Dealing With COVID-19 and the Oil Price Decline: Remedies Available to Secured Energy Lenders That Do Not Require Direct Ownership of Oil and Gas Properties

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A discussion of remedies available to a secured lender in a lending transaction with an upstream oil & gas borrower other than foreclosing on oil and gas assets. These remedies include exercising rights under equity pledge agreements and deposit account control agreements and entering into forbearance agreements.

Amidst price wars, a global pandemic, and the diminished demand for oil, exploration and production (E&P) borrowers and secured lenders face inevitable credit agreement defaults. Crude oil prices have fallen significantly since the beginning of 2020, largely driven by the economic contraction caused by the 2019 novel coronavirus disease (COVID-19) and a sudden increase in crude oil supply following the suspension of the production cuts first agreed in November 2016 among the Organization of the Petroleum Exporting Countries (OPEC), Russia, and other partner countries.

According to data from the Energy Information Administration (EIA), an agency within the Department of Energy, in March 2020, Brent crude and West Texas Intermediate oil prices averaged $32.01/barrel (b) and $29.21/b respectively, compared to $63.65/b and $57.52/b in January 2020. Although OPEC and the other parties have since agreed to new production cuts, this agreement has had limited effect on oil prices as demand remains low and oil inventories remain high (Legal Update, OPEC and Russia Agree to Cut Crude Oil Production and EIA: U.S. crude oil inventories are approaching record-high levels (April 30, 2020)).

As low prices put pressure on many E&P borrowers' balance sheets and jeopardize their ability to repay their loans, lenders must consider the options they have to protect their rights. These loans are typically secured by the E&P borrower's oil & gas assets and foreclosing on these assets is often seen as a secured lender's primary remedy. However, negative oil prices, operational challenges, and the potential for liability may leave some secured lenders contemplating whether a real property foreclosure is the best course of action. For a discussion of the issues that lenders must consider when foreclosing on oil & gas assets, see Practice Note, Security Interests: Oil & Gas (W-006-5197).

Thankfully, secured lenders often have alternative methods to not only protect themselves, but to also maximize recovery when an E&P borrower defaults in its obligations. This Article discusses these alternative methods, including:

- Exercising rights under equity pledge agreements (see Foreclosure of Equity In the E&P Borrower and Exercising Proxy Rights).
- Taking control of the E&P borrower's deposit accounts (see Notice of Exclusive Control Under Deposit Account Control Agreements).
- Entering into forbearance agreements (see Forbearance Agreements).

For more information on lenders' rights, see Lender Checklist When a Borrower is in Default (6-500-5971) and Practice Note, Lender's Remedies and Enforcement Issues (8-500-5970).

NOTICE OF DEFAULT

Once aware of an E&P borrower's default under the terms of the credit agreement and related credit documents, a lender should notify the borrower of the default. A notice of default is a unilateral action by a secured lender and does not resolve the default or provide the borrower any relief. Rather, the notice typically informs the borrower of all or some combination of the following:

- The nature and details of the default or defaults that triggered the delivery of the notice.
- The date on which the default occurred, taking into account any applicable grace periods.
- The interest that has accrued on the obligations and is to be paid at the default rate (usually two percentage points higher than the interest rate charged when the E&P borrower is in good standing) while the default exists and is continuing.
- That the commitments, if any, are terminated.
- That the lender has no obligation to make further loans during the pendency of the default.

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- That the maturity of the unpaid principal amount of the loans (and the lawfully accrued and unpaid interest on these loans) is accelerated and the principal is immediately due and payable.
- That the lender "expressly reserves all of its rights, remedies and powers under the loan documents, at law, in equity, or otherwise."

RESERVATION OF RIGHTS

The reservation of rights language in the last bullet above protects the lender's ability to exercise remedies with respect to the collateral if substantial time passes between the occurrence of a default and the actual exercise of remedies. This language can also be used to counter oral modification, waiver, and estoppel defenses that may be later raised by the E&P borrower. The parties may have also had detailed discussions during which they have sought a negotiated resolution and a lender does not want its rights to be impaired because of those discussions. The lender may also need time to consider what action it can take and decide how it wishes to proceed. This is especially the case in syndicated loans where the bank group consists of many lenders, all of which must be consulted.

Although most credit agreements waive a borrower's right to receive notices regarding defaults, default interest, or the termination of the commitment, E&P lenders typically provide these notices out of an abundance of caution and to begin remedial discussions.

In most cases, the rights reserved in a notice of default are already addressed by existing provisions in the credit agreement. Default interest provisions, for example, typically automatically apply immediately when an event of default occurs, though their exact terms may vary. Similarly, most credit agreements contain express reservation of rights provisions, which state that inactivity or delay by the lender in response to a default or event of default cannot constitute a waiver of the borrower's breach because to be effective, all waivers must be in writing. However, many lenders regard notices of default as a means to:

- Reinforce existing credit agreement provisions.
- Reduce the risk that a court may (using its inherent equitable powers) make a determination that overrides the express terms of the credit agreement if the matter eventually results in litigation.

For more information on these notices and reservation of rights, including explanations and drafting tips, see Standard Document, Notice of Default/Reservation of Rights: Lending (8-517-5929).

ALTERNATIVES TO HYDROCARBON FORECLOSURES

FORECLOSURE OF EQUITY IN THE E&P BORROWER

One option commonly available to a secured lender is foreclosing on the equity of the E&P borrower. As security for the loan, the parent company of an E&P borrower often agrees to pledge its equity in the E&P borrower to the lender to secure the E&P borrower's obligations. The parent's pledge allows the lender to foreclose on the equity on the E&P borrower's default.

Lenders may prefer these equity foreclosures to real property foreclosures because they require a shorter notice period under the Uniform Commercial Code (UCC) and do not require many of the operatorship and regulatory transfer steps that must be completed in connection with an asset foreclosure transfer. However, one drawback of the equity foreclosure is that the lender takes the borrower's equity subject to any existing claims against the borrower. A lender should consider whether the efficiency of the equity foreclosure process outweighs the costs of taking ownership of such claims against the borrower.

If a lender proceeds with an equity foreclosure, the lender must submit a letter of notice of foreclosure sale to the borrower with the following information:

- The date, time, and location of the sale of the collateral.
- Provisions that the sale will be conducted in accordance with the pledge agreement and applicable law if all amounts due and owing have not been paid.
- Reminders that if the proceeds of the sale are insufficient to pay the past due amounts, each person and entity obligated to repay the past due amounts shall be jointly and severally liable for the deficiency unless the party's liability has been expressly limited by written contract or the past due amounts are expressly non-recourse.

For more information on these rights and obligations, see Standard Document, Pledge Agreement (0-501-1550).

EXERCISING PROXY RIGHTS

In addition to, or in lieu of, foreclosing on the equity of an E&P borrower, a lender can exercise proxy rights it may have under the pledge agreement to do any of the following:

- Modify the borrower's governing documents.
- Change the borrower's board of directors, board of managers, or general partner.
- Designate a new operator.

This remedy is often used when a secured lender loses confidence in the ability of a borrower's existing management team or equity backer to act in a manner that protects the lender's interests. Though this remedy can be enacted swiftly, its effectiveness is subject to:

- The nuances of corporate, limited liability company, or limited partnership laws, which vary by state.
- The potential for this action to create lender liability issues.
- The availability of qualified and reputable personnel to replace the borrower's management or operator.

As a result, a secured lender and its counsel must closely examine relevant underlying laws to ensure the exercise of proxy rights will be effective.

RIGHTS TO THE PROCEEDS OF PRODUCTION

A lender may be entitled to receive the proceeds of production attributable to the oil, gas, and other minerals that secure the borrower's obligations under the credit agreement. Assuming a lender and its E&P borrower executed transfer order letters to notify the purchasers of the borrower's production of any changes to the payment structure, a lender would then have the option to send

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these letters to the defaulting borrower's purchasers, directing them to begin making payments to the lender.

Sending the transfer order is only half the battle. It is not unusual for a purchaser of production, after receiving one of these letters, to suspend paying both the E&P company and its lender until it has more formal confirmation that the transfer order letter is valid and effective. The purchaser does not want to expose itself to liability by improperly giving another party the proceeds and will hold onto the cash until it has comfort that it can re-direct the proceeds.

For more information on this issue, see Standard Document, Security Agreement: Accounts Receivable (Basic Form): Drafting Note: Notice of Security Interest in Accounts Receivable (W-017-0953).

NOTICE OF EXCLUSIVE CONTROL UNDER DEPOSIT ACCOUNT CONTROL AGREEMENTS

In the aftermath of the 2014-2016 price decline, lenders began requiring E&P borrowers to pledge their bank accounts to secure their obligations under their credit agreements (see Article, What's Market: US Oil & Gas Sector 2019 (W-022-3372)). Once a default has occured under a credit agreement, a lender may apply the balance in the borrower's deposit accounts to the obligations secured by the deposit account if the lender is the bank in which the borrower's deposit account is maintained.

Alternatively, if a deposit account is perfected by a deposit account control agreement (DACA), a lender may instruct the bank to pay the balance of the deposit account to or for the benefit of the lender. A lender may employ this remedy to pay down the obligations owing to it or as part of a more complex strategy to exercise control over the borrower by blocking its access to its cash.

After receipt of the notice, the bank should only accept instructions from the lender and cease taking instructions from the E&P borrower concerning the deposit accounts. DACA typically provide that the bank need not investigate whether the lender is entitled to give the notice of sole control.

For more information on DACAs and these notices, see Standard Documents, Deposit Account Control Agreement (8-383-3165) and Notice of Sole Control Under a Deposit Account Control Agreement (4-507-2358) and Practice Note, Security Interests: Deposit Accounts (8-382-8183).

FORBEARANCE AGREEMENTS

Another option for a lender seeking recovery post-default is a forbearance agreement. Forbearance agreements are helpful to a lender that wants to continue the relationship with the E&P borrower. With a forbearance agreement, a lender and E&P borrower can establish a formalized recovery plan to address the issues that led to the underlying default and enable the borrower to better fulfill its future obligations under the credit agreement. These agreements also:

- Give a lender time to evaluate its options and formulate a strategy to maximize its recovery.
- Allow a lender to obtain additional collateral or guarantees to secure the debt.
- Allow a lender to collect additional fees and increased interest.
- Enable a lender to amend the credit agreement to tighten or introduce new financial covenants, decrease the commitment, or amend the repayment schedule.

RISKS TO THE LENDER

Forbearance agreements are not without risk or disadvantages. They often restrict a lender's ability to exercise specified rights and remedies during the forbearance period, including those discussed above, unless an event occurs that would terminate the forbearance period. This period is usually less than one year, although borrowers often prefer a longer period to give them more time to work out their issues. After the termination of the forbearance period (including any renewals or extensions), the lender is entitled to pursue its remedies if the borrower remains in default.

To mitigate its risks, before entering into a forbearance agreement, the lender should conduct due diligence to:

- Ensure that its liens have properly been perfected. This includes running UCC-1 lien searches and public record searches for judgments and tax liens. Lenders should be mindful that disclosing deficiencies in its collateral may give the borrower greater leverage in the negotiations.
- Ensure that the credit agreement does not contain any discrepancies or deficiencies that could impede its enforcement and realization.
- Assess the E&P borrower's business and the causes of its financial distress. Financial diligence should reveal whether the company is viable and fixable and whether a strategy should be pursued to maximize the lender's overall recovery. While low prices may be one of the reasons for the borrower's distress, lenders should also consider and analyze the borrower's:
  - leverage. Some E&P borrowers incurred significant amounts of debt that may not be sustainable;
  - general and administrative expenses; and
  - budget and capital plans, including its drilling programs.

The lender should also consider conducting a review of other instruments evidencing other indebtedness or preferred capital, such as intercreditor or subordination agreements. If the borrower has incurred other senior or junior indebtedness, the lender should review the intercreditor or subordination terms to ensure that any restricted payments of this indebtedness or liens securing this indebtedness are being addressed, controlled, and perhaps blocked as provided in those arrangements.

For more information on forbearance agreements, see Practice Note, Forbearance Agreements: Key Issues and Provisions (3-523-5129) and Standard Document, Forbearance Agreement (1-524-1560).

If none of the methods discussed above are able to resolve the E&P borrower's problems and ensure the lender is repaid, the parties

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may have to consider other options including filing for bankruptcy. For more information on these issues, see Practice Note, Distressed Investor Considerations in E&P Oil and Gas Restructurings (W-001-8965).

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