Goodmans LLP Update

Bankruptcy Not a License to Ignore Environmental Obligations – SCC Concludes Reclamation Obligations Not Provable in Bankruptcy May Take Priority Over Secured Creditors

On January 31, 2018, the Supreme Court of Canada (the "**SCC**") released its much anticipated decision, *Orphan Well Association v. Grant Thornton Ltd., 2019 SCC 5* (the "**Redwater Decision**"). The SCC, in a 5-2 split decision, concluded that provincial end-of-life environmental abandonment and reclamation obligations, that are not claims provable in bankruptcy, must be satisfied by the bankrupt estate notwithstanding the impact that may have on secured creditor recovery in an insolvency proceeding.

While this decision rests in part on the provincial oil and gas well licensing framework, it takes a broader view of what has been called the "untidy intersection"[1] of environmental and insolvency law, which view will not likely be confined to the oil and gas regulatory regime. The majority held "Bankruptcy is not a licence to ignore rules" while the minority commented that the majority decision would effectively displace "the 'polluter pays' principle enacted by Parliament in favour of a 'lender pays' principle." The majority and minority decisions also arrived at different conclusions in applying the "Abitibi tests"[2] to determine whether a claim is provable in bankruptcy. It seems the intersection will remain rather untidy.

Background

In Alberta, an oil and gas company is required to assume certain end-of-life abandonment and reclamation obligations (such as capping oil wells to prevent leaks and restoring the surface to its previous condition) to receive a license by the Alberta Energy Regulator (the "**Regulator**") to extract, process or transport oil and gas in the province. The Regulator may require a security deposit from a licensee for end-of-life obligations should it fall below the Regulator's Liability Management Rating (LMR).

In 2014, Redwater Energy Corporation ("**Redwater**"), an Alberta-based publicly-traded oil and gas company, fell into financial difficulty. One year prior, Alberta Treasury Branches (ATB) agreed to provide secured financing to Redwater with knowledge of the end-of-life environmental obligations associated with its assets and in return was granted security in Redwater's present and after-acquired property. By 2015, Redwater's finances had deteriorated and Grant Thornton Limited (GTL) was appointed receiver of the company's property, assets and undertaking. At that time, Redwater owed ATB approximately $5.1 million, and its assets consisted of 84 wells, 7 facilities and 36 pipelines. Many of its assets were inactive or spent, but given its LMR, Redwater was never required to pay a security deposit to the Regulator for its end-of-life obligations.

Following Redwater's receivership, the Regulator advised GTL that it was legally required to fulfil Redwater's abandonment and reclamation obligations for all licensed assets before distributing funds to creditors. GTL concluded it could not meet the end-of-life obligations, as the cost would likely exceed the sale proceeds for the productive wells, and determined it would only take possession of Redwater's productive wells and related assets (the "**Retained Assets**"). GTL took the position it had no obligation to fulfill any regulatory requirements associated with Redwater's unproductive oil and gas assets it was disclaiming and did not take possession of (the "**Renounced Assets**"). This effectively meant Redwater's end-of-life reclamation obligations applicable to the Renounced Assets would be ignored, resulting in numerous environmental and safety hazards throughout the province. In response, the Regulator issued orders against Redwater to properly suspend, abandon and reclaim the Renounced Assets. A bankruptcy order was eventually issued for Redwater and GTL was appointed the trustee in bankruptcy.

The Issue and Lower Court Decision

The question before the courts was how should a trustee in bankruptcy deal with such environmental obligations when tasked with distributing assets of a bankrupt company to secured creditors according to the rules in the federal *Bankruptcy and Insolvency Act* (the "**BIA**").

GTL argued that as it was disclaiming Redwater's unproductive oil and gas assets, the BIA empowered it to walk away from those assets (and their associated environmental liabilities) and to deal solely with Redwater's producing oil and gas assets. GTL also argued that, under

the priority scheme in the BIA, the claims of Redwater's secured creditors must be satisfied ahead of Redwater's environmental liabilities, and that the applicable provincial legislation was inoperative to the extent it required the Regulator to interfere with the BIA's priority scheme.

The chambers judge and a majority of the Alberta Court of Appeal agreed with GTL and held that Redwater's compliance with provincial end-of-life abandonment and reclamation obligations conflicted with the BIA for two reasons: (i) it imposed on GTL the obligations of a licensee in relation to the Redwater assets disclaimed by GTL, contrary to the BIA; and (ii) it upended the priority scheme for the distribution of a bankrupt's assets by requiring that a provable claim of an unsecured creditor, the Regulator, be paid ahead of the claims of Redwater's secured creditors.

In a much anticipated re-visit of these issues, the SCC disagreed with the lower courts.

SCC Decision - ***"Bankruptcy is not a licence to ignore rules"***

In a 5-2 majority decision, the SCC concluded GTL could not walk away from environmental liabilities of the Renounced Assets. The SCC found that while the BIA protects trustees and receivers from being personally liable for environmental liabilities of the bankrupt estate, this does not mean Redwater's estate could avoid its environmental obligations. In applying the "Abitibi test", the SCC found that "the Redwater estate must comply with ongoing environmental obligations that are not claims provable in bankruptcy." It further held that the reclamation costs were not provable claims as they were not technically debts requiring payment. Rather, the end-of-life obligations represent duties to the public and thereby fall outside of the BIA's priority scheme. The SCC noted that the Regulator, in seeking to enforce those claims, was acting in a regulatory capacity (not as a creditor) and does not stand to benefit financially. For these reasons, there is no conflict between the provincial and federal laws. Rather, the provincial and federal acts could co-exist, requiring that the end-of-life environmental obligations first be addressed, following which the remaining assets may be distributed to the secured creditors in accordance with the BIA's priority scheme. The SCC held "Bankruptcy is not a licence to ignore rules, and insolvency professionals are bound by and must comply with valid provincial laws during bankruptcy."

Implications

The Redwater Decision will most certainly impact lenders in the oil and gas sector and in other industries that have significant end-of-life environmental abandonment and reclamation obligations. Directors and officers should also be cognizant of the impact this decision may have on a company's lending value and capacity.

For further information about the Redwater Decision and its implications, please contact any member of our Environmental Law Group.

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[1] *Re Nortel Networks Corporation*, 2012 ONSC 1213, para. 8, Justice Morawetz referring to the *Companies' Creditors Arrangement* and the *Bankruptcy and Insolvency Act* on one hand and Ontario's environmental laws on the other.

[2] *Newfoundland and Labrador v. AbitibiBowater Inc.*, 2012 SCC 67 ("***Abitibi***"). In *Abitibi*, the Court established a three-part test, rooted in the language of the *BIA*, to determine whether a claim is provable in bankruptcy.

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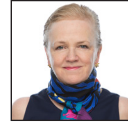

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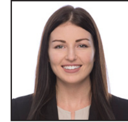

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