

Finance From the Borrower's Prospective

By

Terry Edward "Ted" Smith

Friedman & Feiger, LLP

Term Loan Credit Facility

- Term Loan Credit Facility
- Require the Borrower to repay a portion of the principal amount of the loan through regularly scheduled payments
- Single Lender
- Single Borrower
- If lending syndicate or multiple lenders, all action that can be required by single lender can be required by syndicate if owner of 51% or maybe 75% of the debt all agree to take certain action (ex. declare Borrower in default)

Credit Agreement

- First Round of Funding
- Initial Commitment - \$20,000,000.00
- Subsequent Commitment - \$10,000,000.00 – at Lender’s discretion
- Purpose for borrowing can be used by Lender to limit how the cash commitment is used
- Operators – drilling and other exploration and production activities with proceeds to be paid to Administrative Agent
- Midstream – construction and operation of a pipeline, or building of a gas processing facility with proceeds to be paid to Administrative Agent

Fees Owed by Borrower

- Commitment Fee – Borrower pays to Administrative Agent a fee equal to 1.5% of all amounts committed to be loaned to Borrower
- Applies to both Initial and Subsequent Commitment
- Administrative Fee – Borrower must pay to Administrative Agent a semi-annual fee of \$25,000.00 for every six-month period that the credit facility is in effect
- Exit Fee – Borrower will pay to Administrative Agent upon repayment of all sums borrowed and all fees incurred and termination of the credit facility

Administrative Agent

- Administrative Agent is usually the Lender
- Governs Control of the Lockbox
- Lockbox – a bank account that is established by the Administrative Agent and governs cash inflow and outflow from the Lockbox
- Cash Inflow from (i) the Initial or Subsequent Commitment by Lender, and (ii) proceeds received by Administrative Agent from Borrower's goods or services provided
- Cash Outflow to pay (i) Lender's fees when due, principal and interest then owed, (ii) to third party vendors that furnish goods or services to Borrower, (iii) Borrower's operating costs, (iv) taxes owed on Borrower's proceeds, then (v) to Borrower

Lockbox Bank Account

- Uniform Commercial Code – Article 9 – “Secure Transactions”
- A “security interest” is an interest in personal property or fixtures which secures payment or performance of an obligation
- A “secured party” is a person in whose favor a security interest is created or provided for under a security agreement, whether or not any obligation to be secured is outstanding
- Both Lender and Administrative Agent are secured parties for the Lockbox account which is defined by the UCC as a “Deposit Account”

Deposit Account

- The UCC defines a “Deposit Account” as a demand, time, savings, passbook or other similar account maintained with a bank
- The UCC defines a “Bank” as an organization that is engaged in the business of banking
- Attachment – occurs when the Administrative Agent and Lender’s security interest becomes enforceable against Borrower
- Perfection - is the process of giving notice to the public that a security interest has been created and establishes “priority” to monies within the Deposit Account over Borrower’s claims or third parties claims

Attachment and Perfection

- Attachment and automatic Perfection of a security interest in the Lockbox occurs when the Lender, Bank, and Administrative Agent are deemed to be in “Control” over the Lockbox
- “Control” occurs when (i) the secured party is the bank within which the Lockbox is contained, (ii) the Borrower, Lender, Bank, and the Administrative Agent have agreed in an authentic record that the Bank will comply with instructions originated by the Lender that direct the disposition of the funds in the Deposit Account without further consent by the Borrower, or (iii) Lender becomes the Bank’s customer for hosting the “Deposit Account”
- (ii) is satisfied when Lender, Borrower, Administrative Agent, and Bank enter into a Deposit Account Control Agreement

Deposit Account Control Agreement

- Agreement between Lender, Borrower, Administrative Agent, and Bank
- Both Administrative Agent and Bank have “control” of the Lockbox
- Bank subordinates its security interest in the Lockbox to Administrative Agent and agrees to comply with Administrative Agent’s instructions without further consent of Bank or Borrower
- Incoming funds from Borrower’s goods or services provided that are deposited into the Lockbox are “identifiable proceeds” and Administrative Agent’s security interest in the proceeds has automatic attachment and perfection and Administrative Agent has priority over Bank and Borrower

Administrative Agent

- Not subject to any fiduciary duty
- No duty to disclose information about Lender or Borrower
- No duty of inquiry for a possible notice of default
- No duty of inquiry to validity of any statement of fact (whether written or oral)
- No duty of inquiry to the validity of legal documents
- Manage cash inflow and cash outflow from Lockbox

Events of Default

- Failure to timely pay monies owed
- Non-compliance with representation or warranty
- Violation of affirmative or negative covenant
- Appointment of a receiver or trustee in bankruptcy
- Judgement rendered by court of competent jurisdiction in excess of \$100,000.00

Lender's Remedies

- Declare and accelerate all outstanding debts due and payable (fees, outstanding principal, interest owed)
- Take over and direct the actions of the Borrower operator or terminate any operating agreements
- Directly control the disposition of proceeds instead of Borrower controlling disposition of proceeds
- Foreclose and exercise rights as a secured party to take possession of Borrower's Collateral
- Terminate possibility of lending additional funds

Borrower's Tips

Notice and Cure Period

- Insist on notice and cure period for alleged Events of Default
- 30 days after notice
- Failing to provide reserve reports or financial information when due because of errors or mistakes of third parties (ex: CPA, engineer)

Material Adverse Effect

- An express Event of Default
- Lender can exercise previously discussed remedies
- “A material and adverse change in the business, assets, operations, properties or condition (financial or otherwise) of the Borrower”

Material Adverse Effect

- Limit what constitutes a “Material Adverse Effect” by providing an exclusion for any adverse effect, action, condition, change or circumstance arising from (i) general changes of economic conditions (to the extent not having a disproportionate effect on the Borrower), and (ii) changes to the financial banking, or securities markets (including any disruption thereof and any decline in the price of any security or any market index) (to the extent not having a disproportionate effect on the Borrower)
- If subsidiaries or affiliates are bound, the clause should be modified to apply to all entities as a whole, not each individual entity

Borrowing Base

- Lenders incorporate a borrowing base
- Built in protection for Lender
- The borrowing base will decrease if the Collateral value decreases
- Borrower cannot borrow more than the borrowing base
- If outstanding loans exceed the borrowing base, the Borrower will be required to provide additional Collateral or prepay a portion of the loan

Disbursement Request

- Borrower assumes all risk for acts and omissions of or misuse of Disbursement Requests, even by act of third party
- Add language that if Administrative Agent accepts Disbursement Request in its current form and does not object and Administrative Agent disburses requested funds, the Disbursement Request is deemed acceptable

Limit Power of Lender and Administrative Agent

- “For the avoidance of doubt, Borrower will have full access to the Deposit Accounts contemplated herein for purposes of operating and managing their business and finances and for paying its costs and expenses, and Administrative Agent and Lender may only have access to the funds therein to the extent of payment obligations then due and payable, and required to be paid, in accordance with the terms of this Agreement.”
- If payment not currently due, Administrative Agent cannot debit funds from the Lockbox
- Borrower can negotiate to have proceeds from goods or services rendered to be delivered to Borrower first, then Borrower deposits funds into the Lockbox only when payment obligations become due

Representations and Warranties

- Organization and Power: Borrower's entity is valid and in good standing
- Authority and Enforceability: Borrower has authority to enter into credit agreement
- Approvals and Consent: No other approval or consent is required to allow Borrower to enter into credit facility
- Financial Condition and No Material Adverse Effect: As previously discussed
- Compliance with Law: No violation of applicable law
- Disclosure – No Misstatements: All information furnished by Borrower to Lender is 100% correct

Borrower Adjustment to Representations and Warranties

- Add knowledge qualifier
- Correct in all material respects
- Must only be enforced when credit facility is entered into or when Lender advances additional funds in a Subsequent Commitment
- Examples:
 - Borrower's CPA does not timely pay franchise taxes
 - Disputed unpaid taxes
 - Inadvertent misstatement of fact

Purposes of Representations and Warranties

- Negotiation assists Lender's due diligence process
- Exceptions are set forth in schedules to credit facility
- Confirm assumptions made by the Lender with respect to the Borrower and Borrower's properties and assets in making credit and pricing decisions
- Representations and warranties are required to be repeated as a condition precedent to future borrowings
- Must remain true for Lender to furnish additional funds

Affirmative Covenants

- Borrower maintain existence
- Comply with applicable law
- Pay taxes
- Deliver financial statements and reserve reports
- Permit lender to inspect properties, books and records (limit once or twice a year)
- Timely payment of royalties
- Compliance with existing contracts for sales of production

Negative Covenants

- “No Borrower shall, until satisfaction in full of the obligation and termination of this Agreement”:
- Merger, consolidation, acquisition of assets
- Creation of liens
- Incur additional debt
- Investment by purchasing equity
- Capital expenditures cap
- Amendment of organization documents

Amendment to Negative Covenants

- “No Borrower shall, until satisfaction in full of the obligations and the termination of this Agreement, without the consent of Administrative Agent (which shall not be unreasonably withheld, delayed or conditioned):
- Try to strike capital expenditure limit or increase limit

Successor or Assignee

- “Lenders shall have the meaning ascribed to such term in the preamble to this Agreement and shall include each person which becomes a transferee, successor or assign of any Lender, to the extent approved in writing by Borrower”
- Lender not relieved of obligations
- Cannot increase amount owed if assigned unless approved by Borrower

Permitted Discretion of Administrative Agent

- “Means a determination made in good faith and in the exercise of commercially reasonable business judgement *substantially consistent with the factors and judgement generally applied to other borrowers*”

Obligation of Lender and Borrower

- “Obligation of Lender to fund Borrower, obligation of Borrower to reimburse Lender upon draw is absolute, unconditional and irrevocable, and shall be performed strictly in accordance with this Agreement under all circumstances, including:”
- Claim for breach of warranty, lack of power and authority, insolvency
- *“any other circumstance or happening whatsoever, whether or not similar to the foregoing”*
- Strike this language

Receivables

- “No Borrower will, without Administrative Agent’s consent (*not to be unreasonably withheld, conditioned or delayed*) compromise or adjust any Receivables (or extend the time for payment thereof) in any *material respect* or accept any material returns of merchandise or grant any additional *material* discounts, allowances or credits thereon except for those compromises, adjustments, returns, discounts, credits and allowances as have been heretofore customary in the Ordinary Course of Business of such Borrower.”
- Receivables – UCC Article 9 (i) accounts, (ii) contract rights, (iii) instruments, (iv) general intangibles, (v) all obligations due and owing for sale or lease or rendition of services

Issuance of Equity

- “In the event of any issuance or other incurrence of indebtedness by Borrower or the issuance of any equity interests by Borrower, Borrower shall no later than one business day after receipt by Borrower of (i) cash proceeds from any such issuance or incurrence of indebtedness, (ii) or net cash proceeds of any issuance of equity interests, repay the money advanced in an amount equal to (x) 100% of such cash proceeds in the case of such incurrence or issuance of indebtedness and (y) 100% of such net cash proceeds in the case of an issuance of equity interests.”
- Strike

Ordinary Course of Business

- “Shall mean, with respect to Borrower, the Ordinary Course of such Borrower’s business substantially as conducted, or proposed to be conducted, on the Closing Date and upon the consummation of a Subsequent Commitment to the extent disclosed to Agent in writing”

Asset Sale

- Agreement should contain language allowing for certain assets that are included within the definition of Collateral to be sold or otherwise contractually bound, so long as there is no Event of Default
- Purchase and sale
- Participation or farmout
- Equity sale
- Allows Borrower to conduct business in the Ordinary Course of Business
- Reinvesting proceeds from an asset sale to purchase replacement properties

Scope and Description of Collateral

- What is included and what is excluded
- Subsidiaries and affiliates
- Real property, personal property, fixtures, equity, receivables, contract rights, proceeds
- After-acquired
- If equity interests are pledged to secure a loan, Borrower should request that the Lender will not have voting rights or the right to receive cash dividends from the pledged equity interest unless an Event of Default has occurred

Why Should I Care?

- In charge of ensuring compliance with terms of a credit facility and all ancillary instruments
- Could be responsible for assisting Lender with due diligence that is required before Lender and Borrower can enter into credit facility
- Could be later hired by a lending institution
- Could own your own business and need to be familiar with the lending process

Due Diligence

- Must be completed prior to Lender and Borrower entering into credit facility and all ancillary instruments
- Can be performed by:
 - Landman or Landwoman
 - Accountant
 - Any employee or independent contractor

Corporate Records

- Articles of formation and bylaws, operating agreements, and all amendments
- Ownership records
- Current officers or managers
- Verification of foreign qualification

Financial Statements

- Audited financial statements for previous 2 to 5 years
- Income statement
- Balance sheet

Financings

- Documents for all existing financing obligations
- Third party financing agreements
- Customer contracts

Tax Matters

- Copies of all tax returns for the past 3 to 5 years (federal, state, local)
- Audit reports

Governmental Regulations and Filings

- Material reports and documents that have been filed as required by federal and state agencies
- Governmental permits, licenses, inspections, reports

Employee Benefits, Salaries, Labor Disputes

- Compensation or bonus plans
- Pension, retirement, stock option, profit sharing, employee benefit plans
- Material employment agreements (ex. confidentiality agreements, employment and independent contractor agreements, non-compete and non-disclosure agreements)
- Employee suits or grievance records

Litigation

- Pending or threatened litigation claims
- Civil or governmental proceedings or inquiries
- Injunctions in effect
- Settlements and judgements

Proof of Insurance

- Property
- General liability
- Worker's compensation

Material Agreements

- Partnership, limited partnership, joint venture agreements
- Agreements with major customers and suppliers (ex: gas gathering and processing or gas purchase)
- Intellectual property licenses or rights
- Contractor or sub-contractor agreements (MSA's, drilling contracts)
- Shareholder agreements, stock transfer or unit transfer restrictions
- Purchase and sale agreements
- Exploration and production agreements (ex: participation, farmout, joint operating agreements)

Miscellaneous

- Proposed acquisitions or dispositions and all supporting documentation
- List and type of Borrower's ownership and interest in other entities not previously disclosed
- Inventory committed pursuant to a binding purchase, sale or delivery contract
- All other inventory