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Force Majeure and Material Adverse Change in Reserve Based Lending (RBL): When Two Black Swans Collide

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A "black swan event" is an unpredictable event that is beyond what is normally expected and which has potentially severe consequences. Black swan events are characterised by their rareness and severity.

Independent exploration and production oil and gas companies ("**E&P companies**") are currently reeling from not one, but two, black swan events. First, the collapse in oil prices which, at the time of writing, have fallen to around one-third of the level at which they started the year. Second, the impact of COVID-19, both directly and indirectly, on their businesses. Of course, there are very significant connections between the two but there are also important independent features. If a vaccine for COVID-19 were found and everyone went back to work as normal tomorrow there would still be an oil price crisis to be dealt with because of the decision by OPEC to lift supply restrictions (and indeed, in the case of Saudi Arabia and Russia, to increase production) following the failure by OPEC and Russia to agree on a basis for controlling supply at their meetings in early March.

In light of these events, many E&P companies with RBLs are considering whether there is anything in their loan documentation that might mitigate or relieve their obligations to perform and/or whether these events might constitute a default on grounds that a "material adverse change" has occurred or that these events have had or might have a "Material Adverse Effect".

This article considers the nature of RBLs and considers the question of force majeure and material adverse change in international RBLs (i.e. those under English rather than US law) in the context of these two black swan events.

1. What are the key features of Reserve Base Lending and how does an oil price crash impact?
Reserve Based Lending is a debt financing product which for some decades has been the tool of choice in the armory for E&P companies looking to raise debt finance. It was developed in the London market in the mid-80s but it has a longer history in the US where it developed as an adjunct to real estate lending. Although the term "Reserve Based Lending" and "RBL" is now a global term, there are significant differences between the product and its documentation as between North America and the rest of the world. However what is common as between both markets is that RBL is a form of lending based on allowing the borrower debt capacity sized against future cash flows. It is structured to be flexible and adaptable both to changes in the

borrower's own position (e.g. the performance of its fields) and changes in the global financial and relevant commodity markets. Within a prescribed envelope of an amortizing Facility Amount, the amount the borrower can draw (and its obligations to repay) are determined by periodically re-calculating a so called Borrowing Base Amount, which is the discounted value of the future net cash flows of the interests of the borrower/ borrower group in those hydrocarbon assets the lenders have agreed to treat as "Borrowing Base Assets" divided by an agreed number(s) to provide the banks with an agreed cushion of cover (the "cover ratio").

The Borrowing Base Amount is recalculated, typically twice a year, through a process known as a "redetermination". One of the key assumptions in determining net cash flows is oil and/or gas prices and the lenders will set revised pricing (the "price deck") both for the current year and future years at each redetermination. In normal circumstances the current price deck will be a material discount to spot pricing at the time of the redetermination and future pricing will be at a discount to the relevant commodity price forward curve (though in times of extreme volatility this discount has not always applied).

So RBL is a product which is inherently adaptable. In contrast to most other debt products which do not expand and contract with changing circumstances and which rely on financial covenants that produce a binary outcome of compliance or default (usually by taking a backwards look at the balance sheet and profits) the RBL breathes in and out with the changing circumstances and takes a forward look at projected cash flows. In the normal ebb and flow of commodity price cycles this works well for all parties. But what happens when the oil price dramatically crashes as it has this year (and as it did between late 2014 and early 2016)? The challenge for E&P companies is that at the very point their cash flows are hit by falling commodity prices they also find their credit lines hit. Although RBLs are well structured, secured and have a number of mitigants to provide early warnings and provide a cushion to lenders they (like all other debt products) are not set up to operate serenely in the once in a century storm (or at least not if that storm is a sustained one).

The oil price crash that accompanied the global financial crisis actually produced very few casualties in the international RBL market but it did produce some changes in lending practices. The last oil price crash in 2014-2016 produced much more widespread default and RBL lending since has taken place with that experience in fairly recent memory. Against the backdrop of the last oil price crash lending has been more cautious than it was in the exuberant days that preceded it and borrowers are generally more hedged (whether mandatorily, because the lenders have imposed it, or voluntarily because boards have thought it prudent). This means that many E&P companies are well hedged. Additionally companies are generally being very quick to curtail expenditure. But what if the crisis sustains and those factors are not enough? Against this background borrowers have been seeking advice on force majeure and borrowers and lenders have been considering the ambit of facility provisions that relate to material adverse change ("**MAC**").

2. Force Majeure

With three rather minor footnotes by way of exception, it is probably fair to say that RBLs and loan agreements more generally never contain force majeure provisions (or anything equivalent to them).

If a borrower has an obligation to pay then it is an absolute obligation to pay come "hell or high-water" or, indeed, COVID-19 for that matter. As regards the borrower's other obligations to perform under a loan agreement, such as positive or negative undertakings, while the performance of a particular obligation may be tempered, for instance, so that it is a "reasonable endeavours" obligation rather than an absolute obligation, loan agreements do not excuse performance on grounds of force majeure or anything similar.

The minor exceptions to note are examined below.

Information Provision

It is very common in RBL documentation for the borrower to have information undertakings that could be impacted by force majeure events, requiring the borrower to notify the agent if, for instance, the borrower serves or receives a force majeure notice. If the borrower or any key contractual counterparty is impacted by a force majeure event, the information undertakings in the loan agreement should be checked.

The LMA concept of a "Disruption Event"

The Loan Market Association's ("**LMA**") model form loan documentation embodies a concept of a "Disruption Event" which may give a very short grace period before an Event of Default occurs (in the case of the borrower) or a lender becomes a Defaulting Lender (in the case of a Lender) if that party is unable to pay (in the case of the borrower) or to fund (in the case of a lender) on the due date. The duration of the grace period is a matter for negotiation between the parties and will be set out in the loan agreement but typically it is only two or three days.

There are two limbs to the definition of "Disruption Event". The first relates to something which has impacted the whole market and the second is something which may be specific to the borrower or another party to the loan agreement:

The first limb refers to a "*material disruption to those payment or communication systems or those financial markets which are, in each case, required to operate in order for payments to be made in connection with the Facilities (or otherwise in order for the transactions contemplated by the Finance Documents to be carried out) which disruption is not caused by, and is beyond the control of, any of the Parties*". So if, for instance, the entire SWIFT system goes down this might be covered by the first limb.

The second limb refers to "*the occurrence of any other event which results in a disruption (of a technical or systems-related nature) to the treasury or payments operations of a Party preventing that, or any other Party:*

(i) from performing its payment obligations under the Finance Documents; or

(ii) from communicating with other Parties in accordance with the terms of the Finance Documents,

and which (in either such case) is not caused by, and is beyond the control of, the Party whose operations are disrupted".

So:

- both limbs are about whether a party can actually effect the mechanics of making a payment (not about whether it has the money to make the payment);

- the first limb is about a market wide event and the second an event which may impact only one party;

- both limbs concern technical or systems-related problems in effecting payments or making communications.

One can see that COVID-19 events have the potential to cause a Disruption Event but clearly these provisions have no relevance in the context of commodity price fluctuations, however severe.

Force Majeure affecting an Agent Bank or Fronting Bank

Finally the LMA's model form leveraged acquisition loan agreement has a provision in the Agency section which exculpates the agent and any Fronting Bank (i.e. LC issuing bank) from any liability for losses caused to others as a result of "a*ny act, event or circumstance not reasonably within its control*". The clause goes on to give a list of examples such as failure in transport or communications, natural disasters, strikes, acts of God etc., but these are just examples. Whilst epidemics or pandemics are not listed, protection is given for "*any act not reasonably within its control*" so one can see that, depending on the circumstances, a failure by an agent to properly perform its function due to a "lock-down" or similar resulting from COVID-19 has the potential to be excused by these provisions.

3. Material Adverse Change

In terms of other events which have a "Material Adverse Effect" ("**MAE**") on a Borrower (whether that is COVID-19 related, an oil price collapse or any other adverse event), there are typically two key provisions in loan agreements that need to be examined. One is in the representations section and the other is in the Events of Default section (though there will usually be many other provisions which are qualified by "material adverse effect" language).

"No material adverse change" representations

There are of course variations in the language for this representation across different loan facilities but the "no material adverse change" representation is usually along the lines:

"*Since the date of the most recent financial statements delivered to the Agent there has been no material adverse change in the assets, business or financial condition of the Group*".

The key thing to check with regards to this representation is whether it is given only at the date the loan agreement is signed, or whether it is a "Repeating Representation". There is strong logic for this representation not to be a Repeating Representation, particularly in a RBL where there are cover ratios and financial covenants to monitor the ongoing creditworthiness of the borrower/group and the asset cover provided by the Borrowing Base Assets in a precise and quantitative way. Nonetheless it is common to see this representation designated as a Repeating Representation and accordingly a borrower should carefully consider its ability to give this representation (if repeating) against the backdrop of recent events.

The MAC or MAE Event of default

It is very, very common in RBLs (and indeed non-investment grade documentation more generally) for there to be an Event of Default if a "Material Adverse Change" occurs. There are naturally multiple variations in how MAC or MAE formulations are defined in loan agreements but typically these definitions will require there to be a material adverse change in the " *business, assets or financial condition*" of the borrower / group (so therefore a historic, look back, test) . That said, it is quite common to also find references to there being a material adverse change in the "*prospects*" of the borrower / group which is a prospective, forward looking, test (and very vague).

It is also common for MAC or MAE in RBLs to include a reference to "*the ability of an Obligor to perform its payment / material obligations under the Finance Documents / Transaction Documents".* Whilst the circumstances that oil and gas companies are facing could lead to a trigger on their ability to make a payment, the English courts have, in the rare cases on material adverse change, required that the change in question must be substantially affecting the relevant party's ability to perform the obligation and that the change must not be temporary or transitory.

There are also variations as to whether the test is objective or whether, as is common, the Majority Lenders (acting reasonably) have the right to determine that the event has occurred with a resulting Event of Default if they do.

Is the MAC event of default a worry for borrowers in RBLs? We would say generally not. We have never seen, or heard, of one being called by a bank group in this sector of the finance market and indeed, we have never seen or heard of banks threaten to call one. The reason for this is that MAC is not a precise concept and if banks were to call a MAC Event of Default in error, the potential liability for those banks could be huge.

In practice, banks do not accelerate or enforce security until a clear-cut Event of Default has occurred, such as a non-payment or breach of a financial covenant Event of Default. In addition, in the context of a RBL there is already an in-built mechanism (the scheduled "redeterminations") for the banks to resize the facility if an event occurs which impacts forecast future cash flow (and, additionally, usually a right to call for an interim redetermination if a sudden material and adverse event occurs).

These are still early days and while the impact of both the recent oil price collapse and COVID-19 is still playing out, the potential impact of these events under RBL facilities should be under review now.