2016 CAPL CONFERENCE
A&D – Topical Issues

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INTRODUCTION

- Welcome to the Conference that almost wasn't!
- Soooo, my presentation was reduced from 3 hours to 1 hour.

INTRODUCTION

- As we only have 1 hour, I have torn up my great big Major Agreements presentation and replaced it with this much shorter, **5 Topical Issues** presentation.

- Much nicer for everyone [insert smiley face emoticon here].

- Aside - I am a little bit bitter about doing a great big PowerPoint and then tearing it up, but lets not worry about me.

5 TOPICAL ISSUES

- White Map Asset Sales
- Dollar Deals
- AER Issues – LMR 2.0(ish) and Pipeline Compliance
- Receivership – Disclaimed Assets and Buying from a Receiver
- Disgorgement Damages on Dead Freehold Leases

1. WHITE MAP ASSET SALES

- The addition of White Map language in Asset Purchase and Sale Agreements (PSA) has been a surprisingly resilient change to the core structure of the PSA.

- I had assumed the price collapse would eliminate a vendor's ability to ask for White Map language in a PSA.

WHITE MAP ASSET SALES (cont)

Traditional White Map PSA:

- attempts to define "Lands" in a general or two dimensional fashion (areally).
- this general Lands description forms part of the defined "Assets".
- intended result that the Assets will comprise any and all of the vendor's interests and liabilities in the two dimensional Lands as set out in Schedule "A" to the PSA (i.e. the Mineral Property Report) (MPR).

WHITE MAP ASSET SALES (cont)

Traditional White Map PSA:

- The problem with the Traditional White Map PSA is that it does not deal well with the scope of environmental liabilities.

- Environmental liabilities:
  - are not Assets
  - may not be associated with the MPR lands (even in 2D)
  - e.g. old facility with no mineral rights or off lease issues

WHITE MAP ASSET SALES (cont)

Traditional White Map PSA:

- This problem was fully exposed in *Anadarko Canada Corp. v. Canadian Natural Resources Ltd. (*2006 CarswellAlta 1000).

- Justice Rowbotham was reviewing a PSA from Norcen (now Anadarko) as vendor to CNRL as purchaser.

- At issue was the liability for an old abandoned battery site (abandoned in 1968) located right in the middle of the oil play that was sold to CNRL.

WHITE MAP ASSET SALES (cont)

Traditional White Map PSA:

- The environmental indemnity was tied to the "Assets" and Justice Rowbotham determined that Assets as defined in the PSA meant, essentially, the operational, physical tangibles or PNG Rights.

- An abandoned battery site was not a tangible thing or even an intangible interest (since no surface lease remained) and, therefore, no indemnity was available and Anadarko (as corporate successor to vendor) was stuck with the cleanup bill.

WHITE MAP ASSET SALES (cont)

Land Plat White Map PSA:

- The simple and ingenious solution to the above problem was the introduction of a stand-alone White Map Area definition and land plat in the PSA.
- The White Map Area is defined in relation to a scheduled land plat, with the plat showing a great big red outlined box around the general sale area.
- As they say, a picture is worth a thousand words.

WHITE MAP ASSET SALES (cont)

Land Plat White Map PSA:

- Elegantly simple. Purchaser takes responsibility for all past, present and future environmental liabilities of vendor within the White Map Area (which is the outlined boundary on the land plat).

- If the problem is in the box, purchaser is responsible.

WHITE MAP ASSET SALES (cont)

Why is White Mapping Topical?

- Banks and other lenders have become hyper sensitive to "Asset Retirement Obligations" (ARO).
- A land plat white map increases uncertainty with respect to ARO.
- Purchaser may acquire unknown environmental liabilities.

WHITE MAP ASSET SALES (cont)

Why is White Mapping Topical?

- Any yet, the land plat white map PSA has been surprisingly resilient even during the downturn.
- I just don't understand it.
- Remember: On a corporate deal (share purchase), you take all corporate liabilities, very different than an asset purchase.

2. DOLLAR DEALS

- "Dollar deals" is a phrase coined during stagflation in the 1980's recession. People would sell the house to a scoundrel for a $1 to get out from under a mortgage payment obligation. Dude would live rent free in the property until evicted after foreclosure.

- With stubbornly low oil and gas prices, dollar deals are becoming more and more common in the patch.

DOLLAR DEALS (cont)

- Vendors will sell for a $1 to:
  - Get out from under unwanted ARO
  - Fix a LMR issue
  - Reset your corporate profile

- Can be:
  - Hundreds of operated wells
  - A non-operated WIP in a single well

- Note – selling for a negative amount (i.e. vendor pays purchaser to take the asset) is also possible and increasingly common.

DOLLAR DEALS (cont)

- **Is there "consideration" for such deals?**

- A valid contract must have:
  - Offer
  - Acceptance
  - Consideration

- Not an issue. Assumption of liabilities (abandonment, reclamation and environmental) is consideration.

DOLLAR DEALS (cont)

- **Can these deals be challenged?**

- Likely not for *bona fide* transactions.

- However, if you dump assets into an entity doomed to fail, you may face a fraudulent preference claim or other equitable claims from affected third parties, including the Government.

- There is also a (remote but growing) prior licensee risk with AER if you are transferring AER Licenses.

3. AER ISSUES
PART I - LMR 2.0(ish)

- **In the beginning**, there was *AER Directive 006 Licensee Liability Rating Program* (LLR):

  - Every licensed well and facility
  - Licensee takes 100% of the LLR hit

- LLR gets aggregated into your corporate Liability Management Ratio (LMR).

LMR 2.0(ish) (cont)

- If your monthly calculated LMR falls below a ratio of 1.0, you are required to post a Security Deposit with AER, in a form acceptable under *Directive 068 – ERCB (AER) Security Deposits*.

- *Aside:* The immediate consequence of the failure to pay is Global Refer status. You can still produce under Global Refer. The shit only really hits the fan once AER issues closure and abandonment orders. There seems to be a delay between these steps.

LMR 2.0(ish) (cont)

- **Then came**, *AER Bulletin 2016-16 (Alberta Energy Regulator Measures to Limit Environmental Impacts Pending Regulatory Changes to Address the Redwater Decision).*

- Odd (over) reaction to the *Redwate*r decision (discussed below)

*"*The AER and OWA have appealed the decision. The AER is also working on appropriate regulatory measures to address the decision's impacts and **ensure that statutory environmental liabilities associated with energy development in Alberta are adequately and appropriate addressed**."

LMR 2.0(ish) (cont)

- *Bulletin 2016-16 c*reates the 2.0 Rule:

  "As a condition of transferring existing AER licenses, approvals, and permits, ***the AER will require all transferees to demonstrate that they have a liability management ratio (LMR) of 2.0 or higher immediately following the transfer****."*

- This is after several years of already increased deemed liability values and falling deemed asset values.

LMR 2.0(ish) (cont)

- Immediate application was a shit show, but we are over that.

- Outrage over squashing of A&D flow continues.

LMR 2.0(ish) (cont)

- This lead to, *AER Bulletin 2016-21 (Revision and Clarification on Alberta Energy Regulator's Measures to Limit Environmental Impacts Pending Regulatory Changes to Address the Redwater Decision).*

- Small back peddle on strict 2.0 rule

"(iii) they are able to **satisfy the AER by other means** that they will be able to **meet their obligations throughout the life cycle of energy development with an LMR of less than 2.0**. Licensees can achieve an LMR of 2.0 or higher in a number of ways, including posting security, addressing existing abandonment obligations, or transferring additional assets."

LMR 2.0(ish) (cont)

- "Satisfy the AER by other means" requires a pre-closing meeting with AER to get comfort.

- **Note:** Directive 006 requires the transferor and transferee to have a pre and post LMR of 1.0.

- The Bulletins only amend the **transferee** post closing LMR to 2.0(ish). This will allow 1.0 transferors to transfer negative licensees to qualified transferees.

AER ISSUES
PART II - PIPELINE COMPLIANCE

- *AER Bulletin 2015-34 (Confirmation of the Transfer of Pipeline Records to Be Added to the Licence Transfer Application)*.

- New statutory declaration on AER electronic License Transfer Applications (LTA) under the DDS system.

PIPELINE COMPLIANCE (cont)

- For this issue, it is easiest to simply quote from the Bulletin.

- "**Transferor statement:** The transferor hereby confirms that it has **collected and retained** all records required under the *Pipeline Rules* and *CSA Z662*. The transferor confirms that it **has provided** these records to the transferee by the effective date of the licence transfer."

PIPELINE COMPLIANCE (cont)

- "**Transferee statement**: The transferee hereby confirms that it **has received all records required** to be collected and retained under the *Pipeline Rules and CSA Z662* from the transferor*.* **The transferee is responsible for producing these records on request by the AER. Failure to do so constitutes a noncompliance of AER requirements**."

- Nice.

PIPELINE COMPLIANCE (cont)

- "The AER will conduct compliance monitoring to ensure that these records have been transferred. **Licensees who fail to produce these records are considered to be in noncompliance with AER requirements**."

- "Depending on the situation, the **AER may suspend operation** of the pipeline pending completion of an **engineering assessment** that demonstrates that the pipeline is fit for its intended purpose and service."

PIPELINE COMPLIANCE (cont)

- Leads to real issues on asset sales:
  - Compliance (both Vendor and Purchaser)
  - Who pays any required engineering assessment costs

- I use a relatively low grade clause in my PSA.

- Others are more concerned and use a trust agreement for vendor to hold AER pipeline licenses until confirmation by purchaser of pipeline records compliance.

- See also BCOGC "as built" issues.

4. RECEIVERSHIP
PART I – DISCLAIMED ASSETS

- Queen's Bench decision - *Redwater Energy Corporation (Re)*, 2016 ABQB 278. Currently on appeal.

- Battle between federal *Bankruptcy and Insolvency Act* (BIA) and provincial *Oil and Gas Conservation Act.*

- BIA act wins. Receiver may "renounce" certain AER licensed assets and compel the AER to allow transfer of the rest.

DISCLAIMED ASSETS (cont)

"Subjecting such orders to the claims process does not extinguish the debtor's environmental obligations any more than subjecting any creditor's claim to that process extinguishes the debtor's obligation to pay a debt. It merely ensures that the Province's claim will be paid in accordance with insolvency legislation. **Full compliance with orders that are found to be monetary in nature would shift the costs of remediation to third party creditors and replace the polluter-pay principle with a "third-party-pay" principle.**"

DISCLAIMED ASSETS (cont)

- Everything really turns on the application of 14.06 of the BIA, which states, in part:

Costs for remedying not costs of administration *14.06 (6) If the trustee has abandoned or* ***renounced*** ***any interest in any real property****, or any right in any immovable,* ***affected by the environmental condition or environmental damage****, claims for costs of remedying the condition or damage shall not rank as costs of administration*

DISCLAIMED ASSETS (cont)

- Consequences:
  - Bad assets can be left behind on a receivership or bankruptcy sale ("**Renounced**").
  - Bank gets more money on bankruptcy. Will they push troubled companies through this process?
  - WIPs or OWF get more bad wells.
  - Might help with financings and bank debt.

RECEIVERSHIP
PART II – BUYING FROM A RECEIVER

- Short answer, cheap, but yuck.
- Records deteriorate very quickly after a trustee or receiver is appointed.
- Receiver will make everything your problem.

BUYING FROM A RECEIVER (cont)

- You must do intense due diligence with respect to unpaid:

  - Crown and freehold royalties
  - MD taxes
  - Surface Rentals
  - JIBs
  - Processing and Transportation fees
  - Etc.

BUYING FROM A RECEIVER (cont)

- The main benefit (other than price) of buying out of bankruptcy or receivership is the very powerful Vesting Order granted by the Court to confirm the sale.

- "Vesting" under the BIA allows the insolvent company's assets to move to the purchaser free and clear of almost all claims and encumbrances.

BUYING FROM A RECEIVER (cont)

- However, it is annoyingly unclear exactly when and what debts are cleansed. Complexities arise as the BIA layers itself over each Province and all the various legislation. Must specifically consider all debts which would otherwise follow the assets, such as:

  - Crown and freehold royalties
  - MD taxes
  - Surface Rentals
  - JIBs
  - Processing and Transportation fees
  - Etc.

BUYING FROM A RECEIVER (cont)

- It is best to have the Receiver pay all debts out of your purchase price. However, they often will not do so as the secured creditor (bank) has a priority claim over all funds.

- Ergo, the purchaser is left to rely on the power of the Vesting Order as against prior creditors. Can create post closing difficulties.

5. DISGORGEMENT DAMAGES

- Lastly, a word on the measure of damages under terminated freehold leases. This will apply anywhere in the WSB.

- This issue is a big deal because of the astronomical increase in damages payable by lessees.

- The risk of terminated leases is also on the increase due to wide scale shut-in of production of freehold lands. Be careful if you turn the wells back on.

DISGORGEMENT DAMAGES (cont)

- ***Stewart Estate v. TAQA North Ltd, 2015 ABCA 357***.
- Note – leave to appeal to SCC denied.
- This may be the most important freehold lease case in the last 20 years.

DISGORGEMENT DAMAGES (cont)

- First, a quick summary of the facts:

  - Non-CAPL freehold lease entered into in the 1960s. "Are produced" clause in habendum. "Lack of or intermittent market" or "any cause whatsoever beyond the lessee's reasonable control" not counted provision in the 4th proviso.

  - 7-25 gas well spud and produced during the primary term. No production from 1995 to 2001. Recommences production in 2001. Production suspended by ERCB (AER) in 2011 for other reasons. Sweet Basal Quartz and sour Wabamun production.

  - Lessors, in concert with a top lessee Freehold Solutions, commence a Court action in 2005 seeking a declaration that the leases terminated in 1995 when the 7-25 well was shut-in. They also issued a Notice to Vacate at that time.

DISGORGEMENT DAMAGES (cont)

- Shockingly, the Court found the leases were dead.
- Of course, I jest. The leases are always dead.

DISGORGEMENT DAMAGES (cont)

- First some old news. Speculation is evil.

- From the older, and now classic, decisions of ***Omers*** and ***Freyberg*** the Court searches for the intention of the parties and finds that "speculation" by oil and gas companies is somehow evil:

DISGORGEMENT DAMAGES (cont)

[73] As this court remarked in *Freyberg*, **it strains common sense to think that a lessor would tie up its land past the primary term for a lessee's speculative purposes and for a well that lacked commercial viability**: para 50. As reinforced in *Omers*, the third proviso was not intended to permit a lessee to hold a property for purely speculative purposes: para 95. **The common purpose and goal of parties entering into the lease is to develop the resource for the purpose of making a profit**: *Omers* at paras 77 and 95; Freyberg at paras 50-51. Any interpretation which defeats that purpose should be rejected in favour of one which promotes that purpose and a sensible commercial result: *Omers* at para 78. (emphasis mine)

DISGORGEMENT DAMAGES (cont)

- Once the lease is dead, the issue is how much does it costs the oil and gas company (i.e. what are the damages payable by the lessee to the lessor). Damages are based upon two causes of action, trespass and conversion.

- Best royalty plus bonus rejected by the Court:

[196]… When neither party knew of the trespass and the property owner would have been unable to realize the benefit the trespasser obtained from the trespass, courts have permitted the trespasser to retain the benefit of the trespass and ordered the trespasser to **pay the property owner a reasonable fee for the use of the property**. This is known as the *"royalty method"*. **The lessee pays the property owner contractually agreed royalties and any bonus associated with negotiating a new lease**. (emphasis mine)

DISGORGEMENT DAMAGES (cont)

- Now we get to the crux of the matter. Speculation is evil. Best royalty plus bonus is unfair. So what then is the proper measure of damages? The answer is **disgorgement**:

[213] …but when circumstances call for a different measure, disgorgement of defendant's benefit is a potential remedy…

[416] … the court is not simply compensating for trespass. It is also compensating for a **wrongful conversion**. In other words, **the wrongdoers (the lessees) not only overheld, but they also damaged (depleted or wasted) the reversion while they overheld. An irreplaceable value was taken from the fee**. This was not simply a wrongful occupation of land for which compensation for use and occupation (e.g., rent) might be appropriate. **This was a wrongful failure to vacate accompanied by a wrongful conversion of personal property** (when the hydrocarbons were severed from the realty and produced by the lessees) for which the value of the goods wrongfully converted may be an appropriate measure of damages. (emphasis mine)

DISGORGEMENT DAMAGES (cont)

- At law, disgorgement can be applied harshly or mildly. Two of the three judges choose the "*mild rule*" to calculate damages in this case:

  [1.d.i] Rowbotham JA and O'Ferrall JA direct the respondents to **disgorge revenues less production, gathering and processing, i.e., on a net basis** … (the so-called "mild rule"). (emphasis mine)

- Ouch. The cost for producing a dead lease is now your total **net revenue**. It's not so easy anymore to simply ignore a dead lease and keep on pumping.

DISGORGEMENT DAMAGES (cont)

Final Note:

- The Court of Appeal decision was split among the three judges that heared the case. Even so, leave to appeal was denied by the SCC.

- This has lead many commentators to infer that the measure of damages portion of the decision is unclear or muddled.

- There is some uncertainty, however, what is certain is that the *"royalty plus best bonus"* approach is gonzo and damages for trespass and wrongful conversion under dead freehold leases is now, at least, disgorgement of net revenue.

THANKS FOR LISTENING

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