Daily Oil Bulletin

Impact Of The Redwater Appeal Decision On M&A Activity

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The release this week of the long-awaited court decision by the Alberta Court of Appeal to the appeal by the Alberta Energy Regulator (the "AER") of the May 2016 ruling (the "Redwater Decision") by the Court of Queen's Bench of Alberta that provincial regulations are in conflict with the federal Bankruptcy and Insolvency Act ("BIA", or the "Act") will have implications on oil and natural gas mergers and acquisitions ("M&A") activity. These implications are dependent on a variety of possible outcomes. The path should become clearer in the next few weeks as all parties affected by the decision assess their respective positions.

The AER's appeal was based on the argument that funds from the sale of productive wells must be used to cover expenses for the unproductive wells and that the lower Court's decision to allow the creditors to be paid out before the liability obligations are met was incorrect. The primary but not the sole driver for this appeal was the increased number of oil and natural gas companies entering into receivership and bankruptcy, leading to dispositions of marketable assets by the various Court-appointed receivers ("Receivers") in order to partially satisfy creditor obligations.

Since the Redwater Decision came down, any unmarketable assets of insolvent companies have been disclaimed by the Receivers, with many of these assets ultimately ending up in the industry-funded Orphan Well Association (the "OWA"). The AER takes issue with this approach, a position which led to the appeal of the Redwater Decision.

The Alberta Court of Appeal upheld the ruling of the lower Court; however, one of the three judges hearing the appeal argued that the regulations are consistent with the Act and said the appeal should be allowed.

The best possible outcome for all parties would be acceptance of the decision and a cooperative effort in moving forward. In an ideal world, Receivers would assess the marketability of an insolvent company's assets, along with the potential liability associated with the unmarketable assets. The Receivers would then meet with the AER and the two parties would agree to some sort of revenue sharing agreement, whereby

proceeds from the sale of the marketable assets would be shared by the creditors and the OWA. An M&A process to divest the marketable assets could then proceed unhindered, with all parties knowing that a smooth transition of the assets from the Receiver to an interested party could be concluded. This has been done recently and we see no reason why it can't continue as common practice.

We do not live in an ideal world. This outcome would require tremendous cooperation by all parties, all working with an understanding that there must be a compromise that works for all sides. If either party sees its position as being superior to the other, there is no hope of a satisfactory outcome.

If, in any circumstance, the AER were to insist on what was perceived to be too great of a share of the proceeds, it might not be worthwhile for the Receiver to conduct an M&A sales process. Why would any creditor fund an M&A process with the expected outcome being that the majority of the proceeds would go to the OWA and not to the creditors? In such circumstances, absent an M&A process to divest the assets, ALL of the assets of a particular company could end up in the hands of the OWA.

Conversely, if the Receiver insisted on retaining what the AER determined to be too large of a share of the proceeds, the AER could fall back on its arbitrarily mandated requirement that licensees maintain a Licensee Liability Rating of greater than 2.0 to approve the transfer of well licences in certain circumstances, effectively killing many potential sales transactions if this criteria is not met. Solvent companies might be prevented from taking on assets from an insolvent company. This outcome would also result in the transfer of many assets to the OWA.

There is still significant tension in the air, in particular between the AER and the Receivers, making it difficult for a cooperative effort to succeed at this time. Perhaps there is hope for this at a later date, but right now we give this outcome a relatively low chance of success.

Another possible outcome is a more confrontational one. The tension between the AER and the Receivers could build to the point where it is not feasible to run an effective M&A process to divest the assets of an insolvent company. The results of such an outcome would be horrific, with significantly more wells ending up in the lap of the OWA than should be the case. This potential outcome was addressed on March 23, 2017 by The Honourable Mr. Justice Jones ("Justice Jones"), in hearing an application relating to the receivership sale of certain of the assets of Nordegg Resources Inc. Here is a summary of some of Justice Jones' comments:

"*Were that converse to be the result of accepting the AER position, I consider it entirely possible that, firstly, more licences than would otherwise be necessary would be disclaimed earlier in the receivership continuum than would have otherwise taken place before a considered and rational assessment of, to quote the Chief Justice (Wittmann), "the cost of remedying environmental conditions." This could come at the taxpayer's expense, and secondly, the purpose of the BIA generally would be frustrated leaving creditors, present and future, with an uncertain landscape relating to their expectations of how receivers can function and how they will resolve their responsibilities to creditors, debtors and the Court.*"

Elsewhere in his remarks, Justice Jones said:

"Secondly, by way of example suppose the Court took the position that licences which would otherwise be disclaimed had to be sold with assets a purchaser was otherwise willing to purchase. Assume the only interested purchaser indicates a willingness to purchase all of the debtor's licences for a 95% reduction in the purchase price, which it would otherwise be willing to pay were it able to purchase only those undisclaimed assets it otherwise wanted. It seems to me that would give rise to the following potential consequences: firstly, a huge reduction in the amount available for distribution to creditors potentially jeopardizing their solvency with potential consequences for their investors, employees and our province's tax base, possibly leading to cascading bankruptcies for those creditors and in turn their creditors; further, no guarantee that the licences forced to be sold would be remediated by the purchaser should it subsequently become insolvent; further, distortion in the economics of a sale of assets otherwise conducted on an arms-length basis as a result of the intervention of a third party's policies, i.e. those of the Court."

The AER could appeal the recent decision to the Supreme Court of Canada. In light of the fact that one of the three judges hearing the appeal felt that the appeal should stand, there is a reasonable chance that this is heading to the Supreme Court. This process will take time, and in the period of time until the appeal is heard and a contrary decision is rendered, the Redwater Decision stands and Receivers will continue to act in accordance with same.

Through an appeal process, Receivers will continue to disclaim certain assets of insolvent oil and natural gas companies. This will allow for the maximum possible return to creditors; however, absent any cooperative approach to revenue sharing, the OWA will continue to receive unmarketable assets.

What has been troubling throughout this entire debacle has been the portrayal of our industry in the media. Many articles and commentaries incorrectly spin the actions of the Receivers as "*dumping liabilities on the laps of you and me*" and "*leaving the Province with the burden of cleaning up the environmental liabilities of these companies.*" Further negative and incorrect press has informed the ill-informed public that "*this will cause companies to voluntarily go into receivership rather than dealing with their liabilities.*"

After a recent news report on the television I felt like I should run outside to see how many orphan wells were on my street! The implication of that particular report was that the industry is simply littering these things all over the place.

This type of negative press needs to be corrected. The Canadian oil and natural gas industry is very good at taking care of the environment. As most readers of this article know, the OWA is funded by industry, not by the public. People don't voluntarily put their companies to sleep so they don't have to deal with their liabilities. Yes, there are bad apples in the bunch, as evidenced by the recent press regarding one particular company (NB ONE company is making all of the recent headlines, not several companies), but there are no more bad apples in the oil and natural gas industry than in any other industry, government or association in Canada.

Hopefully, these issues will settle out to a logical conclusion before too long. Our industry does not function well during times of uncertainty. Uncertainty leads to negative press which leads to a reduction in much needed capital flow into the industry. Without capital and continued banking support, more companies will fail. Once again, Justice Jones said it best:

"*... it could have a chilling effect which would envelope capital markets leading to a contraction of credit availability at the very time our province needs certainty and continuity in lending, securitization, restructuring and recovery policies and practices, all of which I believe could result in undermining the spirit and intent of insolvency legislation, a contraction of economic activity, a reduction in the province's tax base, potentially increased unemployment and the migration of capital investment from Alberta.*"

In an ideal receivership M&A process, all of the marketable assets of an insolvent company would be taken out to market. At the end of the process, assets which received acceptable bids from credible buyers would be sold, with the assets previously deemed to be unmarketable and assets which did not receive acceptable bids through the M&A process then disclaimed and sent to the OWA. This is not necessarily a happy ending for all, but it is the best possible outcome with the least possible collateral damage. All parties should keep this in mind and work towards the common goal of minimizing damage.

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CATEGORY: ANALYSIS (/CATEGORY/ANALYSIS/)