

Estate No.: 25-2670585, 25-095164, 25-095165

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**IN THE MATTER OF THE DIVISION I PROPOSAL OF  
ZARGON OIL & GAS LTD., ZARGON OIL & GAS PARTNERSHIP AND ZARGON US  
HOLDINGS LTD.**

**REPORT OF TRUSTEE ON PROPOSAL**

**BACKGROUND**

Zargon Oil & Gas Ltd. (“Zargon O&G”) is a publicly traded company, whose shares traded on the TSX under ZAR. Zargon O&G owns 100% of a Canadian incorporated company Zargon US Holdings Ltd. (“Zargon US”) that in turn had owned two US incorporated companies, Zargon Acquisition Inc. and Zargon Oil (ND) Inc., both of which were sold by Zargon US in 2019. Zargon O&G is also a 99.7% partner in Zargon Oil & Gas Partnership (“Zargon Partnership”, Zargon O&G, Zargon US and Zargon Partnership are collectively referred to as “Zargon”).

On September 8, 2020, Zargon filed a Notice of Intention to make a proposal (the “NOI”) under Part III, Division I of the *Bankruptcy & Insolvency Act* (the “BIA”). The TSX halted trading of the Zargon O&G shares once the NOI was filed.

The initial NOI filing resulted in a stay of proceedings for 30 days. On October 1, 2020, Zargon obtained an Order from the Court of Queen’s Bench of Alberta (the “October 1 Order”) for an extension of the NOI period to November 16, 2020. In addition, the October 1 Order provided for a \$200,000 administration charge for the Trustee, its legal counsel and counsel to Zargon (the “Administrative Charge”) and a \$700,000 interim financing charge (the “Interim Financing Charge”) against Zargon’s assets.

On November 13, 2020, Zargon obtained an Order that authorized it to file a joint proposal.

Zargon’s proposal was with the Office of the Superintendent of Bankruptcy (the “OSB”) on November 13, 2020 (the “Zargon Proposal”).

**SUMMARY OF THE ZARGON PROPOSAL**

The key provisions of the Zargon Proposal are as follows:

1. Secured creditors are unaffected creditors;
2. Blue Sky Resources Ltd. (“Blue Sky”) will sponsor the Zargon Proposal by contributing \$500,000 (the “Proposal Fund”) for distribution to proven Zargon preferred and ordinary unsecured creditors. The Administrative Charge and the Interim Financing Charge do not attach to the Proposal Fund;
3. Payment in full (subject to the OSB levy) will be made to proven Zargon preferred creditors (as defined in the BIA);

4. Payment of dividends to proven Zargon ordinary unsecured creditors (subject to the OSB levy) will be made on a pro rata basis from the amount remaining in the Proposal Fund after the payment of preferred creditor claims;
5. Blue Sky will issue to each Zargon creditor that receives a dividend in point 3 above, a pro rata share of a \$500,000 Contingent Value Note, as defined in the Zargon Proposal. This Contingent Value Note will only become payable should the daily West Texas Intermediate index average be equal to or exceed US\$57.50/BBL for a trailing twelve month period. The Contingent Value Note expires on September 1, 2024. BlueSky will be responsible for monitoring the obligations of the Contingent Value Note and any related dividend (subject to the OSB levy);
6. All Zargon O&G shares will be redeemed as of the date of the implementation of the Zargon Proposal; and
7. New Zargon O&G shares will be issued to Blue Sky giving Blue Sky 100% ownership of Zargon O&G after the implementation of the Zargon Proposal.

**CAUSE OF FINANCIAL DIFFICULTY**

Zargon’s cause of financial difficulty was due to the catastrophic collapse of world oil prices in the spring of 2020 and the dramatic drop in oil and gas demand as a result of the COVID-19 pandemic. This resulted in all but two wells (the “Little Bow Wells”) being shut in by Zargon in the spring of 2020. In November of 2020, one of the Little Bow Wells was also shut in and 02/11/32/14/W4 is the lone well that remains in production.

**FINANCIAL POSITION OF ZARGON**

The original cost in Schedule H of the Zargon O&G and Zargon Partnership Statements of Affairs (“Schedule H”) were not correctly stated. The amounts shown were in thousands and therefore all values needed to have ,000 added to properly reflect the amounts. The estimated to produce column in Schedule H is correct.

Zargon’s assets are as follows:

**Zargon O&G Consolidated Balance Sheet**

Description	Statement of Affairs <sup>1</sup>
Accounts receivable	\$343,000.00
Deposits and prepaid expenses	\$934,000.00
Property, Plant & Equipment <sup>2</sup>	<u>\$47,345,000.00</u>
	<u>\$48,622,000.00</u>
Less:	
Estimated reclamation and asset retirement costs <sup>3</sup>	<u>\$55,268,000.00</u>
Net asset value	<u><u>-\$6,646,000.00</u></u>

1. Values based on the values in the Statement of Affairs signed on November 12, 2020. Amounts on the Statement of Affairs documents reflected the asset values from the Zargon October 31, 2020 internally prepared financial statements, represented in ,000 thousands.

2. Property, Plant & Equipment relate to oil & gas properties, facilities, pipelines in areas.....

3. Based on June 30, 2020 quarterly financial statements and MD&A disclosure Note 5. Management advises that the value is based on Alberta Energy Reulator recognized liability calculations.



**CONDUCT OF THE DEBTOR**

The Trustee has reviewed the Zargon bank statements in relation to potential claims under Sections 95 – 101 of the BIA regarding preferential payments, reviewable transactions or transfers under value. Zargon provided details and documentary support of payments of \$50,000 or greater have been requested from Zargon and upon its final review of those documents, the Trustee advises the creditors that there do not appear to be any transactions that are preferential or transfers under value.

**CREDITORS CLAIMS**

The following is a schedule of claims filed in the proposal as of 3:00 PM MDT on December 2, 2020:

Description	Zargon O&G Statement of Affairs		Proof of Claims filed as of 3:00 MST December 2, 2020	
	Amount		Description	# of claims      Amount
Secured	\$0.00		Secured	1      \$3,099.56
Unsecured	9,149,084.38		Unsecured	48      3,788,988.60
	<u>\$9,149,084.38</u>			<u>49      \$3,792,088.16</u>

1. As a partner of Zargon Partnership, Zargon O&G is responsible for Zargon Partnership's liabilities.  
 Therefore only Zargon O&G's Statement of Affairs' creditors are listed

The Trustee has not yet proven the Proof of Claims filed., however does report that the Proofs of Claim filed are not materially different from the amounts listed in Zargon’s Statements of Affairs.

**INFORMAL MEETINGS WITH MAJOR CREDITORS**

As of the filing of the NOI, Zargon estimated it owed 36 municipalities approximately \$1.2 million in unpaid property taxes. Recent jurisprudence has determined that linear property taxes are unsecured claims in an insolvency proceeding. Of the amount outstanding to the various municipalities, Zargon estimated that approximately \$493,000 would be categorized as non-linear property taxes. While Blue Sky is obligated to fund the Proposal Fund, Blue Sky has agreed to pay these secured non-linear property taxes subsequent to the implementation of the Zargon Proposal. Zargon also estimates that approximately \$662,000 would be categorized as linear property taxes and these unpaid claims, if all categorized as preferred, would have depleted all of the Proposal Fund. Zargon met with the six municipalities that represented over 90% of the outstanding linear claims and has obtained a commitment from these counties to file their linear claims as ordinary unsecured claims. Zargon takes the position that the claims from the remaining 30 municipalities are against properties that have not been producing for many years and therefore have little to no value and their claims should be treated as ordinary unsecured claims and not have the non-linear portion of their claim categorized as preferred claims.

## STATEMENT OF ESTIMATED REALIZATION AND TRUSTEE'S REMUNERATION

The Trustee is of the opinion that, in a bankruptcy, the unsecured creditors would not receive a dividend as the properties are not saleable and would become the responsibility of the Orphan Well Association. The wells that have been shut in would require significant investments to bring them back into production, if in fact, bringing them back into production would be even economic. In addition, the claims of the counties for unpaid property taxes and the abandonment and reclamation obligations would have to be addressed.

The Zargon Proposal allows unsecured creditors, including counties with non-linear property tax claims, to receive a pro rata distribution from the Proposal Fund and a potential further distribution from the Contingent Value Note.

The Trustee's remuneration is being paid either by Zargon from its interim financing advances or by Blue Sky pursuant to a Trustee fee indemnity agreement.

## RECOMMENDATION

Had Zargon not been able to negotiate an acceptable arrangement with the counties on the linear property taxes, the Trustee could not have recommended the Zargon Proposal as there would have been no funds available from the Proposal Fund for the benefit of ordinary unsecured creditors.

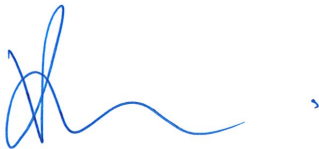
As Zargon has been able to negotiate an arrangement with the key counties, the Zargon Proposal provides the only opportunity for unsecured creditors to receive a dividend as it is the Trustee's opinion that no dividend would be payable to unsecured creditors in a bankruptcy scenario.

Therefore, it is the Trustee's opinion that the Zargon Proposal is fair and reasonable.

DATED at the City of Calgary in the Province of Alberta this 3rd day of December 2020.

MNP LTD.

Trustee acting in re: the Division I Proposal of Zargon Oil & Gas Ltd., Zargon Oil & Gas Partnership and Zargon US Holdings Ltd. and not in its personal or corporate capacity



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