

Supreme Court of Canada decision in Redwater: Early implications

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Introduction

Nearly four years ago, Redwater Energy Corporation (Redwater) was petitioned into receivership by its principal secured creditor, Alberta Treasury Branches (ATB). What started as the insolvency of a small oil and gas company with about 100 properties licensed by the Alberta Energy Regulator (AER), became a catalyst for national consideration of environmental policy, the energy industry, and the financial sector. Locally, the case revealed cracks in the Alberta energy regulatory regime and exposed the financial consequences of the failing system on the Alberta public and responsible resource companies in Alberta.

Initially, former Chief Justice Wittmann in *Redwater Energy Corporation (Re)*, 2016 ABQB 278 determined that the provisions of Alberta's regulatory regime under the *Oil and Gas Conservation Act*[1] (OGCA) and the *Pipeline Act*[2] (PA) were inoperative to the extent such provisions required a Trustee to satisfy the liability inherent in the abandonment and reclamation of an insolvent debtor's oil and gas wells in priority to claims of its secured creditors. His decision and reasons were affirmed by the Alberta Court of Appeal almost a year later, with a strong dissent by the Honourable Madam Justice Sheila Martin.[3] The eyes of Alberta and the nation turned to the Supreme Court of Canada (SCC), as the energy and financial industries, and various regulatory bodies, among others, sought a determination regarding the ability of insolvency professionals to disclaim end-of-life-liability-laden assets to maximize recovery for the debtor's estate.

On January 31, 2019, in a 5-2 split decision, the majority of the SCC allowed the appeal of the AER and the Orphan Well Association (OWA) and held that the abandonment and reclamation obligations of the debtor were binding on the Trustee, were neither "creditor" claims nor claims provable in bankruptcy and, therefore, did not conflict with the general priority scheme in the *Bankruptcy and Insolvency Act*[4] (BIA). Adopting a markedly different approach than those of the trial judge and the Court of Appeal majority, Wagner C.J. writing for the SCC majority, held that the AER was acting in the public interest and for the public good in issuing abandonment orders and enforcing licensing liability management ratio requirements. Thus, the provincial regulatory regime can coexist with, and apply alongside, the BIA.

This decision resolves the uncertainty regarding the treatment of end-of-life obligations owed by an AER licensee debtor in an insolvency proceeding. According to the SCC, the value of key assets of the debtor, if depressed by abandonment and reclamation obligations, is simply the inherent cost of such licenses held by the debtor, and the regime Alberta has chosen to regulate the oil and gas industry and its impact on the environment. While focused on Alberta, this decision will impact the regulation of natural resources across Canada, and the financing sources available to industry participants.

While the SCC has settled the matter for now, only time will tell whether the federal government will accept the invitation of the various judges deciding this matter on its path through the courts to revisit the federal insolvency regime to ensure it accounts for the distinct character and needs of Canada's natural resource industries. For now, the AER, industry participants, financial institutions, insolvency professionals and provincial legislators must work together to ensure the ongoing and responsible development of one of our country's greatest resources – oil and gas in Alberta.

Background

The background in *Redwater* is well known in Alberta. Redwater was a publicly listed junior oil and gas producer. When its principal secured lender, Alberta Treasury Branches, demanded repayment of its indebtedness, Grant Thornton was appointed Redwater's receiver pursuant to section 243 of the BIA.

Upon appointment, the receiver conducted an assessment of Redwater's licensed assets and advised the AER that it would only take control of approximately 20 of the 127 Redwater properties licensed by the AER. The receiver determined that only these 20 licensed assets held value and the remainder were purportedly renounced or disclaimed.

In response, the AER issued closure and abandonment orders in respect of the renounced assets and filed an application to compel the receiver to comply with the orders and fulfil all statutory obligations of Redwater in relation to the abandonment, reclamation and remediation of the licensed assets.

On October 28, 2015, a bankruptcy order was issued for Redwater, appointing Grant Thornton as trustee in bankruptcy. The trustee disclaimed the assets it had renounced as receiver and indicated that it did not intend to comply with the closure and abandonment orders.

As discussed in [previous Osler Updates](#), the Alberta Court of Queen's Bench concluded that the claim of ATB as Redwater's principal secured creditor had priority over the obligations to reclaim wells, thereby determining that Trustees were permitted to renounce an insolvent debtor's interest in its licensed assets while keeping and selling valuable licensed assets to maximize recovery for the debtor's estate. The decision of the Alberta Court of Queen's Bench was affirmed on appeal with a strong dissent from Martin JA (as she then was).

The AER and the OWA both appealed to the SCC.

Decision

Writing for the majority, Chief Justice Wagner found that the AER's use of its statutory powers did not create a conflict with the BIA so as to trigger the doctrine of federal paramountcy. In finding the absence of any conflict between the provincial regulatory regime and the BIA, Wagner CJ considered both the effects of section 14.06 of the BIA and whether abandonment orders issued by the AER were properly construed as claims provable in bankruptcy according to the principles outlined in the Court's earlier decision in *Newfoundland and Labrador v. AbitibiBowater Inc.*, 2012 SCC 67 (Abitibi).

Regarding section 14.06(4) of the BIA, the majority held that the purpose of the section was clear and unambiguous – to protect the Trustee from personal liability for failure to comply with environmental orders or for the costs incurred by any person carrying out the terms of such orders. As the Chief Justice noted, "the provision says nothing about the liability of the

'bankrupt' or the 'estate' – distinct concepts referenced many times throughout the BIA." Section 14.06(4) is concerned with the personal liability of trustees, and does not empower a trustee to walk away from the environmental liabilities of the estate it is administering. The Court found that the provision was motivated by and aimed at concerns about the protection of trustees, not the protection of the full value of the estate for creditors.

In the result, Wagner CJ held that a Trustee's disclaimer of real property where an environmental order has been issued only protects the Trustee from personal liability, while the ongoing liability of the bankrupt debtor is unaffected. Accordingly, given that the AER had not attempted to hold the Trustee personally liable for the abandonment costs and only sought to recover such costs from the value of the assets in the estate, there was no operational conflict or frustration of purpose with the provisions of the BIA.

Turning to the question of whether the abandonment orders constituted a claim "provable in bankruptcy" so as to fall within the priority regime established under the BIA, Wagner CJ turned, as had both lower Courts, to the test determined in the Court's earlier decision in *Abitibi*. However, unlike the lower Courts, Wagner CJ disagreed that the mere fact that an abandonment order diverted value from the bankrupt's estate was sufficient to turn such an order into a claim provable in bankruptcy: "there remains 'a distinction between a regulatory body that is a creditor because it is enforcing a debt, and a regulatory body that is not a creditor because it is enforcing the law.'" As in the earlier decision of the Alberta Court of Appeal in *Panamericana de Bienes y Servicios S.A. v. Northern Badger Oil & Gas Ltd.*, 1991 ABCA 181 (which the Court confirmed remains good law in Canada), a regulatory body enforcing a public duty by way of non-monetary order is not a creditor.

After reviewing the purpose and effect of the abandonment orders, the majority held: "The end-of-life obligations the Regulator seeks to enforce against Redwater are public duties. Neither the Regulator nor the Government of Alberta stands to benefit financially from the enforcement of these obligations. These public duties are owed, not to a creditor, but, rather, to fellow citizens, and are therefore outside the scope of "provable claims."

As a result, the Court allowed the appeal, holding that: (a) there is no conflict between Alberta's regulatory regime and the BIA; (b) although the Trustee remains fully protected from personal liability by federal law, it cannot walk away from the environmental liabilities of the bankrupt estate by invoking s. 14.06(4); and (c) on a proper application of the *Abitibi* test, the AER is not a creditor to Redwater (step one of the test), and Redwater's end-of-life environmental obligations are not sufficiently certain in respect of monetary value (step 3 of the test) to amount to a claim provable in bankruptcy. Thus, the obligations of Redwater owing to the AER are not subject to the priority scheme of the BIA.

The dissent

In the dissenting reasons, Cote J, writing for both herself and Moldaver J, mirrored much of the approach taken by the majority at the Court of Appeal, and directly responded to the analysis and reasons of Wagner CJ. Focusing initially on the application and interpretation of s. 14.06 of the BIA, the dissent highlights how the majority decision functionally removes the express right to disclaim non-profitable assets – a right expressly referenced in that section – for the overall benefit of the estate.

Regarding the application of co-operative federalism in the context of a paramountcy analysis, Cote J points to express language in s. 14.06 that indicates such principles do not apply. Her reasons led to a finding of both an operational conflict as between Alberta's oil and gas licensing regime and a frustration of purpose regarding the BIA priority scheme. She finds that Alberta's licensing scheme effectively operates as a debt collection mechanism vis

a vis a bankrupt company, preventing the Trustee from discharging its duties as Trustee unless the AER's environmental claims are satisfied.

Cote J goes on to take issue with the majority's refining of the Court's relatively recent decision in *Abitibi*. She writes that the concession in the early stages of this case by the AER that it was a creditor sufficiently satisfies the first branch of the *Abitibi* test, and that the factual findings of the trial court provide the necessary evidentiary basis to support the third branch of the test (sufficient certainty of monetary value). Like the majority, the dissent determined that the second branch was satisfied without further need for analysis.

The dissent concludes with Cote J's observations that there may be compelling reasons to find as the majority did, but those reasons are policy, and the Court's obligation is to apply the law – specifically in this case, statutory interpretation and application. Her parting criticism of the AER's position is that it has transferred environmental liabilities to the estate's creditor, "effectively displacing the "polluter pays" principle enacted by Parliament in favour of a "lender-pays regime."

Implications

1. Both the majority and the dissent observe that the interaction between the Alberta oil and gas licensing regime and bankruptcy and insolvency legislation would benefit from parliamentary consideration. Specifically, the particular statutory section at issue "is not a model of clarity" and "Parliament may very well wish to re-examine s. 14.06 during its next review of the BIA."
2. The "polluter pays" principle has enjoyed broad moral, economic, regulatory, and intellectual support from energy industry participants leading up to the SCC's decision, and now has the final legal blessing from Canada's highest court. Industry proponents support the principle behind this decision, with the Canadian Association of Petroleum Producers noting that the value of a bankrupt company's assets should be used to fund its clean-up costs so that responsibility for such matters is not left to other industry participants or the public.^[5] The AER stated that it is "steadfast in its belief that the public should not be on the hook for the closure and reclamation costs of insolvent licensees".^[6] The OWA, a non-profit organization operating under delegated authority of the AER to undertake decommissioning and reclamation obligations presented by orphaned wells but primarily funded directly by the energy industry, is encouraged by the decision but notes that the problem has developed over several years so will take several years to address.^[7]
3. While the decision is a win for those who hope to "restore balance between environmental obligations and creditor interests to that which existed for many years before this case"^[8], the ramifications may be far reaching. The energy industry is battling significant economic and political headwinds as it faces unprecedented legal challenges and regulatory uncertainty. Added to the list of pipeline access constraints, legislated production curtailment, commodity price volatility, carbon taxes, proposed legislation that restricts new infrastructure development, climate change policies, strained inter-provincial relations, uncertainty over impending provincial and federal elections: the impact of this decision could create further instability in the lending and investment climate facing the

- energy industry.
4. Where a licensee is at risk of not maintaining the requisite licensee liability rating, we expect the AER may take action – or be expected by the public to take action– and intervene. At the very least, the AER is likely to more closely monitor its licensee operations and take steps should liability ratings become concerning.
 5. While some lenders may have accounted for the risk of this decision in their lending values when the SCC gave leave to hear this case, it is also likely that the outcome of this decision will form a new basis on which lenders impose more aggressive reductions to lending values available to energy producers, and especially those who carry a high level of abandonment and reclamation obligations (ARO) within their asset base. Although lenders factor a borrower's ARO into the calculation of its lending value, we expect that the way such ARO is taken into account by lenders could change. Lenders may seek to deduct the undiscounted value of ARO from a company's asset value which will generate a lower lending value than the historical approach, which relied on engineering reports that discount the present value of such ARO to their end or reserve life amount. To ensure that borrowers are addressing their ARO as they are incurred rather than deferring responsibility for them to some point in the future, lenders could also incorporate additional covenants in their loan documents requiring borrowers to annually perform certain ARO and regularly report on the completion of such obligations, with the result that producers will have to finance such obligations out of current cash flow. We may even see more diligence being undertaken by lenders to ascertain borrowers' working interest partners to ascertain what risks the borrower might take on in additional liability if it is partnered with potentially insolvent joint venture partners, or conversely, whether such joint venture partners might assume some of the risk of a borrower's insolvency.
 6. Listed companies with high ARO but low licensee liability ratings may experience some stock price decline if shareholders believe it will become more difficult for them to finance future operations. Lower stock prices will result in more difficulty in raising equity and further compound their ability to succeed. Although the universe of buyers for such companies and assets has declined, those who remain are cognizant of the effects of ARO (see *Sequoia Resources Corp.*)^[9]. Companies with strong balance sheets and high licensee liability ratings who can satisfy the additional financial information required by the AER in its exercise of broader discretionary power to approve licensee transfers will have the greater chance of success, to either wait it out or hasten acquisitions of, or joint ventures with, companies or assets for whom lending values have eroded or equity markets stalled.
 7. For those invited to serve on the board of directors of an oil and gas company, Redwater will serve as a reminder to conduct sufficient due diligence of a company's ARO and how its value has or could impact a company's lending value to better understand all sources of capital that may be available to finance its operations. For those currently serving on the board of directors of a company with high ARO and low licensee liability ratings that finds itself unable to adequately fund such ARO through cash flow, the board may consider exploring alternate sources of capital, potential mergers, acquisitions,

divestitures or restructuring efforts to facilitate meeting end-of-life obligations, improve the company's balance sheet and avoid bankruptcy.

8. Although this decision restores certainty over responsibility for ARO in a receivership, the debt financing consequences may make the balance that industry hopes to restore elusive for some and opportunistic for others.

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[1] *Oil and Gas Conservation Act*, RSA 2000, c. O-6.

[2] *Pipeline Act*, RSA 2000, c P-15.

[3] *Orphan Well Association v Grant Thornton Limited*, 2017 ABCA 124.

[4] *Bankruptcy and Insolvency Act*, RSC 1985, c B-3.

[5] See media release dated January 31, 2019 published by Brad Herald, Vice-President, Western Canada Operations, Canadian Association of Petroleum Producers on its website at <https://www.capp.ca/media/news-releases/redwater-decision>

[6] See media release dated January 31, 2019 published by Gordon Lambert, President & Chief Executive Officer of Alberta Energy Regulator on its website at <https://www.aer.ca/providing-information/news-and-resources/news-and-announcements/news-releases/public-statement-2019-01-31>

[7] See media release dated January 31, 2019 published by the Orphan Well Association on its website at <http://www.orphanwell.ca/wp-content/uploads/2019/01/OWA-Media-Release-Redwater-Decision-2018-01-31.pdf>

[8] *Supra*, Note 4

[9] *PricewaterhouseCoopers Inc., LIT, in its capacity as the Trustee in Bankruptcy of Sequoia Resources Corp. and not in its personal capacity v. Perpetual Energy Inc., Perpetual Operating Trust, Perpetual Operating Corp. and Susan Riddell Rose*, Alberta Court of Queen's Bench Action No. 1801-10960.