NEW RULES FOR ASSET SALES BY INSOLVENT PRODUCERS (AT LEAST FOR NOW)

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In Alberta, regulations have historically prohibited purchasers of oil and gas assets from cherry picking operating interests in economic properties while leaving behind interests in uneconomic wells. This has had a significant negative impact on the ability of a receiver or trustee to market and sell assets owned by insolvent companies and on the prices those assets are able to attract.

On May 19, 2016, the Honourable Chief Justice Wittman of the Alberta Court of Queen's Bench released his reasons for judgment in the Redwater Energy Corp. ("**Redwater**") matter. If it is not appealed or rendered moot by new legislation, the decision will fundamentally change the rules of the game.

On May 12, 2015, a Receiver was appointed over all of the assets and undertakings of Redwater, a publically listed junior oil and gas company with assets in Alberta. Like many of its peers, Redwater was partially a victim of low oil prices. The Redwater receivership is unique in that the Receiver (now also Trustee in bankruptcy) of Redwater challenged, on constitutional grounds, the application of the regulatory regime by the Alberta Energy Regulator ("**AER**"). In particular, the Receiver challenged the position taken by the AER that the Receiver was (i) required as "Licensee" to comply with provisions of the regulatory regime, and (ii) prohibited from transferring operating licenses in relation to economic wells without posting security for the abandonment liabilities for all of Redwater's other wells.

The LLR Program

As discussed in our bulletin of January 25, 2016, Compromise with the Alberta Energy Regulator: Navigating a Receivership in Alberta's Oil Patch, the AER is responsible for granting and administering licenses for oil and gas wells, pipelines, and related facilities in Alberta. As part of this mandate, the AER uses the Licensee Liability Rating ("**LLR**") Program to assess a licensee's ability to address the suspension, abandonment, remediation and reclamation activities at the end of the life-cycle of the particular asset. A major component of the LLR Program is the requirement for a licensee to post a security deposit if a licensee's deemed liabilities for well abandonment (denominator) are greater than its deemed assets (numerator), a ratio known as the Liability Management Rating ("**LMR**"). The LMR is calculated on a monthly basis and, if it falls below 1.0 (*i.e.*, deemed

liabilities exceed deemed assets), the AER requires the payment of a security deposit by the licensee. This security deposit is used to secure a licensee's obligation to abandon, remediate and reclaim oil and gas wells and facilities when such wells and facilities are no longer producing or economical.

Before it approves the transfer of a license, the AER requires that the transferor and transferee each have a post-transfer LMR of at least 1.0. Any party with an LMR of less than 1.0 will be required to post security. This can limit the pool of potential buyers, reduce the purchase price that the buyer is willing to pay and in cases where the seller has significant deemed liabilities (often the case with insolvent producers) can prevent the operating licenses/assets from being transferred at all.

In this constrained regulatory environment, an insolvent company attempting to sell its producing oil and gas assets is often required by the AER to post security and/or transfer all of its producing and non-producing wells as a package at a significant discount.

Redwater's Uneconomic Wells

Faced with the above regulatory reality, a dwindling LMR, and a number of uneconomic wells, the Receiver of Redwater elected not to take possession of the uneconomic wells (the "**Renounced Assets**"), which represented a majority of Redwater's AER licensed properties. The AER responded by issuing the Receiver closure and abandonment orders for all of the Renounced Assets, which, if followed, would have imposed a significant financial and regulatory liability on the estate of Redwater.

After the Receiver was appointed as Trustee of Redwater under the *Bankruptcy and Insolvency Act* (the "**BIA**"), the AER and the Orphan Well Association ("**OWA**") filed an application in an effort to enforce the abandonment orders previously issued to the Receiver. The Trustee filed a cross application seeking court approval of a sales process which excluded the Renounced Assets.

Positions of the Parties

The applications were heard by the Chief Justice over two days in December of 2015. Submissions were made by each of the AER, the OWA, the Canadian Association of Petroleum Producers ("**CAPP**"), the Trustee, Alberta Treasury Branches ("**ATB**"), the Province of Alberta and the Canadian Association of Insolvency and Restructuring Professionals ("**CAIRP**").

The AER argued that: (1) the Receiver was appointed as receiver and manager over all assets held by Redwater, and therefore should not be permitted to pick and choose assets to avoid its statutory obligations as a licensee; (2) the Trustee could not disclaim assets to avoid its custody and abandonment obligations as a licensee; and (3) the abandonment orders were regulatory in nature and therefore did not amount to a superpriority over the monies owed by Redwater to its secured lender, ATB. The AER's position was supported by the OWA, CAPP and

the Province of Alberta.

The Trustee argued that: (1) compliance with both the BIA and the provincial regulatory regime was not possible; (2) the provincial legislation frustrates the legislative purposes of the BIA; and (3) if the sales process was not approved in cases such as this, receivers would either refuse to take mandates or would request a discharge. The Trustee's position was supported by ATB and CAIRP (with respect to the impact on receivers and trustees).

The Decision

The Court found that, in this case, there was an operational conflict between the applicable provisions in the BIA and the provincial legislation and that dual compliance was not possible. Specifically, although the BIA permitted the Trustee to renounce some assets and not be responsible for abandonment and remediation work, the provincial legislation did not permit renunciation of assets by a licensee, which includes receivers and trustees.

The Court also found that the legislative purpose of specific provisions of the BIA were frustrated by certain provisions of the provincial legislation in a number of ways. Accordingly, the Court held that the doctrine of federal paramountcy applied to render inoperative those provisions in the provincial legislation which conflicted with the BIA.

The Implications

This decision may be appealed or the provincial legislation may be amended. As a result, the implications of the decisions are not clear. It is possible that there will be a rush to put companies into receivership or bankruptcy, or that there will be a significant number of wells and facilities being renounced. Alternatively, caution may continue to delay these activities until a decision on an appeal is made.

If the decision stands and the legislation is not amended, there will almost undoubtedly be a significant change in the way that receiverships and bankruptcies of oil and gas companies proceed in Alberta.

- Trustees and receivers will be permitted to renounce wells and facilities under the BIA, and will no longer be considered licensees under the provincial legislation with respect to those renounced assets.
- Abandonment orders issued by the AER will not bind receivers or trustees, and receivers and trustees will not be required to assume liabilities, in relation to renounced assets.
- The AER may not block sales of assets of insolvent companies by requiring payment of security deposits or other conditions precedent to approving the transfer of licenses to the purchaser. This should result in increased recoveries for creditors by eliminating this substantial cost and delay. Receivers and purchasers will no longer be forced to negotiate with the AER to ensure that the purchaser is not

required to post security for assets it cannot operate because of the AER's refusal to transfer the applicable licenses.The AER will not be entitled to include renounced assets when calculating a purchaser's LMR for the purpose of determining whether or not it will approve a transfer of licenses.

These changes will provide certainty to lenders as to their priority over their security.

The severely depressed prices for oil and gas will likely result in more producers becoming subject to insolvency proceedings – whether receiverships or bankruptcies – which means more wells will be designated as orphans. Without security deposits from insolvent companies or receivers and trustees, one source of funds to handle the remediation of these wells has been eliminated, leaving the industry as a whole with larger costs to support the orphan well system. On the other hand, the ability of receivers and trustee to package assets for sale in the way they see fit will in some cases facilitate transactions (and the posting of security deposits) that in the past would not have been possible under the old rules.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.