Super-Priority for Environmental Liabilities in Insolvencies - A Comment on the Supreme Court of Canada's Decision in Redwater

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On January 31, 2019, the Supreme Court of Canada released its landmark decision in *Orphan Well Association v Grant Thornton Ltd*, 2019 SCC 5 ("***Redwater***"). The question before the Court was whether the Alberta Energy Regulator and Orphan Well Association (collectively, the "**Regulator**") could require Grant Thornton Limited, as receiver and then trustee in bankruptcy (the "**Trustee**") of Redwater Energy Corporation ("**Redwater**"), to comply with abandonment, reclamation and remediation orders issued by the Regulator, or whether the Trustee was entitled to "disclaim" the assets subject to the orders (the "**Renounced Assets** ") and not comply with the orders.

A 5:2 majority of the Supreme Court determined that the Trustee could not disclaim the Renounced Assets, effectively elevating the environmental orders to a super-priority status. Absent an immediate response from Parliament, *Redwater* will have profound and potentially severe impacts on many solvent and insolvent businesses in Canada, especially in Alberta's energy sector.

The Decision

The issue in *Redwater* was essentially whether the Trustee could (i) disclaim the Renounced Assets, and (ii) sell Redwater's economically viable assets for the benefit of the estate.

The Regulator's positon was that economically viable assets could not be sold without the Trustee first satisfying the liabilities relating to the Renounced Assets. The Regulator refused to permit the Trustee to sell the viable assets unless they were bundled with the Renounced Assets.

In contrast, the Trustee's position was that the Regulator's orders conflicted with the disclaimer powers under the *Bankruptcy and Insolvency Act*, RSC, c B-3 ("***BIA***"), and were thus ineffectual by virtue of the constitutional principle of "paramountcy". Specifically, the Trustee argued that its power of disclaimer under Section 14.06(4) of the *BIA* was paramount to "licensee" obligations under Alberta provincial laws. The Trustee further argued that the Regulator's orders were "provable claims" in the

Redwater bankruptcy proceedings, and should be dealt with in the same priority (i.e. pro rata) as other unsecured provable claims, as specified by the *BIA*.

Chief Justice Wagner, writing for the majority of the Supreme Court, accepted the Regulator's submissions and held that:

1. Disclaimer. The disclaimer power under Section 14.06(4) of the BIA only concerns the "personal liability" of the trustee and "says nothing" about the liability of the bankrupt estate. Thus, the Regulator's orders did not conflict with the BIA, since the Trustee could disclaim the risk of personal liability under Section 14.06(4) while nonetheless causing the bankrupt estate to comply with the orders. The provincial laws were compatible with the BIA and paramountcy did not apply.

2. Provable Claims. Similarly, the Regulator's orders were not "provable claims" within the meaning of the BIA. In particular, the majority held that since the Regulator was acting "in the public interest and for the public good" in pursuing the orders, it was not a "creditor" and its claims were therefore not provable claims stayed by the BIA. In so finding, the majority reformulated the test for "provable claims" established in the prior decision of Newfoundland and Labrador v AbitibiBowater Inc, 2012 SCC 67 ("Abitibi"). Since the Regulator's orders were not provable claims, the majority concluded that "the end-of-life obligations binding on [Grant Thornton] … do not conflict with the general priority scheme in the BIA".

These findings are highly problematic, however, in light of established insolvency law principles, and were forceful criticized by Justice Côté in her 70 page dissent.

First, Justice Côté explained that if the disclaimer under Section 14.06(4) only relieved the Trustee of "personal liability" it would be "entirely meaningless and redundant" as the very same protection is afforded to trustees under Section 14.06(2) of the *BIA*. Parliament should not be interpreted as having drafted superfluous provisions in legislation.

Second, Justice Côté explained that the reliance by the majority on Section 14.06(7) of the *BIA*, which gives a regulator a first charge in property in respect of which the regulator performed remediation, was misguided. The majority held that Section 14.06(7) evinced Parliament's intention to give a special super-priority status to environmental liabilities, even when the strict requirements of Section 14.06(7) did not apply. However, the opposite conclusion is more coherent, in keeping with the structure and intent of the *BIA*. Specifically, Parliament's inclusion of Section 14.06(7) demonstrates that it considered the need for a super-priority for environmental claims, and determined that only a narrow one was justified. Thus, according to Justice Côté, Section 14.06(7) "suggests that Parliament specifically envisioned that the government could obtain a super priority and leapfrog other creditors, but *only* where the government itself has already remediated the environmental damage" (emphasis in original). The BIA is a "complete code governing bankruptcy" (as has been previously noted by the Supreme Court) and Parliament would not imply a general super-priority for environmental claims.

Finally, the majority has over-ruled the test for provable claims established by the Supreme Court only six years earlier in *Abitibi*. In that case, Justice Deschamps set out a three-pronged test for "provable claims" with the first requirement being that the

claimant is a "creditor". Specifically, Justice Deschamps described the creditor requirement by stating that "The only determination that has to be made at this point is whether the regulatory body has exercised its enforcement power against a debtor. When it does so, it identifies itself as a creditor, and the requirement of this stage of the analysis is satisfied". Conversely, in *Redwater* the majority held that where regulators are acting in "the public interest", and do not "stand[] to benefit financially" themselves, they will not be considered creditors. This is a significant departure from the expansive (and reasoned) definition of creditor given by Justice Deschamps. Even more puzzling is that the majority found the Regulator was not a creditor, even though the Regulator *itself* conceded that it was a creditor in both of the lower courts.

Simply stated, the majority has narrowed the long recognized (and necessary) power of a trustee in bankruptcy to disclaim uneconomic assets, granted a super-priority for environmental liabilities which is absent from the *BIA*, and narrowed the tripartite "provable claim" test as established in *Abitibi*.

Implications

Redwater is expected to have significant effects on insolvency law and practice in Canada, including as follows.

1. More Orphan Wells – In light of Redwater, trustees are likely to be prevented from disclaiming uneconomic assets and selling economic ones. Instead, trustees will now be required to sell assets in "bundles" (good and bad assets together), or alternatively, perform abandonment and reclamation obligations as conditions of selling economic assets. Where environmental obligations exceed the total valuable assets, we expect fewer asset sales in ongoing engagements, as well as fewer appointments of receivers and trustees by creditors in the first instance. What buyer would pay for a group of assets with a net negative value? Likewise, what creditor is going to pay the costs of an insolvency proceeding where the proceeds will go to the Regulator? The net result is likely to be that both good and bad assets will be designated as orphans, resulting in a failure to realize any value for any creditors, including the Regulator (whether it calls itself a creditor or not). While creditors will be adversely affected by this, so too will the Alberta public, as the number of orphan wells grows.

2. *Less Financing* – We also expect a chill on lending and investment in the oil and gas industry, and other industries where environmental liabilities feature prominently, such as the mining sector. Lenders and investors may not lend money or make investments where the recovery of their funds is now so uncertain. While equity is likely to dry up, lenders are likely adjust to this new reality by reducing borrowing bases to account for environmental liabilities while simultaneously increasing interest rates to account for the greater risk they are assuming by lending to such industries. Consequently, credit for all businesses in the affected industries will be more expensive and less accessible, stunting economic growth and causing more financial distress and failures. This is unfortunate timing for Alberta's already suffering energy industry.

3. Fewer Insolvency Proceedings – Insolvency proceedings under the BIA are intended to be collective procedures that maximize the value for all creditors. Thus, formal insolvency proceedings provide a societal benefit. However, Redwater creates disincentives for secured lenders to commence insolvency proceedings, as their chances of now recovering any value (after satisfaction of large environmental

obligations) is drastically lessened. Secured lenders are highly unlikely to fund an insolvency process merely for the "greater good", which may have wider social and environmental impacts.

Further, owners and management of insolvent corporations with significant environmental obligations may look to hand the keys over to secured creditors, which will leave the insolvent estate in limbo with no responsible person managing environmentally sensitive (or even dangerous) assets.

4. Priorities under the BIA – Although Redwater concerned the secured claims of Alberta Treasury Branches, it is not only secured lenders who will lose by the re-ordering of priorities in Redwater. All creditors, including employees, tort victims, joint venture partners, trade creditors, etc. will be affected. While banks can protect themselves through adjusting lending practices, these other creditors will have many fewer options.

5. No Disclaimer – Finally, without a clear power to disclaim onerous property encumbered by environmental liabilities, trustees will face significant difficulties in performing their duties. Trustees are officers of the court and serve a social purpose.

In short, *Redwater* has significant implications for Canadian insolvency law and the economy as a whole. The full impact of the decision will depend on the specific policies and orders of the regulators, the will of Parliament and future business practices.

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