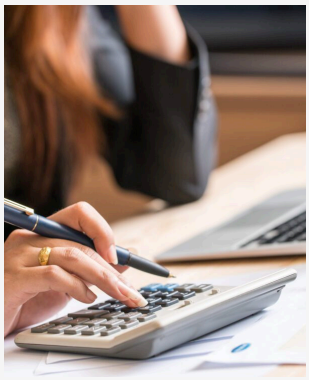
Sequoia Resources: Environmental obligations and the role of the trustee in bankruptcy



FEBRUARY 2, 2021 15 MIN READ

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On January 25, 2021, the Alberta Court of Appeal (the ABCA) released its reasons in *PricewaterhouseCoopers Inc. v Perpetual Energy Inc.,* 2021 ABCA 16 (*Perpetual Energy*). While the issue before the ABCA was of a preliminary nature — namely whether the claims of the trustee in bankruptcy (the Trustee) should be summarily dismissed or struck as not disclosing a cause of action — the legal principles considered by the ABCA extend far beyond the immediate parties and include broader questions around the nature and role of abandonment and reclamation obligations (AROs) after bankruptcy, the scope of a trustee in bankruptcy's duties to third parties, the duties of a director in respect of a company's environmental liabilities, and the scope of releases in favour of directors.

In particular, the ABCA considered (and in some cases, emphasized or determined) the following important issues:

- the nature of AROs, as set out by the Supreme Court of Canada in its 2019 decision in *Orphan Well Association v Grant Thornton Ltd*;[1]
- the ability of a trustee in bankruptcy to obtain status as a "complainant" and launch an oppression action[2] on behalf of the estate of a bankrupt corporation;
- the scope of directors' and officers' duties in respect of environmental obligations owed by a company, including whether directors and officers owe a duty to the public to ensure that a corporation complies with its environmental obligations;
- the scope of releases in sale transactions; and
- the scope of a trustee in bankruptcy's duties.

In the result, the ABCA determined that the case management judge's criticisms of the Trustee were entirely unwarranted. According to the ABCA, the claims raised by the Trustee were complex and, in some cases, raised novel issues, which did not permit for fair disposition on a summary basis. The ABCA accordingly allowed the Trustee's appeal, set aside the award of costs made by the case management judge against the Trustee, found that the award of costs made by the case management judge against the Trustee "in its personal capacity" was "inappropriate," and dismissed the appeal of Perpetual Energy Inc. (Perpetual Energy Parent), Susan Riddell Rose (Ms. Rose) and the other respondents.

Background

Perpetual Energy involved complex claims by the Trustee of Sequoia Resources Corp., formerly known as Perpetual Energy Operating Corp. (Perpetual/Sequoia), against a former director of Sequoia and certain other companies in the Perpetual Energy Group arising from a pre-bankruptcy multi-step transaction.

Transaction

In 2016, Perpetual Energy Parent entered into a multi-step transaction (the Aggregate Transaction) whereby certain mature legacy oil and gas assets, which had significant AROs associated with them, were sold to Kailas Capital Corp. (Kailas). The Aggregate Transaction was structured such that the legacy assets could be transferred without triggering a regulatory review process from the Alberta Energy Regulator (AER).

As part of the Aggregate Transaction, Perpetual Operating Trust, the holder of the legacy assets, initially transferred the beneficial interest in the assets to its trustee, Perpetual/Sequoia, which was then a member of the Perpetual Energy Group (the Asset Transaction). Then, Perpetual Energy Parent sold all of its shares in Perpetual/Sequoia to a subsidiary of Kailas for $1.00, resulting in Kailas becoming the new parent corporation of Perpetual/Sequoia. As is common in sale transactions, Kailas and the sole director of Perpetual/Sequoia, Ms. Rose, signed a resignation and mutual release (the Release) pursuant to which Ms. Rose and Perpetual/Sequoia released each other from claims that they might otherwise be entitled to bring against the other.

Approximately 18 months after the Aggregate Transaction, Perpetual/Sequoia assigned itself into bankruptcy, and PricewaterhouseCoopers Inc. was appointed as Trustee.

Dispute

Following its appointment, the Trustee reviewed Perpetual/Sequoia's affairs and concluded that the Asset Transaction was not in the best interests of Perpetual/Sequoia. In particular, the Trustee alleged that Perpetual/Sequoia obtained only $5.67 million in value for the assets but assumed more than $223 million in obligations, including AROs.

The Trustee commenced litigation against Perpetual Energy Parent, Ms. Rose and other members of the Perpetual Energy Group, alleging that

- the Asset Transaction was void under Section 96(1)(b) of the *Bankruptcy and Insolvency Act*[3] (the BIA), because it was not at arm's length, was within five years of the bankruptcy and was at an undervalue (the Section 96 Claim);
- the business of the corporation had been operated in an oppressive manner, contrary to the provisions of the *Business Corporations Act* (Alberta) (the Oppression Claim);
- the Aggregate Transaction was contrary to public policy, was illegal or otherwise was in violation of equitable principles; and
- Ms. Rose had breached her duties as the sole director of Perpetual/Sequoia.

Both the Trustee and the defendants applied for summary judgment of the claims.

Summary judgment decisions

The case management judge struck or summarily dismissed most of the Trustee's claims. In particular, the Oppression Claim was struck for failure to disclose a cause of action, because the Trustee was not a "proper person" to be a "complainant" pursuant to the *Business Corporations Act* (Alberta), or alternatively because the oppression claim lacked merit. The claim against Ms. Rose was struck for failure to disclose a cause of action, and it was also summarily dismissed on the basis that the Release was a complete defence.

Subsequently, the case management judge ruled that the Trustee should pay 85% of Ms. Rose's solicitor and client costs, and that the Trustee should be personally liable for those costs. In his costs judgment, the case management judge set out several new duties that he found the Trustee owed to Ms. Rose (which duties he found the Trustee had breached), including that the Trustee owed a duty of procedural fairness to Ms. Rose in the course of conducting its investigations.

The Trustee and the Perpetual Energy defendants both appealed the summary judgment decisions, and the Trustee also appealed the costs award.

Result

The ABCA:

- allowed the Trustee's appeal, restoring the corporate oppression and public policy claims and granting the Trustee complainant status to pursue the corporate oppression claim if it so elected;
- dismissed the Perpetual Energy defendants' cross-appeal; and
- allowed the Trustee's appeal with respect to the ruling on costs and found that the case management judge's criticisms of the Trustee were "unwarranted."

Analysis

Nature of AROs

Central to these decisions was the SCC's decision in *Redwater,* which confirmed that the AER was not a "creditor" with respect to AROs and that AROs were not "claims provable in bankruptcy." In reliance on this proposition, the case management judge determined that AROs were "assumptions and speculations" that did not exist, were not obligations of Perpetual/Sequoia, and therefore should be valued as "nil" on Perpetual/Sequoia's balance sheet.

Rejecting the case management judge's interpretation of *Redwater*, the ABCA noted that AROs may not be current liabilities or obligations of a company, but are nevertheless real liabilities. While such obligations may be contingent in the sense that the moment that production will cease and such obligations come into existence may be uncertain, they are not contingent in the sense that they will only come into existence upon the occurrence of a defined condition precedent. The existence of AROs is a certainty, as their coming into existence is inevitable.

As a result of this analysis, the ABCA noted that while AROs may not be conventional "debt," they are an obligation of oil and gas companies "owed to the public" and surface landowners

that the trustee in bankruptcy cannot ignore. AROs operate in the insolvency context by depressing the value of the assets and, as the SCC held in *Redwater*, are obligations that must be "discharged even in priority to paying secured creditors."

The ABCA's conclusions regarding the nature of AROs had a significant impact on the result reached by the Court:

- First, the ABCA noted that as AROs depress the value of the assets, they could have an impact on whether there is a transaction at "undervalue," so as to open the door for the Trustee to argue that the Asset Transaction was void under section 96 of the BIA. Importantly, in determining that the Section 96 Claim should be restored, the ABCA noted that the proper focus of the analysis under section 96 of the BIA was on the Asset Transaction (i.e., one step in the overall transaction), not the Aggregate Transaction (i.e., the entire multi-step transaction). Accordingly, each component of a multi-step transaction must meet statutory requirements and is separately open to challenge as a transaction at undervalue.
- Second, the ABCA noted that, contrary to the holding of the case management judge, AROs may be relevant to an oppression claim brought by the Trustee on behalf of creditors even though such obligations are not directly associated with a "creditor." As AROs are real liabilities and obligations of oil and gas companies, it is possible that the directors and officers of a corporation might manage AROs in a manner that is unfairly prejudicial to the interests of creditors.
- Third, the ABCA disagreed with the case management judge that *Redwater* had the effect of extinguishing the Trustee's public policy claim because AROs are not corporate liabilities and the AER is not a "creditor." The ABCA noted that, in fact, *Redwater* held that the public is the beneficiary of the environmental obligations inherent in AROs and that in this sense the "public policy" was engaged by the Trustee. The ABCA left open the question of the exact scope and enforceability of the public interest but concluded that the Trustee's public policy claim should not have been struck.

The ABCA's determination that AROs are real obligations and liabilities of oil and gas companies in Alberta accords with common understandings of the term in Alberta and with what the ABCA found to be common practice amongst many oil and gas companies to report such obligations on their balance sheets. The decision resolves what has been criticized as the "absurd" interpretation of AROs reached by the case management judge, which has been noted as "open[ing] the door to interpretations where general laws become meaningless and only debts owed to creditors count"[4] — a result expressly rejected by the SCC in *Redwater*. The ABCA's decision resolves the apparent disjunction between, on the one hand, the "polluter pays" principle endorsed by the SCC in *Redwater* and, on the other hand, the case management judge's application of *Redwater* in a manner that permitted the Perpetual Energy Parent to take the benefit of oil and gas assets while producing, and then shed associated AROs when no longer economically viable.

While simply a byproduct of the ABCA's decision, the result reached by the ABCA establishes a thread of consistency between the courts and the AER to create greater accountability for environmental protection and remediation by those who choose to participate in Alberta's oil and gas industry. View information on the latest steps taken by the AER to implement its new Liability Management Framework.

The status of the Trustee in advancing oppression claims

In declining to grant the Trustee status as a "complainant," the ABCA held that the case management judge failed to appreciate the collective nature of the role of the trustee in bankruptcy. The Trustee was not purporting to bring the oppression action on behalf of individual creditors, but on behalf of the entire estate of Perpetual/Sequoia. As the ABCA noted, by definition, the Trustee represents all creditors of the bankrupt, and the aggregate claims in a bankruptcy always consist of a number of individual claims.

Importantly, the ABCA confirmed prior jurisprudence establishing that oppression claims are not to be used as a method of debt collection; the mere fact that a corporation does not or cannot pay its debts as they come due does not amount to oppression. However, as the ABCA clarified, the Trustee was not asserting that Perpetual/Sequoia could not simply pay a debt. The Trustee's allegation was that Perpetual/Sequoia had been reorganized in such a way that it had been rendered unable to pay its debts. The Trustee alleged that the Asset Transaction was unfairly prejudicial to the creditors of Perpetual/Sequoia.

Whether the Trustee will be able to prove this claim remains to be seen, but the ABCA held that the oppression claim ought not to have been summarily dismissed. Noting the complexity of the issues raised by the Trustee, the ABCA determined that the oppression claim should be restored and the Trustee granted complainant status to pursue such claim if it so wished.

The scope of directors' duties

Without deciding the issue, the ABCA highlighted that a director may potentially owe an obligation to ensure that the corporation complies with its environmental obligations. Such obligation is currently "potential" and "ill-defined," and could be owed to the public, not necessarily to the corporation exclusively. The ABCA emphasized that the Trustee sought to hold Ms. Rose to account for allegedly having structured the affairs of Perpetual/Sequoia in such a way that made it impossible for Perpetual/Sequoia to discharge its public obligations. This was a novel claim that should not have been resolved summarily.

The ABCA observed that generalized releases of directors (which are commonly used in change of control situations) may not cover a director's potential obligation regarding environmental liabilities. Since this obligation may be owed to the public, private parties may not be able to release a director from it.

The ABCA also emphasized that there is no change in a director's duties when a director is acting for a special purpose corporation or wholly owned subsidiary: a director must always act in the best interest of the corporation. As sole director, Ms. Rose was responsible for ensuring that the Asset Transaction was in the best interests of Perpetual/Sequoia: "if Ms. Rose did not agree that the instructions [from Perpetual Energy Parent] were in the best interests of Perpetual/Sequoia, her obligation was to resign." At this stage, it was inappropriate to strike or dismiss the Trustee's claim for breach of director's duties.

Finally, this decision suggests that directors and officers should take care to evaluate separately all steps involved in multi-step transactions, which are often used for tax planning purposes. Although it has long been accepted that a taxpayer can structure its affairs to reduce tax liability, that concept does not apply to Section 96 of the BIA. When addressing the Trustee's claim that the Asset Transaction was void pursuant to Section 96, the Perpetual Energy Group argued that the Asset Transaction should be analyzed only as a component of the overall Aggregate Transaction — which was, writ large, an arm's-length transaction and not voidable under Section 96. However, the ABCA indicated a willingness to analyze the

transactions on a step-by-step basis, and not in the aggregate. The ABCA observed that if a transaction is entered into in violation of Section 96, it is no defence that it was connected to a number of other transactions that did not engage Section 96 at all. The ABCA did not determine whether an oil and gas company can arrange its affairs so as to avoid regulatory scrutiny, in a manner that is analogous to income tax law. *Redwater* does not provide an answer on this point and this type of novel issue must be tested at trial.

The scope of the duties of a trustee

The case management judge heard a subsequent application by Ms. Rose for enhanced costs and concluded that the Trustee should pay 85% of Ms. Rose's solicitor and client costs and that the Trustee should be personally liable for those costs. The case management judge made that determination on the basis that the Trustee, as an officer of the court, should be held to a higher standard than normal litigants. Such higher standard required the Trustee to comply with principles of procedural fairness; comply with duties imposed by the courts of equity on trustees in general (that is, not trustees in bankruptcy); present facts to the court without opinions, argument or evidence; and complete an appropriate investigation prior to commencing litigation. The case management judge concluded that in failing to meet those higher standards, the Trustee's conduct was "egregious" and the Trustee "exercised very poor judgment that equate to positive misconduct."

Overturning the case management judge, the ABCA found that there was nothing "egregious" about the Trustee's conduct, that the criticisms levied by the case management judge against the Trustee were "unwarranted," and that the case management judge had made errors both in principle and in law in awarding costs against the Trustee. Most importantly, the ABCA affirmed that while a trustee in bankruptcy is an officer of the court, a trustee in bankruptcy's "primary duty… is to the creditors of the estate through the inspectors." A trustee in bankruptcy does not owe duties to potential defendants in estate litigation, and in fact would be placed in a conflict of interest if it was also under a legal duty to third parties. As the ABCA noted, "a trustee in bankruptcy is not an administrative tribunal," and the principles of administrative law have no application in civil commercial matters. As a result, the Trustee had no obligation to hear the defendants' views before pursuing litigation or provide the defendants with advance notice of a statement of claim.

Furthermore, as the ABCA noted, a trustee in bankruptcy's position and exercise of judgment could require it to take an adversarial role in litigation. Once the Trustee came to the conclusion that Perpetual/Sequoia had potential claims against various defendants, the Trustee was not only correct to pursue those claims but obliged to do so.

Overall, the ABCA judgment strongly affirms a trustee in bankruptcy's duty to creditors and its obligation to exercise its own judgment, under the supervision of inspectors, for the benefit of the bankrupt estate. In pursuing this duty, a trustee is not burdened by administrative law obligations and has no generalized duty of fairness to third parties.

PricewaterhouseCoopers Inc v Perpetual Energy Inc, 2021 ABQB 2

Prior to the release of the ABCA's decision, the case management judge released a further decision on the merits of the Section 96 Claim on January 14, 2021, in *PricewaterhouseCoopers Inc v Perpetual Energy Inc*, 2021 ABQB 2. In this decision, the Alberta Court of Queen's Bench (the ABQB) found that Perpetual/Sequoia was not insolvent at the time of the Asset Transaction or rendered insolvent by the Asset Transaction. Underpinning this finding was the assertion that AROs should be valued at nil for the purposes of the BIA. As the ABCA has now unequivocally rejected this view, thereby undermining the foundation of the ABQB decision, the ABCA may have a further opportunity to revisit these issues in short order.

[1] 2019 SCC 5.

[2] Under the *Business Corporations Act*, RSA 2000, c. B-9.

[3] RSC 1985, c. B-3.

[4] Yewchuk, Drew, *The Sequoia Bankruptcy Part 1: The Motion to Strike and the Interveners*, https://ablawg.ca/2021/01/18/the-sequoia-bankruptcy-part-1-the-motion-to-strike-and-the-interveners/ (January 18, 2021).