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Bankruptcy and Insolvency

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THE TIDES HAVE TURNED WITH REDWATER: PROVINCIAL ENVIRONMENTAL OBLIGATIONS HAVE PRIORITY OVER SECURED CREDITORS IN A BANKRUPTCY

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In the much anticipated decision, *Orphan Well Association et al. v. Grant Thornton Limited et al.*[1], (Redwater), the Supreme Court of Canada (SCC) held that a bankrupt estate is required to comply with environmental obligations imposed by a provincial regulator before distributing assets to secured or unsecured creditors. Redwater alters the scheme of distribution and payment priorities under the *Bankruptcy and Insolvency Act*[2], (BIA) and the expectations of numerous stakeholders in the Canadian energy and financial services industries.

Background

Redwater Energy Corp. (RECorp) was a publicly traded oil and gas company whose primary assets consisted of wells, pipelines and facilities and licenses issued by the Alberta Energy Regulator (AER). When RECorp experienced financial difficulties in 2014, ATB Financial, its senior secured creditor, obtained an order appointing Grant Thornton Limited (GTL) as RECorp's receiver, and eventually, its trustee in bankruptcy.

The dispute in Redwater concerned the bankrupt estate's obligation to comply with provincial environmental laws concerning abandonment and remediation of uneconomic oil and gas wells, known as end-of-life obligations. The AER imposes end-of-life obligations on licensees to render spent oil wells environmentally safe at the end of their life span. GTL determined that the cost of the end-of-life obligations for RECorp's spent wells would exceed the sale proceeds for its productive wells and therefore renounced the spent wells. GTL maintained that it was not obligated to fulfil regulatory requirements associated with the renounced assets.

In response, the AER issued abandonment and reclamation orders respecting the renounced wells. GTL asserted that it was not a "licensee" of the wells, refused to comply with the AER's orders, and disclaimed the renounced assets in bankruptcy. AER took the position that GTL's disclaimers were unlawful.

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[1] 2019 SCC 5
[2] RSC 1985, c B-3

Both the Alberta Court of Queen's Bench and Court of Appeal found that Alberta's environmental regulatory scheme conflicted with the BIA. Both Courts held that the BIA was paramount legislation and therefore the trustee was not required to satisfy provincial abandonment and reclamation liabilities in priority to claims of secured creditors. GTL was justified in disclaiming the end-of-life assets to maximize recovery for the bankrupt's estate.

The Issues addressed by the SCC

On appeal the SCC focused primarily on the following issues:

- Does Alberta's regulatory regime conflict with the BIA and if so was the BIA paramount?
- Is AER a creditor of the bankrupt and its environmental claims provable in bankruptcy?
- Is a trustee or receiver a 'licensee" subject to the orders of the AER?
- Can a trustee or receiver use the BIA to disclaim abandoned assets?
- How does the provincial priority claim affect creditors of the bankrupt estate?

The Decision

Conflict and Paramountcy

Chief Justice Wagner, writing for the majority, concluded that there was no "operational conflict" between the BIA and the provincial environmental regulatory regime which would render compliance with both legislative schemes impossible. The SCC endorsed the principle of co-operative federalism; "courts should avoid an expansive interpretation of the purpose of federal legislation which will bring it into conflict with provincial legislation".

AER's Status as a Creditor

The Court found that the AER was not a creditor of the bankrupt estate[3]. The SCC reasoned that AER would not be enriched by the super priority it was trying to enforce. It was acting in the public interest, rather than in its own interest, to ensure that abandoned wells were remediated. As the AER was not asserting a claim provable in bankruptcy, the SCC held that AER's claims were outside of the BIA's statutory priority scheme.

Ability to Disclaim Abandoned Assets under the BIA

The SCC found that GTL was a "licensee" of the wells and a stay under the BIA did not prevent this result. The SCC also found that since GTL was not exposed to the risk of personal liability, GTL could not disclaim the abandoned wells under the BIA. The assets of the bankrupt estate were therefore available to satisfy the end-of-life environmental obligations enforced by the AER.

[3] the SCC narrowly applied the three-part test established in Newfoundland and Labrador v. AbitibiBowater Inc., 2012 SCC 67, [2012] 3 S.C.R. 443 to determine whether a claim is provable in bankruptcy

Effect on Priority of Creditors

As the SCC held that the AER was not asserting a 'provable claim in bankruptcy', the BIA did not stay AER's power to enforce end-of-life obligations. Remediation costs are not 'debts', and therefore the assets of the bankruptcy estate were available to satisfy pre-existing remediation costs of the abandoned wells, ahead of the secured creditors. The result is a 'super-priority' for environmental remediation.

Impact of Redwater

- Redwater takes a 'polluter pays' approach and fundamentally redirects asset value away from secured creditors.
- Redwater may directly affect the value of assets in some industries and deter lenders from committing capital to going-concern businesses, or insolvency professionals from accepting mandates in distress situations.
    - Lack of certainty for lenders regarding future outcomes will impact credit applications. Restrictions on liquidity negatively impact pricing and credit limits, particularly with smaller entities in exposed industries and may result in a credit chill, or reallocation of assets and lending covenants used in securing corporate liquidity for committed loans.
    - Increased uncertainty for insolvency professionals (trustees, receivers, etc.) about their ability to use statutory protections in accepted mandates could lead to fewer restructuring or liquidation proceedings to maximize value in an estate falling within regulatory control. Court supervised sales and other going concern value recovery proceedings under the CCAA, BIA, among others, may be discouraged in some circumstances.
- Regulatory uncertainty and regulator super-priority, may reduce the appetite for going concern asset sales in formal and out of court restructuring situations. Exposing assets to the broader market can result in surprisingly good recoveries, including potential surpluses for subordinate creditors and equity holders. These sales are now less likely.
- By the time a liquidation proceeding is commenced, it is often too late to fully remediate. Regulators may intervene earlier while there is still a business to save.
- With a new 'super priority', it is unclear how regulators like the AER will sort out their inter-priority status with others, such as CRA.
- Paramountcy is now much more narrowly applied and therefore bankruptcy proceedings involving provincial regulators more uncertain. Uncertainty is most acute in the environmental sphere, *Redwater* may affect other areas like priority of pension rights.

Recommendations

Banks and Lenders: As proceeds from collateral must cover environmental liabilities first, lenders should re-examine their credit matrixes for risk assessments in lending or realization situations. This may require refreshed legal and valuation opinions at the inception of loans, or commencement of insolvency and restructuring proceedings. Secured creditors will be asked to provide more fulsome

indemnities to insolvency professionals to cover fees and expenses that may not be recoverable from the estate assets under applicable court orders.

Energy extraction companies: Anticipate increased uncertainty in obtaining credit or in crisis management. Timelines will likely be extended and cost estimates for positive outcomes may change. Situational and fact specific guidance to boards of directors and management of distressed entities and their stakeholders will be required.

Insolvency professionals: With BIA protections including disclaimer rights and assets available for administrative primed charges under court orders curtailed, roll up assessments and valuations are now more important than ever in exposed industries. Before accepting mandates in files with regulatory obligations, the requirement for secured indemnities from sponsoring constituencies is highly recommended.

Businesses generally: If you operate in an area of heightened regulatory compliance, there may be greater expectations imposed by regulators in the shorter term. This will vary depending on the province of operation and the nature of business, with environmental risk being a key factor.

Land owners in Alberta: Take heart in the increased resources allocated to environmental remediation requirements of third parties on your lands.