Distressed cycles often test the limits of "market" terms and documentation principles prevalent in industry-specific financing arrangements. For independent oil and gas exploration and production (E&P) companies, the industry turmoil that peaked in 2015-2016 put the fundamentals of reserve-based loans (RBLs) under the microscope.

Now that many E&P companies have deleveraged their balance sheets and commodity prices have begun to stabilize, many of the same lenders that suffered through the downturn are back in the market providing new RBLs. Although what is "market" for these facilities continues to evolve, the new RBLs reflect greater sensitivity to risk than their pre-crisis predecessors, but they are already moving away from some of the restrictions that were required for many of the Chapter 11 RBL exit facilities now being refinanced.

Before the Downturn

An RBL is a unique form of asset-based financing that has been commonplace in the E&P industry for decades. In essence, RBL lenders provide revolving credit against a borrowing base set by valuing an E&P borrower's hydrocarbon reserves. Lenders set and reset the borrowing base periodically based on engineering assessments of proven and unproven reserve levels, commodity price expectations, and other factors.

For many years before the 2015-2016 downturn, commercial banks competed heavily for opportunities to underwrite or participate in RBL facilities. Lenders generally viewed RBLs as low-risk loans; they were modeled after asset-based loans, which are structured to ensure that borrowings can be repaid following a default by liquidating the borrowing base assets.

The late 2014 drop in oil prices was preceded by a long and steady climb. For example, West Texas Intermediate crude oil prices increased from the low- to mid-$40s per barrel in early 2004 to more than $100 per barrel in early 2014. The prosperity enjoyed by the E&P industry during those years created opportunities for borrowers to increase their leverage and finance ambitious development plans.

Private equity-sponsored borrowers were able to move the market toward increasingly aggressive capital structures with term loans and/or bond debt layered below the RBLs. Very few RBLs required cash controls. Commodity price hedging was permitted but not necessarily required. The confluence of these market norms created a perfect storm when falling commodity prices wreaked havoc on the E&P industry.

Fallout from the Downturn

As commodity prices plummeted in late 2014 and throughout 2015, many E&P companies found themselves unable to operate and service their debt with their diminishing cash flows. Borrowers desperately needed liquidity to survive the downturn, and it became clear that borrowing base redeterminations would shrink or eliminate borrowing capacity under the RBLs. In some ways, the downturn served as a "stress test" for these RBLs.

Some borrowers worked with RBL lenders to delay redeterminations or stretch borrowing bases temporarily to buy time for a commodity price rebound. Others took more aggressive measures by drawing down the full availability under their RBLs while they still had the chance. In many cases, the borrowings were deposited in accounts with banks outside the RBL syndicates, leaving lenders with massive borrowing base deficiencies, no control over the borrower's cash, and the potential for substantial value leakage to junior creditors (in or out of bankruptcy).

Even in cases where borrowers did not elect to draw down and hoard cash, the fact that RBL facilities usually were not secured by 100 percent of a borrower's hydrocarbon assets meant that there were often more than *de minimis* unencumbered assets to give borrowers and junior creditors leverage in restructuring negotiations.

As prices continued their downward trajectory in 2015, dozens of E&P companies filed Chapter 11 proceedings. Some cases were more painful than others, with some involving massive intercreditor disputes, delays, and legal fees (*e.g.,* Sabine, Energy XXI, and Samson). Yet despite the unwelcome pressure and risk that RBL lenders faced during the downturn, RBLs fared reasonably well, both in bankruptcy cases and in out-of-court restructurings.

The E&P companies that reorganized under Chapter 11 shed massive leverage and usually satisfied their RBL debt with a restructured RBL facility or replacement term loan with enough value to make the RBL lenders whole. E&Ps that restructured outside of bankruptcy generally increased their leverage but used the proceeds to repay and/or downsize their RBL facilities.

With restructuring advisors at the negotiating table for these exit RBL facilities and out-of-court RBL amendments, several lender-friendly refinements gained traction in the market: mandatory delivery of deposit account control agreements on the borrower's accounts, aggressive anti-cash-hoarding provisions, tighter financial covenants,

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BY ANA ALFONSO, PARTNER & WESTON EGUCHI, COUNSEL, WILLKIE FARR & GALLAGHER LLP

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mandatory hedging requirements, and amendments to intercreditor agreements designed to expand first lien lenders' protections in bankruptcy against interference by second lien lenders.

The Newest Round

The rebound in commodity prices and deleveraging in the E&P sector have alleviated some of the pressure on borrowers and have spurred early signs of a rebound in RBL activity. Although some commercial banks have exited the market permanently, many others are showing renewed interest in RBL lending. Recent facilities have generally been smaller than pre-crisis RBLs, and several have been oversubscribed. Although a number of these new RBL facilities maintain vestiges of lessons learned from the 2015-2016 cycle, a number of crisis-driven restrictive covenants have already fallen out of vogue.

Based on an informal survey of industry participants, the authors note several ways the crisis has impacted the current state of RBL lending:

- Virtually all new RBL financings require borrowers to deliver deposit account control agreements.

- In some larger corporate deals, borrowing bases could previously be increased with something short of unanimous lender approval. Now, virtually all RBLs require 100 percent lender approval for borrowing base increases. Lenders can no longer be "dragged" to stretch a borrowing base, and market participants are comfortable relying on "yank-a-bank" provisions to avoid the problem of obtaining consents from holdouts. (Of course, holdouts tend to emerge in distressed situations, when other lenders are unlikely to buy out a syndicate member at par, but lenders presumably are willing to trade the flexibility of outvoting a holdout for the right not to be dragged.)

- Anti-cash-hoarding provisions are *not* being required in most new RBLs.

- Lenders are requiring mortgages on less than 90 percent of the economic value of proved reserves. Typically at 80 percent before the crisis, the ratio had crept up to 90 percent or higher during the crisis.

- Provisions governing restricted payments have tightened in some deals to require satisfaction of liquidity and leverage tests.

- Many RBL deals have a minimum liquidity closing condition equal to 10 to 20 percent of the borrowing base.

- Pricing for new RBLs has crept up compared to pre-crisis levels.

- It is common for new RBLs to impose two- to four-year minimum hedging requirements.

- As before the crisis, it is standard for new RBLs to include financial maintenance covenants based on leverage ratio and current ratio tests. (Other financial covenants, such as interest coverage ratios, are less common.) However, to ensure that new RBLs meet the leverage guidelines established by the Office of the Comptroller of the Currency (OCC) in 2016, commercial banks are now requiring more stringent leverage ratio tests.

- The same OCC leverage requirements are making it more difficult for commercial banks to allow borrowers to incur junior lien debt. As such, junior capital is increasingly taking the form of preferred equity, with intercreditor protections being replaced with limitations imposed by restricted payment covenants.

These trends are a product of RBL lenders' testing and revisiting lender protections that arose out of the 2015-2016 E&P restructurings. Ultimately, it remains to be seen whether these terms will survive sustained competition and/or the perpetually short-term memories of loan market participants in search of opportunities. For now, market intelligence suggests that RBL lenders are remaining vigilant in their risk mitigation efforts and borrowers are gradually regaining lost ground in the balance of risks. J

Ana Alfonso is a partner in Willkie Farr & Gallagher LLP's Business Reorganization & Restructuring practice in New York. She primarily represents financial services industry clients as creditors in bankruptcy proceedings and out-of-court restructurings. She has led numerous E&P sector restructuring engagements on behalf of administrative agents, lender groups, and bilateral credit providers, including in the Chapter 11 cases of Energy XXI, Goodrich Petroleum, and Samson Resources. Alfonso can be reached at 212-728-8244 or aalfonso@willkie.com.

Weston T. Eguchi is counsel in Willkie Farr & Gallagher LLP's Business Reorganization & Restructuring practice in New York. He represents ad hoc groups, private funds, banks, financial institutions, and other parties in connection with restructurings, distressed asset sales, and financing transactions, both in and out of court. He also regularly advises buy- and sell-side firms on investments in distressed and stressed credits, and has substantial experience in cross-border insolvencies. Eguchi can be reached at 212-728-8881 or weguchi@willkie.com.