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Buying and Selling RBLs: What You Always Wanted to Know but Were Afraid to Ask

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Introduction

The effects of the precipitous decline in oil and gas prices after mid-2014 are well chronicled, but are still unfolding. Although oil prices have risen recently, the current price environment continues to adversely affect a broad range of energy-industry and related-industry businesses, including exploration and production, service and supply, and midstream companies, as well as those that directly or indirectly support or contract with those businesses. In particular, given their voracious appetite for new capital – and despite widespread reductions in their exploration budgets and spending – exploration and production companies are significantly affected by restricted access to capital, whether through capital markets, private equity, joint investment, commercial bank reserve-based loans ("**RBLs**"), or other investments or extensions of credit.

RBL lenders, in turn, are dealing with the combined effects of (1) deterioration in the financial condition of their borrowers and the value of their collateral, and therefore greater uncertainty regarding the ability of some borrowers to repay their loans on a timely basis, (2) increased regulatory scrutiny of, and related reserve requirements for and write-downs of, RBLs, and (3) in some cases, declines in the price of their own stock, at least partly as a result of their exposure to energy credits. Also, and especially for those who may have entered this market near the top of the price cycle, or do not have the depth of talent needed to wrestle with RBL evaluation, administration and collection in a distressed market, some lenders are reconsidering their commitment to this market. At the same time, billions of dollars have been raised by funds and others interested in acquiring energy-based assets, with the prospect of achieving significant investment returns as the prices of oil and gas rebound.

As a result of these and other factors, there is increasing interest in the benefits, as either a seller or buyer, of transfers of RBL credit exposure. This alert will summarize some of the questions that arise when a lender in a secured RBL facility negotiates and consummates a sale to a buyer of all or part of the lender's RBL facility position. The alert primarily addresses sales of individual "whole loans," but makes additional observations regarding transfers of loans/commitments in syndicated facilities, the transfer of participation interests, and the sale of RBL portfolios.

Business Considerations

Of course, the most fundamental business issue is the price to be paid for the RBL, presumably at a discount from the face value of the outstanding loan amount (including outstanding principal, accrued-but-unpaid interest, and unpaid fees and expenses). There often continue to be gaps between bid and asked prices: in some cases due to differences of opinion regarding future commodity prices and therefore collateral value, and the borrower's projected revenues, income, and ability to repay the RBL; and, in other cases due to the size of the discount that the buyer needs to achieve its target return on investment, compared with the size of the loss that the seller is willing to accept as an economic and accounting matter. Given the volatility of the underlying collateral commodity prices, to help bridge the gap, some RBL-sale transactions are providing for a fixed upfront payment, with the potential for additional consideration to be paid to the seller if commodity prices later reach certain thresholds.

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While an RBL position may be purchased by a bank, much of the buy-side interest today is being expressed by private equity funds and other non-traditional lenders, who perceive an opportunity to achieve a good ROI, without being burdened by the accounting and regulatory issues that affect traditional banks. Purchases by non-bank lenders will, however, be particularly affected by some of the other topics noted below, including funding of future advances, the contractual eligibility of assignees, and the experience and staffing needed to administer an RBL.

An RBL buyer’s due diligence analysis approximates that of a bank or other lender making a new RBL, including as to borrower financial condition, the current and projected value of collateral for the loan, perfection and priority of liens in the collateral, status of any third-party credit support, title to valuable assets, contract counter-party performance risks, and business, contract, and legal issues affecting leases and operations, including insurance, lease termination, and plugging and abandonment obligations. In a distressed RBL situation, however, the buyer will consider the additional uncertainties, delays, and costs in payment/performance that may result from possible bankruptcy proceedings. At the very least, there will be incremental diligence related to the status, performance, and maturity of debts and obligations owed to other creditors (including junior lien creditors, unsecured bondholders, royalty and co-working interest owners, and mechanics and materialmen), maintenance of undeveloped leases, environmental compliance, increased regulatory bonding requirements, up-front operator cash calls pertaining to AFEs, and operating stress caused by workforce reductions and tighter operating margins.

If the RBL facility includes the lender’s commitment, typically on a revolving basis, to make additional advances, and the commitment is still in effect (i.e., prior to the maturity of or default under the RBL), then the RBL loan agreement likely restricts the assignment of the funding commitment. The buyer of such an RBL of course must be prepared to fund the commitment, and (if the RBL is not syndicated) administer a “live” credit facility, including periodic borrowing base redeterminations. If the selling lender has also issued letters of credit for the borrower’s account, then additional considerations and arrangements come into play. These issues may lead to consideration of a participation sale/purchase, described below. Also, although the buyer of a revolving RBL could achieve economic benefit by purchasing, at a discount, the funded portion of the RBL, traditional discount-purchase economics do not apply to the unfunded commitment or an undrawn letter of credit (“**LOC**”).

If the borrower has put hedges on future production, then the buyer will consider the valuation of the hedges and the effect on future performance and revenues of the expiration or early termination of the hedges. When the seller of the RBL is also the hedge counterparty, then the seller may consider novation (with the consent of the borrower and the transferee) or early termination of the seller’s hedge contracts to the extent permitted thereunder, and the calculation of related payment obligations. If the seller retains its hedge contracts, then considerations include the continuation of its liens in the collateral for the RBL, which liens typically also secure the borrower’s performance of its hedge obligations, what rights, if any, the seller retains in the administration of the shared collateral, and other effects of separating the hedge and RBL arrangements.

Typically, the buyer of an RBL will not receive any representations, confirmations, or other comfort from the borrower, other than that expressed in existing loan and collateral documents.

Other Typical Document and Legal Issues

Transfer of an RBL will include evaluation of intercreditor issues, of course, if the payment of the subject loan, or the lender’s lien in the collateral for the loan, is contractually subordinated to the repayment or lien priority of a senior creditor; or if the RBL is a senior loan, but there is a junior loan/lien position. Mechanic’s and materialman’s liens also come into play, especially with a borrower whose financial condition has deteriorated, and the buyer should evaluate the relative priority of these liens and the RBL liens.

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Special issues accompany transfer of an RBL whose holder acquired overriding royalty interests, net profits interests, equity warrants, or other equity kickers in connection with the making of the RBL. These include valuation and transfer issues, if the kicker is to be sold, and interest-alignment and protection issues, if not.

The buyer will consider issues regarding unintended assumption of liabilities that arose before the transfer of the RBL, and the RBL seller's indemnification against such liabilities. Absent unusual circumstances, the buyer should not be responsible for pre-transfer liabilities, but its right and ability to enforce and collect on the RBL may well be subject to valid defenses of the borrower that arose pre-transfer.

If a purchaser of an RBL anticipates the possibility of later agreeing with the borrower to amend or restructure the RBL loan terms, it should consider the potential income tax effects of the amendment or restructure. In particular, if there is a significant modification of a debt instrument, then the debt instrument is deemed to be "exchanged" and the lender will recognize gain (particularly relevant, of course, if the RBL is purchased at a substantial discount) or loss on the exchange. Although it would be unusual for a modification to be negotiated and agreed prior to the sale of the RBL, such an agreed, pre-transfer modification could help avoid unwanted tax consequences.

Buyers and sellers will negotiate a loan purchase agreement that will cover, in addition to fundamental transfer (typically without recourse) and price provisions, seller representations and warranties, closing conditions, transfer of liens and security interests, required notices, delivery of files and information needed for the administration of the loan, seller (and in some cases buyer) indemnifications, treatment of seller hedges, and agreements concerning continued cooperation between the buyer and seller related to the loan transfer.

Sales of Syndicated RBLs

In many respects, the transfer of a syndicated loan member's RBL position is simpler than the transfer of a "whole loan," because the credit agreement and assignment documentation are fairly standard and the agent bank nominally holds the liens and security interests and continues to administer the overall loan for the benefit of all lenders. Pertinent (although not specifically tailored) to sales of distressed, syndicated RBLs, the LSTA has published a standard purchase and sale agreement for distressed loans. On the other hand, the typical syndicated loan agreement restricts the types of "eligible assignees" that may acquire loans, requires the consent to assignment of the agent bank, certain other credit-fronting banks (e.g., issuers of letters of credit), and a non-defaulting borrower, and imposes certain other requirements on assignment. Especially with respect to syndicated RBLs that are in distress, and are likely to undergo additional transfers of syndicated RBL positions among a variety of holders with potentially differing goals, the buyer will assess the future voting positions of current and potential syndicate members, on such issues as waivers of compliance, substantive amendments, borrowing base redeterminations, declarations of default, enforcement of debt and lien positions, and a multitude of potential lender decisions in a bankruptcy proceeding.

There is an active secondary market for sales of syndicated RBLs, in many cases with recognized discounts on a borrower-by-borrower basis. While many issuers of publicly-traded bonds are currently purchasing their own bonds, in the open market, at favorable discounts, the typical syndicated RBL credit agreement prohibits the borrower and its affiliates from purchasing syndicated RBL positions.

Sales of Loan Portfolios

As noted above, there are several reasons why an RBL lender may want to sell its entire RBL portfolio. From the buyer's standpoint, a portfolio purchase may create a favorable investment and ROI profile, including by achieving a favorable "group discount" and spreading the buyer's investment risk and reward

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across multiple loans. In some cases, a portfolio purchase also reflects a strategic move to create or expand a position in the RBL market, including acquiring associated human capital. The “one man’s trash, another man’s treasure” theme has, of course, historically played out in numerous other market and sector downturns, including not only energy but also commercial real estate, subprime mortgages, and sovereign debt.

When a portfolio of multiple loans, as opposed to a single loan, is being transferred, special loan purchase agreement issues and provisions include scope of due diligence on individual loans, ability of buyer or seller to remove loans from the transaction, and potential purchase price adjustments. A potential buyer of an RBL portfolio of course undertakes a significant due diligence and transfer-documentation burden. Consents from borrowers may be needed and, as mentioned above, outstanding letters of credit and hedging obligations must be addressed. If underlying RBL documentation is not clear on these issues, then amendments to the loan documents may be needed. Requesting borrower consent to assignment or agreement to an amendment of course opens the door to the borrower’s negotiation of certain waivers or other contractual quid pro quo.

Also, the buyer must confront the best way to administer the RBL portfolio going forward, which (depending on the nature of the buyer) may include hiring, and taking steps to retain, relevant personnel of the portfolio seller.

The seller will determine the best process for contacting, facilitating due diligence by, and soliciting offers from prospective buyers. Related questions include whether to engage advisors to assist in the process and to require bids to be based on a specified form of purchase agreement.

“Loan to Own”

Additional business, documentary, and legal analyses occur when a “loan-to-own” buyer of a distressed RBL is primarily interested in parlaying the purchased loan position into an acquisition of the borrower’s assets or equity.

The buyer anticipates the possibility or even likelihood of a bankruptcy case, and resulting attacks on the coverage, perfection, or priority of liens securing the RBL. Other issues include the status of subordinate creditors, how best to convert the loan into asset/equity ownership, access to capital needed to operate the acquired assets and business, and environmental, fiduciary, and other “ownership” liabilities.

While the next topic addresses possible advantages of a junior lien creditor buying a senior RBL, in some cases it will be the purchase (presumably at a deep discount) of a junior RBL that best positions the buyer to acquire, in reorganization, the equity of the borrower. Naturally, the wisdom of either a loan-to-own or loan-to-control strategy hinges on a good assessment of the value of the collateral for the RBL, and, correlatively, which strata of RBLs are, and are not, well secured, both at the time of purchase and over time as affected by developments in the reorganization process and fluctuations in commodity prices.

“Loan to Control”

In an effort to maximize debt capital and optimize loan terms and costs, many E&P companies have borrowed significant sums under second-lien RBL facilities. The decline in collateral coverage and risks of loss in an out-of-court restructure or bankruptcy proceeding often are felt most acutely by holders of this second-lien debt. As a result, second-lien creditors with access to capital increasingly are considering and accomplishing purchases of senior RBLs, as a strategy better to control the major decisions in a restructure or bankruptcy.

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For example, the purchase of a senior RBL gives the purchasing second-lien creditor an additional advantage as a potential debtor-in-possession ("**DIP**") loan provider in a bankruptcy case. The intercreditor agreement between the senior RBL lender and the second lien creditor generally prohibits the second-lien creditor from advancing a DIP loan to the debtor unless it is subordinated to the senior RBL. This insures that the senior RBL lender maintains its senior position and has a first right to provide a senior DIP loan. Purchasing the senior RBL and providing a DIP loan in the bankruptcy case gives the purchasing second-lien creditor better control over the outcome of the case.

Sales of Participation Interests

For either economic or loan administration reasons, the parties may prefer that the current RBL lender continue to hold the loan, and sell to the buyer a "participation interest" (typically an undivided, pro rata interest) in the RBL. The parties will negotiate the basic economic terms of the sale, including discounting the purchase price to be paid for the participation interest, and the rights of the participant to approve certain loan matters, including material amendments or waivers, borrowing base redeterminations, releases of collateral, and enforcement actions. The RBL credit agreement may restrict the RBL lender's right to grant a participant certain approval rights. If the borrower is still entitled to request advances, then the agreement will address the participant's obligation to fund its share of future advances; but as noted earlier, a revolving credit does not lend itself to a typical discounted-purchase arrangement. To effect the intended legal and accounting results, presumably the RBL lender will sell the participation "without recourse," with no obligation to repurchase the participation, and with no other (e.g., "first out") priority to the buyer.

In sum, although numerous business, legal, and document considerations affect RBL sales and purchases, we expect that sophisticated parties increasingly will consider these transactions as a way to achieve their respective business goals in the turbulent RBL market.

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