ISDA NEGOTIATIONS FOR RESERVE-BASED BORROWERS

In the scramble to close a reserve-based financing, producers may forget to scrutinize their hedging documents. Here are key considerations in negotiating these documents.

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Hedging oil and gas production is a key price-risk-management practice for many U.S. E&P companies, particularly those having a nonrecourse reserve-based lending (RBL) bank facility that requires hedging in connection with the loan agreement. In the scramble to close a reserves financing there is typically a lot of focus on the credit facility, but much less focus on the ISDA (International Swaps and Derivatives Association) documentation that will govern the hedging.

The lesser attention to hedging documents may happen for several reasons. If the credit agreement allows for hedging to be completed *following* the loan's closing, the ISDA negotiation may be put off. The nature of the ISDA documents themselves may be a factor, as they are not easy reading for newcomers. However, ignoring the content of the ISDA documentation carries risks. In this article we highlight some key considerations when negotiating ISDA documents in connection with North American RBL arrangements.

ISDA documents are "framework" agreements that govern the terms of individual over-the-counter (OTC) derivatives transactions between two parties. While the front-end documents are quite lengthy and can involve negotiation, completion of the framework allows each subsequent trade to be expressed in a brief "confirmation" confined to a few basic commercial terms—term, price, quantity and so forth. The components of the framework ISDA documentation are the Master Agreement; the Schedule, which completes the master; the Credit Support Annex (CSA); and the Paragraph 13, which completes the CSA. (The ISDA documents additionally depend on substantial underlying published material, such as the ISDA definitions, commodity definitions, and enforceability opinions.)

The borrower's success in shaping key terms of the ISDA (or making any headway at all) will of course depend greatly on its bargaining position. A small E&P borrower obtaining a loan from a single bank can expect to hold less sway than a large E&P concern entering credit arrangements with a syndicate of banks. The considerations below have to be viewed within the context of the negotiating position of the borrower.

Cross default vs. cross acceleration

A principal negotiation point focuses on whether the ISDA's indebtedness event of default will be "cross default" or "cross acceleration." A cross default gives a party the right to terminate the hedge transaction if an event of default has occurred. Cross acceleration provides the right to terminate only if the loan's repayment obligations have been triggered.

For example, if there were a default on a loan but the bank group was working with the borrower to resolve the default, grounds would exist for terminating the hedge transaction under cross default but not cross acceleration. If a default under the ISDA is declared, the borrower would immediately owe a termination payment to the lender counterparty in the amount that the borrower's hedges were out-of-the-money. Following termination, the borrower would no longer be hedged against price risk.

As to the competing interests here, the lender counterparty typically will seek flexible rights allowing its decision to terminate at the first "sign of danger," truncate its risks, and collect a liquidation payment. The borrower, by contrast, wants to steer by the principle that its default under the ISDA should not occur more readily than its default of the credit agreement. In the context of a syndicated loan, consideration should be given to what advantage a lender who is an ISDA counterparty might have over non-ISDA counterparty lenders.

The published text of the ISDA master defines several events of default that may give the lender the ability to declare a default more swiftly than under the credit agreement. Care must be given to the defined scope of several key terms, including "Specified Indebtedness," which defines the agreements and commitments that could trigger an event of default;

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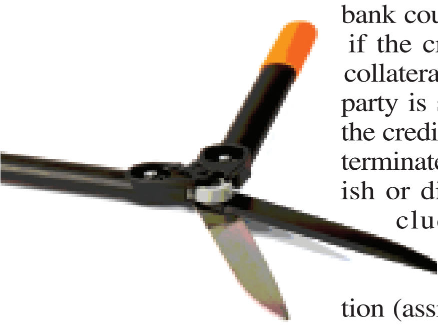

"Specified Entity," which governs the borrower affiliates that could trigger a default; "Credit Support Documents," which should refer solely to the security documentation under the pertinent credit agreement, e.g., a pledge/collateral agreement; and "Credit Support Provider," which should bring in as limited a group of entities as possible.

Additional termination events for borrowers. Additional Termination Events (ATEs) are events negotiated and added by the parties to the ISDA master format that would give rise to a right to terminate the hedge transaction. Two ATEs typical to RBL ISDAs cover (1) if the bank counterparty ceases to be a lender, and (2) if the credit facility is paid off or substantial collateral is released. Where the lender counterparty is secured solely by the reserves securing the credit facility, that lender wants the ability to terminate the hedges should that security diminish or disappear. ATEs may be crafted to include curative provisions allowing immediate posting of collateral under a CSA that "springs to life," or the novation (assignment) of the ISDA to another lender by a lender-counterparty who exits the credit facility.

Characteristically, lender(s) supporting a credit facility may exit or enter over time. Novation allows the borrower to maintain its existing hedges by their assignment to a bank that will remain in, or enter, the credit facility.

Other ATEs may address change of ownership or control of the borrower; material adverse change (MAC) clauses measuring the borrower's liquidity or coverage; and credit rating downgrades. The borrower wants any ATEs to match the lender's rights under the credit agreement and favors provisions allowing transition to another lender counterparty or replacement security arrangement.

Borrower's credit support from the lender. ISDA documentation proposed by banks in the RBL context seldom contain credit support provisions protecting the borrower against plummeting lender creditworthiness. However, we have seen from the demise of Enron, Lehman Brothers, and Bear Stearns that seemingly financially strong counterparties can pose a credit risk to the borrower. In the non-RBL context, parties may install margining rights as to one another by use of a negotiated bilateral CSA, calibrated to credit ratings or other measures of credit health.

"Unilateral" CSAs benefiting the borrower are rare in the RBL context. Many borrowers are not staffed properly to monitor counterparty credit quality under a CSA. Moreover, in the case of rapid declines of creditworthiness, even day-to-day attention can't prevent credit exposures and loss. Where the lender is an affiliate of a larger bank organization, a parental guaranty issued for the benefit of the borrower is probably the best obtainable credit support. Other provisions to consider as to the lender include a MAC clause, or credit downgrade ATE—though such provisions may be difficult to obtain without a superior bargaining position.

Documentation deliverable by borrower. Any required deliveries of due diligence documentation, such as periodic financial statements and evidence of authority/valid signatories, should be reviewed to assure they fit what the borrower can actually deliver. Attention to these matters before the document is executed lets the borrower deliver necessary materials at the time of the ISDA's execution, avoiding a delayed completion of the hedge transaction.

Eliminating irrelevant portions of the Schedule. The lender's format ISDA schedule will often contain provisions fitting a broad variety of swaps that the lender customarily trades but irrelevant to a borrower whose sole interest is hedging commodity price risk. Deleting these superfluous provisions will ease the review and approval by the borrower's management.

ISDA Dodd-Frank Protocols. In connection with completing an ISDA, a borrower will find it necessary to review and affirm adherence to several Dodd-Frank Act (Wall Street Reform and Consumer Protection Act) related ISDA Protocols. At the date of this article, ISDA has published the August 2012 Dodd-Frank Protocol, dealing with external business conduct standards placed on swap dealers and major swap participants, and the March 2013 Dodd-Frank Protocol, relating to internal business conduct standards imposed on such parties. At least one more ISDA Protocol is expected.

Cross-border Issue. Having a lender counterparty that is a foreign chartered bank or other entity raises additional issues, including those relating to the Dodd-Frank Act and counterpart foreign regulations.

Conclusion

Borrowers should not allow the ISDA contracting to be a neglected aspect of the credit agreement's completion. If done concurrently, the two types of documentation can be aligned—a key benefit to both the borrower and the lender. Modifications and conflict resolution will be much more difficult if the loan under the credit agreement has been closed.

ISDAs *are* negotiable. The borrower in most cases does not need to sign verbatim the lender's ISDA format, and will generally benefit from review by advisers with derivatives documentation experience. That is not to say that the borrower will always make great headway. But it has to be considered a win for a borrower where terms of the lending agreement and the ISDA hedging arrangements dovetail, are understandable and livable. □

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