January 27, 2015

Addressing Oil and Gas Loan Defaults: Options and Consequences

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The prior article in our series of alerts relating to distressed commodity prices discussed options that producers and bankers can use to stretch a borrowing base. If an E&P company cannot stretch its borrowing base and ends up with a borrowing base deficiency that is not timely cured, it will default under its credit agreement. Even if a borrower is not overdrawn on its credit facility, the sudden and steep drop in oil prices may cause it to default under another provision of its credit agreement, such as a financial covenant. For the last several years E&P companies thrived on high commodity prices and borrowed money from financial institutions eager to take part in the U.S. oil and gas renaissance. In this new price environment many producers will face a different situation—default—which they will need to resolve with their lenders. Producers and their bankers should understand the various ways in which they can address a default under a credit agreement. This alert lays out a range of options that are available to temporarily or permanently move past a default under an E&P company's reserved-based credit facility.

OVERVIEW

A bank may respond to a default by accelerating, after any applicable grace period, the debt and exercising remedies, especially in the case of a material default where deterioration of collateral or the borrower's financial condition requires quick action for the bank to maximize its recovery. However, if there is a reasonably clear path forward, such as optimism that commodity prices will recover, or a likelihood that the borrower will obtain additional or replacement capital, the lenders will most likely provide the borrower relief from the default. There are different ways an E&P borrower can be relieved from a default—some of the measures provide permanent forgiveness, while others only allow for temporary reprieve.

Both parties to a loan agreement—borrower and lender—are incentivized to address a default. A default deprives the producer of its ability to borrow under its credit facility, is concerning to its investors and generates cross-defaults under other contracts. It may also result in a new party unfamiliar to the borrower holding all or a portion of its debt. The E&P company normally has a consent right when an existing lender, such as a commercial bank, desires to assign its loans and commitments to a financial institution that is not currently party to the credit agreement, such as a distressed debt fund. This consent right disappears any time a default exists.

Inaction after default can be harmful to the lender as well. Banks do not want defaulted loans sitting on their balance sheets. Failure to act can make it easier for the E&P company to raise certain challenges and defenses in a bankruptcy proceeding. Below are ways in which lenders and producers may address a credit agreement default.

ADDRESSING DEFAULTS

1. Notice of Default and Reservation of Rights

A notice of default to the E&P borrower is often the first formal action a bank takes upon the occurrence of a default. The notice is a unilateral action by the bank that is designed to make clear to the borrower that a default has occurred and provides an opportunity to cure if a grace period is applicable; it does not resolve the default or provide the producer any relief. If it is likely that, in addition to the specifically identified default(s), other defaults exist, then the lender should state that the identified default is "among others".

Prudent lenders will also include "reservation of rights" language in their default notices, which states that the lenders "expressly reserve all of their rights, remedies and powers under the loan documents, at law, in equity, or otherwise, including, without limitation, the right to declare all obligations under the loan documents immediately due and payable." This language protects the bank's ability to exercise remedies if substantial time passes between the occurrence of a default and the actual exercise of remedies and can be used to counter oral modification, waiver and estoppel defenses that are later raised by the borrower.

The occurrence of a credit agreement default may give the lenders the right to charge the E&P borrower interest at the default rate, which is usually two percentage points higher than the interest rate charged when the producer is in good standing. A default notice can be used to notify the producer that it will be charged default interest while the default exists. If the lenders do not initially charge default interest, but later elect to do so, the notice that default interest is being charged should repeat the reservation of rights language contained in the original notice of default. The default notice also serves to notify the borrower that the lender has no obligation to make further loans during the pendency of the default. Almost every loan agreement waives the borrower's right to receive notice of default, default interest, or termination of the loan commitment. Nevertheless, out of abundance of caution, lenders will typically provide such notice.

2. Forbearance Agreement

A forbearance agreement is a temporary measure in which a lender provides a borrower relief from specific defaults by agreeing to refrain from exercising (forbear) its remedies with respect to the specified defaults for a certain period of time. It neither eliminates the specified defaults, nor does it protect the borrower with respect to any existing or future defaults that are not identified in the forbearance agreement. Time is the main reason a producer and its banks will enter into a forbearance agreement, whether it be that the parties need time to work out a permanent loan modification or the producer needs time to accomplish something that will resolve the default, such as a refinancing or asset sale.

The E&P company seeking forbearance will be required to identify specific defaults and other credit agreement violations subject to forbearance, acknowledge their existence and agree that the lenders have the right to accelerate the loans as a result of those defaults upon termination of the forbearance. Any guarantor will also be asked to make such acknowledgements and agreements. The lenders will agree to forbear and refrain from exercising rights and remedies with respect to the designated defaults until a specified date or occurrence of any other defaults not covered by the forbearance. Though a forbearance agreement does not typically make major modifications to the credit agreement, lenders will sometimes require satisfaction of certain conditions or covenants or impose specific milestones in exchange for forbearance. They may charge a forbearance fee, require that the producer regularly update the banks on the company's finances or, if applicable, asset divesture or refinancing efforts, or give the lenders an approval right on large capital expenditures.

There are a number of other standard, but important, components of a forbearance agreement, all of which are for the benefit of the lenders. The E&P company and its guarantors will be required to waive all defenses as to claims based on the specified defaults, agree not to contest any future enforcement of remedies and reaffirm all liens and security interests. Lenders will want the borrower and guarantors to release them from all claims relating to the loan transaction, including the forbearance and any loan workout. The producer is expected to bring down all loan document representations and warranties, certify that no defaults exist, other than the designated defaults that are covered by the forbearance agreement, and acknowledge the outstanding principal, interest and fees owing to the lenders. A reaffirmation of the guaranty agreements by the guarantors will be required.

Since the lenders have the upper hand in a forbearance negotiation, they may use it as an opportunity to require that the producer mortgage additional oil and gas properties—either to conform to existing credit agreement requirements or to provide the lenders added coverage. Any bank considering conditioning its agreement to forbear on the borrower providing additional collateral should consult with bankruptcy counsel. It is possible that the grant of the forbearance in exchange for the collateral will not constitute a transfer of reasonably equivalent value, which would make the additional collateral susceptible to a fraudulent conveyance claim. Also, if the producer files for bankruptcy protection within 90 days after the banks perfect their liens on the additional collateral, such liens may be challenged by other stakeholders as a preference.

Ideally the E&P company and its lenders will reach the end of the forbearance period with a resolution to the situation that caused the default. If the forbearance period expires without complete resolution, a prudent lender, as an initial measure, will notify the producer of the expiration and include "reservation of rights" language in that notice.

3. Waiver Agreement

A waiver agreement is a form of relief in which the banks waive the producer's default and restore all credit agreement parties to their pre-default positions. The agreement will be limited to one or more specifically identified defaults and is often titled as a "Limited Waiver". Relationship factors often motivate lenders to agree to a waiver, especially if the default is the result of an isolated non-payment credit agreement violation and not caused by the E&P borrower being deeply distressed.

Waivers typically have a permanent effect, but in some instances can be temporary in nature. For example, if a producer defaults under its hedging negative covenant by being over-hedged, the lenders may temporarily waive that default for the next 60 days. This is advantageous to the E&P company—it is no longer in default under a material debt agreement and has a little breathing room to find an optimal time to unwind its hedges—but also protects the banks by giving them a second bite at the apple if the borrower fails to comply.

From a documentation perspective, waiver agreements vary more than forbearance agreements. Whereas a forbearance agreement does not usually make major modifications to the loan terms, a waiver agreement is sometimes used for the dual purpose of amending the credit agreement. For example, a waiver of an existing financial covenant default may also amend the loan agreement to modify how "EBITDAX", "Funded Indebtedness" or other components of the financial covenant equations are calculated or add an "equity cure right" that the E&P company can utilize in the event it will not be able to satisfy a financial covenant in the future.

Waiver agreements contain many of the components that are found in forbearance agreements. The E&P borrower will identify and acknowledge the default that exists and will, along with the guarantors, acknowledge the lenders' rights with respect to such default. The company and guarantors will also be asked to give the same defense waiver, agreements not to contest, release, representation and warranty bring-downs, no default certification, and reaffirmations that are found in the forbearance agreement. A fee will often be charged as consideration for the lenders granting the waiver.

In structuring a waiver agreement, the producer may be able to negotiate away one of the more objectionable provisions found in both forbearance agreements and waiver agreements: the broad release of the lenders from claims relating to the loan transaction. E&P lenders may not force the company to grant this release if the default is less serious, they have a strong relationship with the company or the company has a long history of compliance and gives the lenders comfort that it will continue to comply with the credit agreement in the future. In the event the producer cannot negotiate away the release, it may be able to negotiate it down to just a representation and warranties that the loans parties do not know of any claims they have against the lenders.

4. Curative Credit Agreement Amendment

A curative credit agreement amendment allows an E&P borrower and its lenders to amend troublesome provisions of a credit agreement so that the default never actually happens. From a timing perspective, this is more easily done prior to the default occurring so that the producer and its lenders can work through the issue and make the necessary amendments before it arises. However, the prior occurrence of the default does not prevent the parties from using a credit agreement amendment as an option to address it. The parties can enter into a curative amendment with an effective date that is back-dated to the day the default occurred.

One major advantage of the curative amendment is that it prevents cross-default issues. A producer may be party to a number of other contracts which provide that a default under the credit agreement is also a default under those contracts. By avoiding a credit agreement default, the producer is not faced with resulting defaults with other contracting parties.

A curative amendment is clearly the most beneficial to the producer, but also the most difficult for the banks to agree to. A bank will have a more difficult time going along with this approach if the required amendments are substantial and cause the terms of the credit to stray too far outside the range of what is customary. In exchange for making curative loan agreement amendments, the lenders may also request other modifications that the E&P company finds undesirable, such as pricing grid increases, a lock box for hydrocarbon sales, or additional reporting requirements. Additionally, banks may still seek the onerous waiver and release of all claims that they ask for in forbearance agreements and limited waivers.

When a producer attempts to obtain a waiver agreement or curative amendment for a syndicated credit facility, the voting requirements will vary depending on the nature of the default. A payment default waiver will require all lenders to approve, whereas a financial covenant amendment will only require lenders holding half or two-thirds of the commitments and loans to consent.

In a situation where the credit agreement requires that all lenders in the syndicate consent to a waiver or curative amendment, the producer may find that a handful of banks refuse to go along. In such a case the producer may be able to push the waiver or amendment through if the credit agreement contains a "yank-a-bank" provision. This provision gives the producer the right to replace a lender that refuses to sign a waiver or amendment, so long as a certain percentage of other lenders (usually lenders holding half or two-thirds of the loans and commitments) agree to such waiver or amendment. To make this work the E&P company will need to find a replacement lender, which is not always easy to do when in default or approaching default. Additionally, some banks may be limited on how much capital they can use for new loans, with such limits being driven by either internal policies or Office of the Comptroller of the Currency (OCC) regulations. Any replacement lender must be acceptable to the credit facility's administrative agent and qualify as an "eligible assignee" under the loan agreement.

CONCLUSION

There are different options an E&P company and its lenders can use to address a credit agreement default. Ultimately, underlying circumstances—severity of default, viability of the company and its assets, commodity price strength and party relationships—will play a key role in which approach is chosen. The information above provides a general outline of the available options and factors to consider in the process of moving beyond a default, but each situation is unique and will likely raise issues beyond the scope of this article. Producers, their lenders and the agent banks administering the credit facilities should always consult with legal counsel when consider the various legal structures available so that they can properly identify the issues each option will create and the effect the chosen option will have on the parties.

The next article in our series of news alerts relating to distressed commodity prices will discuss mechanics and materialmens' liens in the oilfield and issues relating to filing, handling and enforcing those liens that service providers and producers should understand.

Please **click here** to view prior articles in our series.

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