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Trading Reserve-Based Energy Loans

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As debt issued by oil and gas exploration and production companies continues to trade at distressed levels, the secondary loan market has focused on the distinct lending structures developed to finance the exploration and production of energy in the United States. One such structure is "reserve-based financing," under which a lender's commitment to lend is based on the predicted future value of the borrower's oil and gas reserves that serve as collateral for the loan. The contractual method of determining the borrowing base and the nature of the collateral give rise to unique issues that need to be considered when parties trade loans and commitments of this type.

In today's volatile price environment for energy-related commodities, the borrowing bases for reserve-based revolvers – and therefore the amount of commitments available under these credit agreements – have declined dramatically with the price of oil. This decline and the diminished potential for future increases in borrowing bases affect the economic assumptions of parties who trade reserve-based revolvers in the secondary market.

This article provides a roadmap for market participants as they identify, analyze and value reserve-based energy loans and commitments.

BACKGROUND: HOW RESERVE-BASED FINANCING WORKS

Oil and gas exploration and production companies use different forms of financing for their project development, liquidity and working capital needs. Sub-investment grade companies often use loans primarily secured by the borrower's oil and gas reserves. In the U.S., the energy reserves that qualify as collateral for this type of financing are typically categorized as (i) proved, developed and producing, (ii) proved, developed and non-producing, or (iii) less frequently, proved and undeveloped. In international markets, other types of reserves (*e.g.*, probable reserves) may be used as collateral as well.

Reserve-based credit facilities are generally sized by reference to a "borrowing base amount," which is the aggregate forecasted value of the hydrocarbons in the reserves, calculated based on commodity price assumptions and discounted by a haircut applicable to the category of reserves. The borrowing base amount is redetermined periodically (generally twice a year, in spring and fall) to take into account changes in commodity prices as well as any depletion of existing reserves or acquisition of new reserves.

In the U.S. market, lenders may have substantial control over the art, as opposed to the science, of redetermining the borrowing base. This level of lender control differentiates reserve-based revolvers from traditional asset-based loans secured by receivables or manufactured inventory. During the borrowing base redetermination process, a decrease in the borrowing base amount typically requires the approval of lenders holding a majority of the commitments. An increase in the borrowing base amount on the other hand may require approval by a supermajority or all of the lenders. In non-US markets, individual lenders may not have approval rights over borrowing base redeterminations.

The substantial protection afforded to lenders in the redetermination process is typically restricted by certain limits and prerequisites. In order to challenge a borrowing base amount proposed by the borrower or the administrative agent (or another bank charged with the function), a lender may be required to propose its own borrowing base amount within a certain time frame, using customary (or otherwise prescribed) oil and gas lending criteria. The lender's silence may be deemed consent to the proposed borrowing base. The technical expertise required in the calculation and negotiation of the borrowing base may present an issue for non-bank lenders unfamiliar with arcane borrowing base calculations.

Borrowers can typically control the identity of the lenders who remain obligated to fund future drawdowns – if a lender sells its commitment to a third party, the borrower may have the right to consent before the third party can purchase the commitment by assignment. To the extent that the borrower does not consent, the lender may sell an economic participation in the commitment, but under the terms of the credit agreement the participant may be barred from influencing the redetermination process (unless the participant holds the entire position of the lender and can effectively direct the lender to take actions in connection with any redetermination). Obtaining a security interest in oil or gas reserves is complex, but relatively straightforward in the U.S. as compared to many other jurisdictions. In the U.S., mortgages can be taken over real property and mineral rights, and a security interest may be granted and

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perfected on reserves while they are still in the ground.[1] In the case of a producer bankruptcy in the U.S., the automatic stay under Chapter 11 would prohibit a counterparty under a lease or license from terminating the lease or license without leave of the court, thereby protecting the debtor and, indirectly, the interests of the lenders.[2]

SECONDARY LOAN TRADING CONVENTIONS IN THE U.S.

Over the past few decades, the secondary loan trading market has developed and matured in the U.S. and its main trade organization, The Loan Syndications and Trading Association (LSTA), has substantially standardized the trading terms and conventions. The brief summary of these terms and conventions below provides some contexts in which issues relating to trading reserve-based revolvers arise.

When a fully-funded loan trades at a rate lower than par, the purchase price that a purchaser would pay is the product of the purchase rate and the principal amount of the loan. When a commitment is only partially funded, however, the purchase price needs to reflect the obligation assumed by the purchaser to fund the commitment in the future. As a result, the purchaser would receive a credit towards the purchase price in an amount equal to the product of the principal amount of the unfunded commitment and the difference between par and the purchase rate. This convention ensures that if and when a purchaser funds a future drawdown on the commitment as a lender of record, it does so at the same purchase rate it would have had if the commitment were funded at the time of purchase. On the other hand, if the commitment is never drawn, then the purchaser would benefit from a "windfall" because it already received the credit from the seller in relation to the funding obligation. A purchaser of a loan usually takes the place of the seller as a lender of record after settlement of the transaction (the so-called "assignment") and enjoys important rights under the credit agreement, including votes to take actions or approve or disapprove amendments or waivers. If, however, such an action, amendment or waiver arises while a purchase is pending, market convention does not provide the purchaser with a contractual entitlement to exercise the voting rights under the credit agreement. Instead the seller may, and in practice usually does, give the purchaser an opportunity to express a preference, though the seller is not obligated to take the action preferred by the purchaser.

1 Sometimes this security interest might be affected by the alleged property rights of the borrower's counterparties under so-called "midstream contracts," under which the borrower dedicates its reserves to a midstream counterparty's gathering and pipeline system and covenants to produce a minimum volume of oil or gas from its fields, thereby ensuring the minimum utilization of the gathering and pipeline system. This controversial issue is the subject of ongoing litigation in the bankruptcy cases of *Sabine Oil & Gas Corp.* and *Quicksilver Resources Inc.* On March 8, 2016, Judge Chapman ruled in the *Sabine* case that the midstream contract counterparties do not have a property right and their contracts can be rejected by the debtor.

2 The laws of other jurisdictions are less clear and certainly not uniform. In emerging markets, in particular, government consent may be required in granting or enforcing security interest in the reserves because the right to explore for or extract hydrocarbons may require the grant of some form of license or concession from, or a production sharing agreement with, a governmental authority.

An assignment of loans and commitments typically requires the consent of the administrative agent under the credit agreement and, to the extent that commitments are assigned, consent of the borrower. Sometimes such consent is not forthcoming, necessitating a different transfer mechanism (the so-called "participation") for which the agent's and the borrower's consent is typically not required because the seller remains a lender of record to whom both the agent and the borrower would look for future exercise of rights and performance of obligations under the credit agreement. The seller would grant the participation to the purchaser, which typically gives the purchaser a contractual right to direct the seller to take, or refrain from taking, actions under the credit agreement.

Such contractual rights are always subject to the limitations under credit agreements, which often enumerate matters in which participants can (indirectly) have a say, while prohibiting lenders from voting in accordance with participants' directions with respect to other matters. A participant's voting rights are also limited by the fact that it may hold less than a majority of the seller's position in the loan. When the seller's vote under the credit agreement is not divisible, the vote would be controlled by holders of a majority of its lender-of-record position, calculated based on all participants holding a participation interest from the seller and the seller itself (to the extent the seller keeps beneficial ownership of a portion of its position). The seller, therefore, would not be obliged to comply with the directions of any participant that does not agree with the majority.

TRADING RESERVE-BASED REVOLVERS

Calculating Credit for the Unfunded Commitment

As outlined above, a purchaser receives a credit of the difference between par and the below-par purchase rate on any unfunded commitment that is "assumed by" the purchaser. In a declining oil price environment, it is likely that the current borrowing base amount, which is based on the forecasted future value of oil and gas reserves, is now substantially lower than the original commitment amount specified in the credit agreement, and may not soon revert to the maximum commitment levels negotiated when oil and gas traded at pre-crash levels.

As a result, the established pricing convention raises an immediate question for purchasers and sellers of reserve-based revolvers: should a purchaser receive a credit for the maximum commitment permitted under the credit agreement if there is little present prospect that future energy prices will allow a borrower to draw down on the maximum commitment? A seller is likely to argue that purchase price credit should be calculated based on the current (reduced) available and unfunded commitment amount because the borrowing base redetermination process is unlikely to allow the original commitment amount to be drawn. Since a purchaser only receives a credit for the unfunded commitment that it actually assumes, whether, and to what extent, a purchaser has control over future borrowing base increases under the credit agreement may

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be important in determining the amount of the credit a purchaser should get for an unfunded commitment.

If a lender (*i.e.*, the purchaser who acquires the commitment by assignment) has an absolute right not to agree to fund an additional commitment based on an increase in the borrowing base amount, as is the case with some agreements in the U.S. reserve-based market, a seller may argue that the purchaser is only assuming the unfunded commitment calculated based on the existing borrowing base amount. On the other hand, as discussed above, a purchaser may respond that a lender's right to object to an increase in the borrowing base amount may not be absolute, and in any event the purchaser's vote may be insufficient to block an increase of the borrowing base amount. Under those circumstances, a purchaser may be forced to "assume" the unfunded commitment up to the original commitment amount.

This is a real economic issue, one which may result in a gap between the expectations of sellers and purchasers. Indeed, oil prices have begun to recover since the most recent redetermination in spring 2016, and there will likely be increases in borrowing bases in the next redetermination this fall. This experience may further inform the market as to the practical approaches parties should take in pricing of the unfunded commitments.

If the spread between the seller's offer and the purchaser's bid is too wide on the purchase price credit issue, parties may try to strike a risk-sharing compromise. For example, a seller may be willing to "co-fund" any future draw and agree to remain liable to contribute (at the rate of 100% minus the purchase rate) a portion of any future draw on the unfunded commitment in excess of availability based on the existing borrowing base amount. This way the seller can avoid giving an up-front credit to the purchaser and effectively pay that credit only if the available commitment is increased through the redetermination process and the additional commitment is drawn down. The downside, of course, is that the seller may not be able to de-recognize the commitment from its books, and may continue to take the credit risk of the purchaser.

Most importantly, identifying the effect that redetermination of the borrowing base may have on calculation of the purchase price before committing to a trade will allow a purchaser and a seller to ensure that they agree on the purchase price calculation. They may need to negotiate and possibly modify the standard trading terms to reflect a fair resolution of this important issue.

Controlling Redetermination as a Purchaser

At this stage of the commodities cycle, one of the most important rights of a lender is control over the redetermination of an energy producer's borrowing base amount. Therefore, a purchaser's due diligence should include a careful review of the credit agreement to understand the type of control a lender has over redeterminations.

Secondary market purchasers should also be aware that, under the trading conventions adopted by the LSTA, during the period from trade date to settlement date a purchaser does not technically have a right to vote (or otherwise participate or control the seller's participation in the redetermination process), although this right may be extended by the seller as a courtesy. If a redetermination is expected to occur between trade date and settlement date, a purchaser would be well advised to specifically require a right to direct the seller to act on the issue.

Controlling Redetermination as a Participant

Borrower's consent is usually required for transfers of commitments by assignment. If a distressed borrower is wary of accepting new (and possibly aggressive) lenders into the lending syndicate, a purchaser may need to acquire the debt by participation. A participant's vote,

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however, may be restricted under the credit agreement. For example, a credit agreement may permit a participant to vote only with respect to limited matters, which may not include redetermination of the borrowing base. Even if a participant can vote on redetermination matters, there could be practical limitations on the participant's vote, to the extent that the participant does not hold at least a majority of the lender's position in the loan, since a lender usually takes most, if not all, actions according to a majority vote of its participants, which majority could take into account the seller itself if it continues to own a portion of the loan.

The control issue is also a concern for sellers that grant participations, because they will continue to have obligations under the credit agreement as lenders. It is therefore in the seller's best interest to negotiate a voting (or consultation) regime that satisfies the seller's obligations under the credit agreement as a lender and, to the greatest extent possible, avoids and resolves conflicts with a participant in connection with redetermination issues.

Transferring Security Interest

Because the value of a reserve-based loan depends on the lending syndicate's security interest in the reserves, a purchaser of the loan will need to ensure that the security interest will be transferred with the loan and the priority of the security interest will be preserved. In the U.S. this is straightforward because a collateral agent typically holds the security interest on behalf of all current and future lenders. In a non-U.S. jurisdiction, however, transfer of the security interest could present issues. For example, governmental or third-party consents may be required for the transfer, and such consents may not be forthcoming. In addition, a transferee of the security interest may lose priority if it acquires the loan under a novation structure.

Maintaining Priority Status of Security Interest on Hedging Swaps

Lenders in the bank group may provide swap products for the borrower to hedge commodity price or interest rate risks. These swaps are typically secured on a *pari passu* basis with the loans under the credit agreement and therefore share the backing of the reserve-based collateral. When a lender sells its loan position, it should carefully analyze the impact of the sale on the priority status of its hedging swaps. If the seller no longer owns any loan position, any new swaps that the seller provides may not be secured under the credit agreement even though its existing swaps may continue to benefit from a *pari passu* security interest.

CONCLUSION

Reserve-based revolvers present unique challenges and opportunities for participants in the secondary trading market for energy loans. Parties should carefully consider how their economic assumptions will be affected by the borrowing base redetermination process and each party's ability to control that process. While the market's view on future changes in borrowing base amounts, largely determined by future commodity prices, will serve as a rational basis for any pricing model, each trading counterparty will need to ensure that their individual rights and obligations under their documentation will be consistent with that model. Modification or clarification of trading conventions and standard terms may be necessary to reallocate the risks, control, obligations and rights between parties to a secondary trade.

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Drawing on her background in securities offerings and her previous experience as the acting chief operating officer of a trading desk, Ms. Lu focuses her practice on distressed debt and derivatives markets. She advises clients in transactional and regulatory aspects of their trading businesses, and collaborates with them to formulate strategic, pragmatic legal solutions to complex trading and risk management issues. In her distressed debt trading and special situations practice, Ms. Lu collaborates with her clients – major broker-dealers and hedge funds – to formulate policies and procedures, and to structure and draft standard documentation. She also helps clients formulate strategic approaches to special situations trading and investment opportunities in the distressed markets. Previously, Ms. Lu was seconded to Goldman Sachs as COO of the bank loan trading and syndication desk.