Regulatory Issues that Arise
in Connection with the Insolvent Oil and Gas Operator

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Orest Konowalchuk, Senior Director, Alvarez & Marsal Canada ULC, Calgary

Sean Collins, Partner, McCarthy Tétrault LLP, Calgary
Introduction / Issues

The dramatic decline in oil and gas commodity prices has resulted in a generational decline in the fortunes of oil and gas exploration and production companies, particularly in Alberta. We are presently witnessing an ever-increasing number of insolvency proceedings involving insolvent oil and gas production companies. The legislative and regulatory framework in Alberta mandates that trustees and receivers (sometimes hereinafter referred to collectively as an “insolvency representative”) are deemed to be “licensees” for the purpose of compliance with the underlying statutory and regulatory regime as it pertains to the exploration, development and production of petroleum and natural gas. While a certain degree of risk attends with this legislative and regulatory characterization, a fundamental tenet of Canadian insolvency legislation and policy is that the insolvency representative is not, absent demonstrable evidence of wilful misconduct or gross negligence, and in limited statutory circumstances that are beyond the scope of this paper, personally responsible or liable to creditors and stakeholders for defaults committed by the insolvent entity.

In Alberta, compliance by licensees and other participants in the oil and gas industry is regulated by the Alberta Energy Regulator (the “AER”). The AER’s policy with respect to insolvent oil and gas entities is that the insolvency representative, in its capacity as “licensee”, steps into the shoes of the insolvent licensee. As a result, it is the AER’s position that on appointment, receivers and trustees of oil and gas property subject to the AER’s regulatory oversight, must comply with all applicable statutory and regulatory obligations to which the licensee is subject.

As an independent officer of the Court, the insolvency representative has a positive duty to administer the affairs of the insolvent estate in a fair and even-handed manner, in compliance with applicable laws, and in a fashion that does not favour the interests of one stakeholder over another. The very nature of insolvency, however, is that there is invariably insufficient financial resources available for the insolvency representative to cause the insolvent estate to discharge all of its obligations to all of its stakeholders. In resolving this issue, inevitably conflicts will arise as between stakeholders who claim that their respective rights enjoy priority over other stakeholders. With the goal of the administration of the estate being to maximize recovery, for the benefit of all stakeholders, we hope to explore in this presentation certain of the issues that arise in connection with the position of the AER as it pertains to its view on the requirement of the insolvency representative to discharge the obligations under applicable legislation and
regulations with the competing claims of creditors, particularly secured creditors, who assert that their claims rank in priority to the obligations owing to the AER by the insolvent estate. At present, there is uncertainty in the legislation and case law as to how the conflicting duties ought to be resolved. While it is hoped that further clarity will emerge for the benefit of all concerned in connection with the resolution of the inherent conflict, as at the date of preparing this presentation, no clear legislative or jurisprudential direction has arisen. Accordingly, the presenters will provide an overview of the legislative and regulatory regime, discuss certain of the issues that arise in the administration of the estate of an insolvent oil and gas operator, and offer some practical tips and advice as to how to navigate through these relatively murky waters.

**Legal Framework**

**Oil and Gas Regulation and the AER**

The AER’s position, is that on appointment, receivers and trustees “step into the shoes” of the AER licensee by virtue of the definition of “licensee” in section 1(1)(cc) of the *Oil and Gas Conservation Act* (“OGCA”) and section 1(1)(n) of the *Pipeline Act*. Specifically, the definition of licensee in both statutes explicitly includes trustees and receiver-managers. As a result, it is the position of the AER that on appointment, receiver-managers and trustees of the properties of AER licensees are subject to applicable statutory and regulatory obligations to which the licensee is subject.

**Statutory and Court Protection for the Insolvency Representative**

Receivers and trustees enjoy statutory protection and, in the case of being appointed under an order of a Court of competent jurisdiction, typically are afforded additional or supplemental protections in the Court order. In particular, as it pertains to environmental liability, section 14.06 of the BIA expressly mandates that a trustee or receiver is not personally liable for any environmental condition or environmental damage that occurred prior to the insolvency representative’s appointment or subsequent to the appointment unless it is established that the environmental condition arose as a result of the insolvency representative’s gross negligence or wilful misconduct. Moreover, to the extent that an environmental condition arises and a regulatory body having jurisdiction demands that the environmental condition be remediated, the BIA mandates that the insolvency representative is not personally responsible for the costs in connection with carrying out remediation nor is the insolvency representative personally liable for failure to comply with the order if the insolvency representative abandons or disposes of any
interest in the property that is subject to the remediation order prior to the expiration of the time required to remediate or, if no time is specified, within 10 days of the date of the order.

The template receivership order that is used in the province of Alberta (and, indeed, in the other common law jurisdictions in Canada with template orders) supplements the protections of section 14 of the BIA by essentially restating section 14 of the BIA and by also, among other things, providing that a receiver is not liable for anything done in the furtherance of discharging its duties in that capacity save for any liability that arises as a result of the receiver’s gross negligence or wilful misconduct.

The protections in the BIA and template receivership order are part of a long-standing recognition that receivers and trustees have no direct economic or pecuniary interest in the insolvent’s estate. Rather, receivers and trustees are independent officers of the Court with a mandate to administer the estate and realize upon the property under administration for the benefit of all stakeholders. Absent the protections available to receivers and trustees, it is posited that it would be difficult to incent trustees and receivers to accept appointments in many circumstances where personal liability would otherwise attend.

**The Position of the AER upon the Appointment of the Insolvency Representative**

The AER’s mandate, as stipulated by its enabling legislation, includes providing “efficient, safe, orderly and environmentally responsible development of energy resources in Alberta”. In carrying out its mandate, the AER establishes rules and issues licenses, approvals, and the like in furtherance of the purposes of the underlying legislative and regulatory framework. In its interpretation of its statutory duty and in carrying out its regulatory function, the AER takes the position that a receiver or trustee must confirm that it is assuming care, custody and control of an insolvent licensee’s AER licensed assets. Upon a receiver or trustee being appointed in connection with an insolvent licensee, the AER issues a standard directive (a “Standard Directive”) to the trustee or receiver which provides that:

“The AER takes the position that [the receiver or trustee] is legally and statutorily obligated to fulfill these obligations, and must do so prior to distributing any funds or finalizing any proposal to creditors, secured or otherwise. The AER is of the view that the current law in Alberta and federally supports this position and notes that the suspension and abandonment addressed primarily public safety issues
as opposed to environmental concerns, and constitute a carrying out of a duty owed by the licensee to the public."

In addition to the foregoing, the Standard Directive also purport to require:

“written confirmation that [the receiver or trustee] has taken possession of the AER license properties, is providing care and custody of the properties and is taking steps to ensure compliance with the licensee’s responsibilities and obligations under [applicable legislation and regulations]."

**The Licensee Liability Rating Program**

In addition to the myriad of regulations relating to the safe and efficient operation and management of licensed properties, the AER administers a program known as the “Licensee Liability Rating” (“LLR”) program. The purpose of the LLR program and license transfer requirements that accompany the program are to ensure that there are sufficient funds for end-of-life obligations, to prevent the cost to suspend, abandon, remediate and reclaim AER licensed properties from being borne by the Alberta public should a licensee become insolvent.

Under the LLR program, the AER conducts a liability assessment for each licensee, which is based on the estimated cost to suspend, abandon, reclaim and remediate the AER licensed properties of that licensee. Based on that assessment, the AER assigns a liability management ratio (“LMR”) to each licensee, which is the ratio of the licensee’s eligible deemed assets as compared to its deemed liabilities. The assessment is conducted monthly and on receipt of an application to the AER to transfer existing AER licences. As part of its assessment of an application to transfer licenses, the AER assesses the pro forma / post-transaction LMR of both the transferor and the transferee. If either party’s post-transaction LMR is below 1.0, the AER will either deny the transfer application or require additional security. Any licensee that fails to comply with the AER LLR program is considered in non-compliance by the AER and is subject to enforcement action by the AER, including the ability of the AER to issue suspension or closure orders.

In the ordinary course of a solvent licensee’s operations, the licensee usually has the ability to discharge its obligations to the AER including either ensuring a LMR of 1.0 or greater or posting security in an amount required by the AER if a licensee’s LMR is less than 1.0. A receiver or trustee, on the other hand, may not have sufficient funds on hand or access to liquidity to cause
the insolvent estate to comply with the regulatory requirements of the AER. In some circumstances, particularly as it pertains to the licensee’s LLR, secured creditors of the insolvent estate may assert that their security takes priority over the obligation of the insolvent licensee to comply with the AER’s requirement that it post security. The issue becomes particularly acute where a receiver or trustee, after having conducted a sales process, receives offers that represent the best value to be received by the estate for the sale of all or some of the insolvent licensee’s oil and natural gas properties. The AER’s position has been, absent a negotiated position, that it will not approve license transfers if the LMR of the transferor (in particular) is less than 1.0 following consummation of the transaction.

As a result, an issue that is faced by insolvency representatives is the ability to transact when the insolvent licensee’s LMR is less than 1.0. There have been cases where the insolvency representative has purported to disclaim the low value licenses of the licensee to create a LMR of the assets under administration to be greater than 1.0 and have argued that effect of such strategy is that the AER ought to approve the license transfer. The AER maintains that its regulated licenses are not capable of disclaimer and, in any event, it retains the overriding jurisdiction to approve license transfers. In such circumstance, the issue arises as-to whether the AER’s power to refuse license transfers is in fact a cloaked attempt to enhance its priority above that which is otherwise prescribed by applicable law. At present, there is great uncertainty as to the relative position of secured creditors, on the one hand, and the ability of the AER to both assert that the receiver or trustee is obliged to comply with the underlying legislative framework and refuse license transfers. As at the date of preparing this paper, the issue is before the Court of Queen’s Bench of Alberta in the case of the receivership and bankruptcy proceedings involving Redwater Energy Corp. While a decision in the Redwater Energy case is expected in the immediate near future, it may be that either as a result of subsequent appeals or legislative amendments, any certainty that might otherwise flow from the Court’s initial decision in Redwater Energy will be undermined.

Closely related to the foregoing issue is the ability of a receiver to purport to take possession of some, but not all, of the insolvent licensee’s licensed properties in addition to the ability of the insolvency representative to disclaim licenses of properties it has assumed and for which the AER has issued a compliance, abandonment or closure order.
Suggested Tips and Best Practices

It is against the foregoing backdrop that the presenters of this paper wish to discuss and offer tips and best practices when administering the estate of an insolvent licensee. Prior to so doing, however, the authors hasten to note that they should not be taken in this presentation as advocating for or against positions taken by relative stakeholders in disputes between the AER, on the one hand, and secured creditors on the other. There is no doubt that the AER, in the positions that it takes, is doing so as a result of its belief that its positions are in the best interests of the AER’s stakeholders and supported by statutory and regulatory framework and existing case law. Similarly, positions advanced by the holders of security over the assets of the insolvent licensee are, for the purpose of this analysis are assumed to be acting in the best interests of their stakeholders. That is to say, there exists the potential for conflict between the positions that are advanced in cases where there are insufficient financial resources available to permit the receiver or trustee to fully discharge all of the insolvent licensee’s obligations to the AER, on the one hand, and to pay creditors, in particular secured creditors, amounts owing to them, on the other. Against this backdrop, we offer the following observations:

(a) Advanced planning is critical

While the exigencies of any given file will determine how much advance planning can be undertaken prior to accepting a formal appointment, in those instances where there is an opportunity to give advance consideration to the issues, the proposed receiver or trustee must do its best to inform itself as to the issues that might arise in connection with the administration of the estate and attempt to formulate a plan to deal with potential issues from the outset. For example, what is the anticipated LMR of the insolvent licensee going to be? If the appointment is being made on application by a secured creditor, what arrangements will be made with the secured creditor to fund the ongoing liquidity requirements to comply with health, operational and safety mandates and directives of the AER? Are there major issues that can be identified up front and is there a possibility to attempt to agree to a framework as between the secured creditor and the AER prior to the initiation of the formal process?

(b) Obligation to administer the estate in compliance with applicable legislation

It is often not possible to deal with all potential regulatory matters in advance of a formal process being initiated. In those cases, and in any event, the trustee and receiver must
keep its primary duty present to mind, which is to maximize the value of the estate for the benefit of all stakeholders while discharging its duties in a fair, transparent and lawful manner. Having said this, the receiver and trustee must also be vigilant to ensure that it continues to receive the benefit of the protections afforded to it under the BIA and any Court order appointing it. Accordingly, consideration should be given to the following issues:

(i) If there are anticipated material issues that will arise post-appointment, then consideration should be given as to whether or not the receiver or trustee should encourage the applicant to provide advance notification to the AER in connection with any order that is being sought.

(ii) The receiver or trustee must be mindful of the fact that the legislative framework surrounding its appointment does not permit it to carry on a business that is not in compliance with the authorization conferred upon the insolvent by an applicable regulatory authority. In those circumstances, what arrangements will be made by the receiver or trustee to make arrangements with the, in this case AER, to continue in operation or to cease operations? To the extent the AER takes a position that the receiver or trustee, in consultation with its counsel, determines is contrary to or overreaches the obligations of the receiver or trustee under applicable law, then the position of the receiver or trustee should be communicated in response to the AER in writing and as soon as possible following receipt of the AER standard directive.

(c) Attempt to encourage dialogue and facilitate resolution as early as possible in the case

In circumstances where it is evident that there will be insufficient resources to comply with AER directives, then the receiver or trustee should attempt to facilitate a protocol through dialogue between the affected stakeholders (usually the senior secured creditor) and the AER. In the ongoing insolvency proceedings involving Spyglass Resources, for example, the receiver negotiated a prearranged formula that sets out the payments to be made by the Receiver to the AER in connection with the sale of licensed properties in return for the AER’s agreement to agree to licenses transfers.
Conclusion

The downturn in economic activity in the oil and gas industry is not expected to abate any time in the near future. With this, there will undoubtedly be an increase in formal insolvency proceedings involving licensees of AER licensed properties. While it is hoped that further clarity will emerge either as a result of or in combination with the Court’s decision in *Redwater Energy* and/or legislative amendment, there will undoubtedly be circumstances where seemingly irreconcilable conflicts among stakeholders will continue to present. The effective insolvency professional will do its best to discharge its duties and attempt to facilitate agreement or a compromise among affected stakeholders, while at the same time ensuring that the protections afforded to it will continue to apply during the course of its administration of the insolvent licensee’s estate.