ANALYSIS

Collateral Damage Caused By The Supreme Court Of Canada's Decision To Overturn The Redwater Decision

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The release on January 31, 2019, of the long-awaited court decision (the "Appeal Decision") by the **Supreme Court of Canada** to the appeal by the **Alberta Energy Regulator** (the "AER") of the May 2016 ruling by the **Court of Queen's Bench of Alberta** that provincial regulations are in conflict with the federal Bankruptcy and Insolvency Act (the "Redwater Decision") was publicly lauded by many observers as the correct "*social*" decision. The public-at-large generally accepts the "*polluter pays*" thinking that was behind the decision as being the correct outcome.

In this lengthy article we will not touch on the social issues resulting from the Appeal Decision. We will focus instead on the broader implications of the Appeal Decision which we believe will inflict significant collateral damage on oil and natural gas companies, bankers, receivers, the AER and ultimately, and most importantly, the **Orphan Well Association** (the "OWA"), the very organization that the Appeal Decision was indirectly designed to protect.

Background

Before discussing the broader business implications of the Appeal Decision, it is worth clarifying some of the background issues. One key point to note is that the assets of an oil and natural gas company are unlike those of a mining company, or almost any other industry which would be impacted by the Appeal Decision. A non-oil and natural gas company typically has a very small number of assets which might lead to future environmental obligations. An oil and natural gas company, on the other hand, might have hundreds or even thousands of such assets. Of note is the much-discussed receivership of **Lexin Resources Ltd.** et al ("Lexin"), which left behind approximately 1,500 licenced wells and approximately 1,500 licenced pipelines and facilities. Most of these licenced assets were eventually dropped into the lap of the OWA.

If an insolvent entity with a relatively small number of assets goes into receivership ("Receivership"), it is relatively straightforward for the court-appointed receiver (the "Receiver") to deal with the very small number of assets, as compared to handling the thousands of discrete assets that result from the insolvency of an oil and natural gas company such as Lexin.

Subsequent to the Redwater Decision and prior to the Appeal Decision, the Receivers of insolvent oil and natural gas companies, generally acting on behalf of the most senior secured creditors, i.e. the creditor with the most to lose (which could be a chartered bank, a mezzanine finance lender or any other secured creditor (the "Creditor or Creditors")), worked to monetize some of the assets from the insolvent companies which could be sold (the "Saleable Assets") in order to recover some of the funds owing to all of the secured creditors.

Until the Appeal Decision was announced, any unsold oil and natural gas wells, pipelines, facilities and equipment (the "Residual Assets") were disclaimed by the Receivers and ultimately delivered to the OWA, the **industry-funded** organization mandated to "*safely decommission orphan oil and gas wells, pipelines and production facilities …*"

As very publicly reported over the past several months, this resulted in a significant increase in the OWA's orphan well count. This has led to much public discussion, discussion which generally points the finger at the big bad Receivers acting on behalf of the socially insensitive Creditors to saddle the public with the financial burden of dealing with the resulting environmental obligations of the Residual Assets. As a related aside, rarely does it get reported that **the oil and natural gas industry, not the public, funds the OWA.**

The Reality

We believe that the Appeal Decision will ultimately result in **more** Residual Assets being delivered to the OWA for further handling than would have been the case if the Redwater Decision was not overturned by the Supreme Court. Further, the Appeal Decision was believed to be a method to provide much needed cash to the OWA to handle the liabilities, by directing the proceeds of any dispositions of Saleable Assets to the OWA. We do not see how this can happen.

The sale of an insolvent entity's assets through a Receivership can only occur if there is a party which is willing to fund the costs of the Receivership. These costs are very real and they can quickly become significant. Included in the costs of a Receivership are the costs of the Receiver's time, the Receiver's third party costs, legal expenses, court filing fees, selling agents' fees, etc. The Creditor will typically advance funds to the Receiver at the start of a Receivership process to cover these costs only if it is believed that the recovery from the liquidation of the Saleable Assets will exceed the costs of the Receivership and the settling of any priority claims to the estate.

Sayer has been involved in Receivership asset sales for several years, acting as sales agent for the Receivers of 36 insolvent entities. These entities collectively held approximately 4,000 licenced wells. We were able to sell approximately 30 per cent of these wells, 1,200 in total. Absent sales processes funded by Creditors through Receiverships, the 1,200 wells that were sold would likely have been delivered to the OWA along with other related Residual Assets.

As previously mentioned, for approximately 32 months subsequent to the issuing of the Redwater Decision and prior to the issuing of the Appeal Decision, Receivers were able to act on behalf of Creditors to sell whatever wells, facilities and equipment could be sold from the estates of insolvent oil and natural gas entities. Subsequent to the disposition of any Saleable Assets, Receivers were able to disclaim any Residual Assets and deliver them to the OWA.

With the Appeal Decision in place, any funds realized from the Saleable Assets must now be ultimately directed to the OWA, not to the Creditors, so that the OWA can use the funds to manage the abandonment and restoration of any environmental liabilities associated with the Residual Assets. While the social aspect of this is quite clearly understood, the collateral damage that will result is significant.

Creditors will now be loath to put insolvent entities into Receivership. Why would a Creditor fund a Receivership if there is not a realistic expectation of recovering its costs as well as a meaningful portion of the funds owing to it by way of its secured debt position?

Instead of pushing companies into Receivership some Creditors will possibly force insolvent entities to minimize overhead, following which the Creditor will then bleed off any available cash flow to help to pay down the debt position until such time as the operations are unsustainable. After cutting the losses, it is possible that the Creditor will simply just walk away from its position once the operations are unsustainable. The likely outcome of this scenario, collateral damage caused by the Appeal Decision, is that **all** of the assets of insolvent oil and natural gas entities will end up as Residual Assets, bagged, tagged and delivered to the OWA.

As previously mentioned, absent funding by Creditors, this type of scenario would have resulted in roughly 1,200 additional wells being sent to the OWA from only the 36 Receiverships that Sayer has been involved in. If you consider the numerous other recent oil and natural gas industry Receiverships, plus all of the future ones, the collateral damage from having to deal with this likely avalanche of Residual Assets will undoubtedly overwhelm the OWA.

One way for the OWA to receive funds from the sale of the Residual Assets in a scenario such as was previously discussed would be if the AER were to act as a Creditor, forcing the sale of assets for the account of the OWA. Without going into too much detail, Sayer recently worked with **Grant Thornton Limited**, Lexin's Receiver, in managing the sale of assets from Lexin on behalf of the AER, Lexin's Creditor by way of the funds owed to it. We believe that after being front and centre in that process, the AER would not be interested in getting actively involved in another Receivership. As well as creating obvious conflicts, we believe that acting as a Creditor in such scenarios is beyond the mandate of the AER as an independent regulator.

Another significant outcome of the Appeal Decision is that bankers may not continue to provide debt funding to junior oil and natural gas companies. The implications of this collateral damage are tragic, and could spell the beginning of the end of this once robust segment of our local economy.

Background to One Possible Solution

Sayer does not believe in criticizing anything without providing an alternative solution to a problem. To that end, approximately 18 months ago we initiated a meeting with Mr. Jim Ellis, the CEO of the AER at the time, to discuss the aforementioned possible outcomes to the Appeal Decision, which was still pending at that time. I will quote our advice to Mr. Ellis.

"*Jim, regardless of how the Supreme Court rules, the AER, the Creditors and the Receivers must all learn how to play nice together in the sandbox.*"

We presented a possible solution (the "Solution") to Mr. Ellis, who did not disagree with the need for a similar outcome. The Solution, which we stand by today, is actually quite simple. To better understand the Solution a bit of background information is in order.

Before a Creditor pushes an insolvent entity into Receivership, the Creditor prepares an economic evaluation of the costs and benefits of the potential process. On the benefit side, the Creditor will typically engage the services of a mergers and acquisition specialist firm like Sayer (the "M&A Advisor") to provide an analysis of what the proceeds from the sale of any Saleable Assets might be. An experienced M&A Advisor can generally predict which assets can be sold, what the sale proceeds will be, and which assets will become Residual Assets. If the Creditor believes that the proceeds will exceed the expected costs of a Receivership, a Receiver is hired, and a process to market the assets is undertaken through an M&A Advisor.

At the conclusion of the Receivership, the Creditor receives the proceeds of the sales of the Saleable Assets, net of costs. The Residual Assets are then disclaimed by the Receiver, ultimately ending up in the OWA.

One Possible Solution

Sayer's Solution is that prior to putting a company into Receivership, the Creditor, the AER and the M&A Advisor would work together to discuss the assets. With many details to work out, the basic workings of the Solution would involve the following steps. The first step would be to have the Creditor advise the group as to the amount it requires to satisfy its position. The M&A Advisor would then provide its best estimate of whether or not the estate has any Saleable Assets, and, if so, what the proceeds of a sale of those assets might be.

Once the estimate of which of the assets will become Saleable Assets is in hand, the AER would then provide its best estimate of the cost to deal with the obligations of the Residual Assets which the M&A Advisor believes will be left to deal with.

The parties now have an estimate of the results of a liquidation of the estate, factoring in the estimated cost of the Receivership, the estimated proceeds from the sale of any Saleable Assets, and the estimated cost of dealing with the Residual Assets. With this information in hand, the disposition of assets can take place in an orderly, equitable manner.

Let's use as an example a situation where the Creditor needs $20 million, the M&A Advisor estimates the market value of the Saleable Assets to be $12 million and the AER needs $10 million to deal with the Residual Assets. Using an allocation determined by the proportionate shares of the required recoveries of $20 million (Creditor) and $10 million (AER), the Creditors, requiring two-thirds of the estimated recovery, would pay for two-thirds of the costs of the Receivership. The AER, requiring one-third of the estimated recovery, would pay for one-third of the costs. The net proceeds from the sale of the Saleable Assets would be distributed to the two parties using the same two-thirds to one-third split, in this example $8 million to the Creditor and $4 million to the AER.

Recognizing that the M&A Advisor's estimates will be good, but not perfect, after the assets are sold and it is time to wind up the Receivership the allocation of net proceeds and expenses would be adjusted to account for the realized proceeds from the sale of the Saleable Assets and for the

estimated cost of dealing with the resulting Residual Assets.

The end result of the Solution should be that the number of Residual Assets would be minimized, while providing some funds to the OWA to deal with the Residual Assets, overall a far more palatable outcome might be expected absent a Receivership process.

Potential Backlash to the Solution

While the Solution appears at first glance to be fair and equitable to all parties, before considering going down this road the AER would need to find a way to manage the public perception. In light of the negative sentiment to the industry resulting from the recent public discussion of a few notable insolvencies, including Lexin, and in light of the Appeal Decision, the public backlash of this cooperative approach to lightening the load of the OWA would most likely be huge.

If the AER and a Creditor were to work together to share the costs and proceeds from the liquidation of assets in a Receivership, well-meaning but ill-informed third parties would look at this in horror, as the Solution conflicts with the ruling of the Supreme Court that effectively says that the OWA would be entitled to receive **all** of the proceeds from any asset sales in a Receivership. This will not likely be publicly-received as the good news story that it is; it will likely be treated as a travesty of justice. It is possible that legal challenges to any cooperative effort will follow.

The flip side is that any approach that is not collaborative is likely to result in a very significant increase in the Residual Assets heading to the OWA. No matter how you look at it, that would not serve the best interests of any party, especially the OWA, the AER, the Creditors, the oil and natural gas industry, and even the general public.

Conclusion

While our proposed Solution has obvious positive factors rendering it worthy of consideration, the negative implications may prove to be difficult to overcome. We are tabling it here as a starting point for discussions, as we believe that the ultimate solution will require a collaboration of industry, the financial community, government and the public. We are sure that other solutions can be found; however, we have not yet heard of any proposals. For the sake of our industry’s future, we all need to step up and work towards collaborative solutions to these types of issues, sooner rather than later.

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