

WHITE PAPER

**Redetermining Borrowing Bases and Falling Prices:
Where Discretion Meets Good Faith**

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Redetermining Borrowing Bases and Falling Prices: Where Discretion Meets Good Faith



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Executive Summary:

- ▶ Credit facilities tied to borrowing bases are common throughout the oil and gas industry. With the steep decline in energy prices, borrowing bases are likely to decline significantly when they come up for redetermination.
- ▶ In addition, many lenders now feel added pressure to pull in capital and be more conservative with their credit as a result of the current financial crisis.
- ▶ Although borrowing base loans typically give the lender wide discretion in revaluing borrowing bases, this discretion is not unfettered. When borrowing base redeterminations are challenged, the cases will often turn on whether the lender acted in "good faith" while setting the valuation.
- ▶ The meaning of the duty of good faith differs among jurisdictions. For example, the UCC and Texas have a standard that is relatively easy to satisfy so long as the parties abide by the express provisions of their loan agreement. On the other hand, in New York an implied duty of good faith and fair dealing underlies commercial contracts, including loan agreements, and this duty can potentially be violated even where the defendant has not violated any express provision of the agreement.
- ▶ In the context of borrowing base redeterminations, it is possible that a lender may violate the duty of good faith under New York law even though the loan agreement gives it wide discretion to set the valuation. A fact question may exist where the lender is alleged to have acted inconsistently in applying its borrowing base analysis, or to have been motivated to use the redetermination as a reason to pull in credit where it previously would have extended it – a fact question that may ultimately be decided by a jury.
- ▶ Lenders and borrowers would be wise to consult the choice of law provisions governing their borrowing base loans, and take account of their potential impact on redeterminations. Lenders should take care to act in accordance with their duty of good faith when making these revaluations, and borrowers should scrutinize their lenders' actions in light of this duty.

Redetermining Borrowing Bases and Falling Prices: Where Discretion Meets Good Faith

Lines of credit tied to the value of mineral interest-based borrowing bases are common forms of financing in the energy industry. With the steep fall in energy prices, the revaluation of these borrowing bases will cause some borrowers to default on their loans. This situation may be further compounded by the current financial crisis, which is putting pressure on lenders to pull in capital and be more conservative with their lending practices.

While lenders generally have wide discretion in determining the value of borrowing bases, this discretion is bounded by a duty to act in good faith. The extent of this duty varies among jurisdictions, compelling borrowers and lenders to consider exactly how courts may regard the resetting of the borrowing base.

In particular, loan agreements governed by New York law expose lenders to potential liability for acting in "bad faith" - in some instances, even when the terms of the agreement are otherwise followed. Lenders must act cautiously notwithstanding their wide discretion under the loan agreement, while borrowers should be sensitive to redeterminations that run counter to their reasonable expectations.

► **The Cautionary Tale of the Flying J**

On December 22, 2008, Flying J Inc., one of the 20 largest privately held companies in America, with 2007 consolidated sales in excess of \$16.2 billion, filed for Chapter 11 bankruptcy protection. *In re Flying J Inc.*, No. 08-13384 (Bankr. D. Del., Dec. 22, 2008). This came three days after a series of loan defaults by its subsidiaries began, triggered by the precipitous fall in oil prices during the last half of 2008. At the time of the filing, oil prices had fallen over 75% from their high of \$147 per barrel reached in July 2008.

Flying J Inc. presides over a vertically integrated group of companies that includes the exploration, refining and transportation of petroleum products, as well as a large retail distribution system that includes over 200 travel plazas. The credit facilities that went into default were secured by various assets. In particular, Flying J's pipeline group had a \$120 million revolving credit line with Merrill Lynch Capital Corporation and other lenders that was secured in part by the value of the petroleum products in its roughly 700-mile long pipeline between El Paso and the Texas Gulf Coast. When the value of this "linefill" declined with oil prices, the pipeline group was required to make mandatory prepayments of its outstanding indebtedness. These prepayments contributed to a constriction of liquidity that rippled throughout the organization. This triggered a series of defaults that began on Friday, December 19, 2008. Flying J filed Chapter 11 the following Monday.

► **Borrowing Base Credit Facilities**

Unfortunately, variations of Flying J's story will be repeated in the weeks and months to come, as the steep decline in oil and gas prices affects the

collateral securing credit facilities throughout the energy industry. In particular, revolving credit lines in which the availability of credit is tied to the value of the borrower's mineral interests – the "borrowing base" – are coming up for redeterminations, and with the decline in commodity prices, this will result in revaluations of credit limits that, in many cases, will put the borrower "under water" and result in calls to make up the difference which, if not met, will lead to defaults. In many instances, these calls will require immediate repayment.

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Typically, the borrowing base is a function of the value of proved reserves. The base may be limited to proved, developed and producing reserves (PDP), or it may include some portion of proved, developed and non-producing reserves (PDNP) and proved undeveloped reserves (PUD).

While definitions differ from loan to loan, the borrowing base can generally be reduced to some formula equal to the product of the amount of reserves multiplied by their per unit value. The commodity prices that determine unit value are, in particular, outside the control of the borrower and, as the market has made all too obvious, subject to

volatility. An extreme drop in commodity prices can result in a sudden diminution of the value of the borrowing base and corresponding decrease in the amount of available credit. Obviously, if much of the credit line is outstanding, this can quickly turn the loan upside down and require the borrower to rapidly pay shortfalls or risk default.

Borrowing base loans typically require a redetermination of the borrowing base every six months, and they may also include provisions allowing the lender to call for additional redeterminations at will or under certain circumstances, such as a perceived change in the value of the collateral minerals. While the timing, criteria and procedure for the determination of the borrowing base are generally described in the loan agreement with great specificity, these factors often reduce down to the production of reserve reports by an independent engineer, which are evaluated by the lender, who then determines the borrowing base.

An agreement that gives the lender discretion to determine the value of the borrowing base gives the lender wide latitude in actually making the evaluation. Nevertheless, there are limits to the amount of discretion that may be exercised.

Among these loan agreements, perhaps the most important variable is the amount of discretion given to the lender to determine the borrowing base from the reserve report. While the lender always has control over the determination, the agreement may give the lender "sole discretion" to come up with a value, or it may require the lender to apply a more objective analysis, such as one tied to "reasonableness" or (rarely) a pre-determined formula, or it may be some combination, such as the following:

Each redetermination of the Borrowing Base by Lender shall be based on the loan collateral value which Lender in its discretion (using such methodology, assumptions and discount rates as Lender customarily uses in assigning collateral value) assigns to such Oil and Gas Properties of Borrower at the time in question and based upon such other credit factors consistently applied (including, without limitation, the assets,

liabilities, cash flow, business, properties, prospects, management and ownership of Borrower) as Lender customarily considers in evaluating similar credits. It is expressly understood that Lender has no obligation to designate the Borrowing Base at any particular amount, except in the exercise of its discretion.

In this common example, subjective and objective elements are combined – the Lender has discretion to determine the base, but agrees to use an analysis that is internally consistent with the analysis it applies to other borrowers.

The loan agreement, together with the notes, security instruments and other documents that make up the loan transaction, constitutes a contract. As with any other commercial contract, the parties to a borrowing base loan are generally free to agree on its terms, and courts will interpret the contract consistent with those terms. An agreement that gives the lender discretion to determine the value of the borrowing base therefore gives the lender wide latitude in actually making the evaluation. Nevertheless, there are limits to the amount of discretion that may be exercised, not only in the express terms of the agreement, but existing statutorily and at common law as well. As discussed below, the bounds of these limits may be greatly impacted by the choice of law governing the loan.

► ***The Credit Crisis***

Borrowing base credit facilities have been impacted not only by the fall in energy prices, but by the financial crisis that has affected credit markets across all industries. Even in a favorable credit environment, borrowing bases would tend to be downwardly adjusted as a result of the drop in prices. Lenders, however, face significant additional pressures to pull in capital and act more conservatively in their decisions to extend credit. While these pressures may come from outside a lender's relationships with individual borrowers, they are quite real and, in many instances, cannot help but color the lender's view of a given loan.

Although these are legitimate business pressures, the degree to which they influence a lender's

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redetermination of a borrowing base may factor into the scrutiny to which the revaluation is later subject. For instance, in the example provision above, the lender is bound to apply its analysis in a "consistent" and "customary" manner, implying a level of stability and constancy. The current economic environment, however, is anything but stable, and may cause shifts in the application of evaluating factors relevant to both lender and borrower. Such a shift, however, may have implications on the lender's duty to act in good faith.

► **The Duty of Good Faith**

The fall in energy prices will naturally result in borrowing base redeterminations that detrimentally affect borrowers, no matter how conservative lenders may be in exercising their rights and remedies. Challenges to redeterminations will be rare, and findings that they are wrongful even more so. Nevertheless, when litigation does arise, the dispute will often turn on questions regarding not only *how* the redetermination was performed, but may even stretch into questions of *why* – i.e., the lender's motivation. In some cases – and jurisdictions - these questions will be decided on summary judgment or as a matter of law, but in others, the inquiries will be much more fact-intensive and may ultimately rest on jury determinations (a scary thought for many defendants). Where the lender's actions may have been influenced by outside factors such as the credit crisis, these inquiries could take on an added layer of complexity.

In the example above, the lender has control over the determination of the borrowing base, but is contractually bound to follow an internally consistent analysis. The lender of course must abide by its contractual obligation, but even where the lender's discretion is broader, it has an obligation to use good faith in performing its valuation. What "good faith" means, however, differs among jurisdictions. There is relatively little case law specifically addressing the issue of a lender's rights and abilities to determine a borrowing base, whether in energy-related loans or other borrowing base credit facilities outside the industry, such as those tied to

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inventory or accounts receivable. Perhaps this is not surprising - although borrowing base loans are common, they are meticulously drafted to avoid ambiguity and insure the ability of the lender to control its extension of credit. In those instances where borrowers and lenders have fought over the issue of determining the borrowing base, however, the key question often comes down to whether the lender acted in "good faith" in exercising its discretion.

► **The UCC**

Many borrowing base credit facilities are governed in part by the Uniform Commercial Code. The credit facility is made up of a series of agreements, and while the loan agreement itself may fall outside the UCC's scope, other aspects of the credit facility fall within its scope, including the secured transaction establishing the collateral, and the promissory note (if a negotiable instrument) evidencing the borrower's repayment obligation. The UCC also tends to establish commercial standards that are followed beyond its scope.

Under the UCC, the good faith requirement "does not create a separate duty of fairness and reasonableness which can be independently breached."

Section 1.304 of the UCC requires that "[e]very contract or duty within this title imposes an obligation of good faith in its performance and enforcement." "Good faith" is defined in Section 1.201(b)(20) as "honesty in fact and the observance of reasonable commercial standards of fair dealing."

But, the comment to Section 1.304 makes clear that this section "does not support an independent cause of action for failure to perform or enforce in good faith." Instead, the requirement of good faith is tied to *specific* duties and obligations delineated under the contract. That is, the failure to perform or enforce a specific duty or obligation in good faith results in a breach of the contract – but the good faith requirement "does not create a separate duty of fairness and reasonableness which can be independently breached."

The intent of the comment is to direct a court "towards interpreting contracts in the commercial context in which they are created, performed, and enforced" – a context in which sophisticated parties deal with each other fairly but at arm's length. While it is difficult to reconcile the difference

between acting in "good faith" with respect to specific obligations versus a good faith requirement that establishes a more generalized duty, it appears that under the UCC, if the lender acts in accordance with its specific rights under the agreement in determining the borrowing base, it will not breach the duty of good faith so long as it does not act with subjectively "bad" motives. In the commercial context, parties are expected to act in their self-interest, which will sometimes be to the detriment of the other party.

A breach of good faith under the UCC standard would seem to require an intent that goes beyond mere self-interest, perhaps requiring an ill-intended motivation that drove the exercise of a specific duty or obligation. Looking again at the example provided above, if the lender did not follow the internal analysis it consistently applied to other borrowers, or suddenly changed that analysis to apply more restrictive standards to the borrower, that may violate the good faith obligation. But if the lender abides by the letter of the contract, that would almost certainly not violate the good faith standard.

► **Texas**

In part, the comment to UCC Section 1.304 takes pains to emphasize that the duty of good faith does not create a separate, generalized duty that can be breached notwithstanding that the specific duties, obligations, and rights set forth in the agreement have been followed, because the courts of many states have, at one time or another, found such an implied duty of good faith underlying at least some commercial contracts.

Texas jurisprudence has expressly rejected the existence of any implied duty of good faith among parties to a commercial contract, absent some "special relationship" between the parties. See *UMLIC VP LLC v. T & M Sales and Environmental Systems, Inc.*, 176 S.W.3d 595, 612 (Tex. App.—Corpus Christi 2005, pet. denied). While this special relationship has been found where the contractual relationship is based upon a shared trust or suffers from an extreme imbalance of

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bargaining power, it is a rare exception that does not arise between commercial borrowers and lenders, particularly among the sophisticated parties to borrowing base loans. See *Victoria Bank & Trust Co. v. Brady*, 779 S.W.2d 893, 902 (Tex. App.—Corpus Christi 1989), *rev'd on other grounds*, 811 S.W.2d 931 (Tex. 1991) (citing *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962) ("We know of no cases in this state which impose a duty of good faith and fair dealing on lenders in general to their borrowers: a debtor-creditor relationship does not give rise to such a duty . . ."); *Lovell v. Western Nat'l Life Ins.*, 754 S.W.2d 298, 303 (Tex. App.—Amarillo 1988, writ denied) ("[T]here exists no special relationship between the [borrowers and note-holder] and, therefore, no duty of good faith and fair dealing is implied.").

While the Texas Business & Commerce Code includes the UCC's obligation of good faith, Texas courts have also adopted the reasoning of the comment to Section 1.304, requiring "a specific duty or obligation to which the good faith standard could be tied." *Northern Nat. Gas Co. v. Conoco, Inc.*, 986 S.W.2d 603, 606 (Tex. 1998). In Texas, there is no independent duty of good faith that can be breached in the context of UCC-governed transactions, and there is no common law duty of good faith underlying commercial contracts, absent a special relationship between the parties.

Accordingly, a borrowing base redetermination decided under Texas law is unlikely to be found wrongful so long as the lender abides by the express terms of the agreement and otherwise acts without bad faith with respect to its specific duties and obligations.

Under New York common law, an implied duty of good faith and fair dealing underlies commercial contracts.

► **New York**

Many borrowing base loan agreements contain choice of law provisions that require them to be governed by New York law. Although one might think that, as the country's commercial center and the home of so many large lending institutions, New York law was especially favorable to lenders, in fact the opposite is true regarding the duty of good faith. The obligation is much broader than it is under the UCC or in jurisdictions such as Texas.

Under New York common law, an implied duty of good faith and fair dealing underlies commercial contracts. Unlike the UCC, this common law duty stretches beyond an obligation to exercise good faith only with respect to the performance and exercise of specific rights and obligations; and, unlike in Texas, this duty is not limited to those instances where a "special relationship" exists between the parties.

Rather, this duty of good faith is more generalized and informs the entire relationship between the parties. In some instances, it may even be violated where the defendant has abided by the contract to the letter:

[E]ven where one has an apparently unlimited right under a contract, that right may not be exercised solely for personal gain in such a way as to deprive the other party of the fruits of the contract. This limitation on an apparently unfettered contract right may be grounded either on the construction of the parties' fiduciary obligations or *on the purely contractual rule that even an explicitly discretionary contract right may not be exercised in bad faith so as to frustrate the other party's right to benefit under the agreement.*

Richbell Information Services, Inc. v. Jupiter Partners, L.P., 309 A.D.2d 288, 302, 765 N.Y.S.2d 575, 587 (Sup. Ct., App. Div. 2003) (majority shareholder exercised express contractual rights to the detriment of the minority shareholder) (emphasis added).

Although the *Richbell* court found that some fiduciary-like duties were owed by the defendant as a majority shareholder, it also expressly rejected the defendant's argument "that the implied covenant of good faith cannot create new duties that negate explicit rights under a contract" – *i.e.*, a standard akin to the UCC and Texas interpretations. *Id.* The court acknowledged the apparent conflict between exercising express contractual rights and violating a more ephemeral duty, but seemed motivated by the defendant's allegedly malicious intent:

We recognize that there is clearly some tension between, on the one hand, the imposition of a good faith limitation on the exercise of a contract right and, on the other, the avoidance of using the implied covenant of good faith to create new duties that negate explicit rights under a contract. However, the allegations here clearly go beyond claiming that [defendant] should be precluded from exercising a contractual

right; they support a claim that [defendant] exercised a right malevolently, for its own gain as part of a purposeful scheme designed to deprive plaintiffs of the benefits of the joint venture Whether the bad motive imputed to [defendant] was its actual motive is an issue of intent generally left to the trier of fact.

Id. at 302-303, 587.

Cases finding the violation of an implied duty of good faith notwithstanding the defendant's compliance with the express language of the contract generally rest on bad facts – situations in which an intent to injure the plaintiff are plausibly alleged. For example, in *Travelers International, A.G. v. Trans World Airlines, Inc.*, 41 F.3d 1570, 1575-76 (2d Cir. 1994), the defendant and plaintiff had a marketing agreement, which the defendant decided to terminate in an effort to eliminate the plaintiff as a costly middle-man, so that it could market directly. There was no question that the defendant had the right to terminate the agreement, and the defendant argued that cost-cutting was a legitimate business objective. Nevertheless, the court upheld the trial court's finding that this was an improper motive going beyond the desire to maximize profits. *Id.*

The *Travelers* case does not make clear, however, where the line is between bad intent and competitive business decisions. Under New York law (and jurisdictions following similar reasoning), this line is certainly not clear as a matter of law, and when an issue comes down to a determination of fact, it is very hard to know what a jury will do.

Thus, although the lender under a borrowing base loan may well have wide discretion to determine the borrowing base under the terms of the contract, that discretion is far from unfettered. "Even when a contract confers decision-making power on a single party, the resulting discretion is nevertheless subject to an obligation that it be exercised in good faith. . . . [E]ven in a discretionary contract, the obligation of good faith remains, and the particular duties of each party are 'derived both from the common expectations of the parties . . . and from the relationship of those parties as structured by the contract.'" *Id.*

The good faith standard can potentially be very uncertain. At the far end, there are instances where all of the defendant's actions have been unquestionably within its express rights under the agreement, but the motive has been found to be in bad faith – and those very acts themselves have been found to be the evidence of bad faith. In *Carvel Corporation v. Diversified Management*

Corp., 930 F.2d 230-31 (2d Cir. 1991), the appellate court rejected the breach of contract charge to the jury as "misleading" because it asked the jury to determine whether specific acts that were taken by the defendant and allowed under the contract constituted a breach:

This appears to be a mischaracterization of [plaintiff's breach of good faith] claim. More accurately stated, [plaintiff's] essential assertion is that [defendant] breached the agreement by breaching the duty of good faith and fair dealing, not by each of the specific acts enumerated. These acts were offered more particularly as *evidence* of [defendant's] bad faith. Since the contract gave [defendant] considerable discretion with regard to [these acts], the jury, as instructed, could have mistakenly believed that [defendant] was not in breach because it had near absolute control over these matters. However, *even if it acted within the bounds of its discretion, [defendant] would be in breach if it acted unreasonably.*

Id. (emphasis added) (Also stating, "[u]nder New York law, every contract contains an implied covenant of good faith and fair dealing. This covenant includes 'an implied undertaking on the part of each party that he will not intentionally and purposefully do anything to prevent the other party from carrying out the agreement on his part.' *Grad v. Roberts*, 198 N.E.2d 26, 28 (1964)."). *But see UniCredito Italiano SpA v. JPMorgan Chase Bank*, 288 F. Supp.2d 485, 502-03 (S.D.N.Y. 2003) ("Although New York law implies a duty of good faith and fair dealing in every contract, 'no obligation can be implied that would be inconsistent with other terms of the contractual relationship.'").

Although the lender under a borrowing base loan may well have wide discretion to determine the borrowing base under the terms of the contract, that discretion is far from unfettered. Even when a contract confers decision-making power on a single party, the resulting discretion is nevertheless subject to an obligation that it be exercised in good faith.

The possibility exists that a lender may violate the implied duty of good faith even while expressly complying with every provision of the loan agreement.

These cases are somewhat muddled, but it is clear that the possibility exists that a lender may violate the implied duty of good faith even while expressly complying with every provision of the loan agreement. Furthermore, the allegation of a breach of the implied duty of good faith has the potential to convert a case that would otherwise be likely to be dismissed or defeated into one that cannot easily be decided on summary judgment, and instead becomes a deeper exploration of the lender's motivation, which may ultimately be resolved by a jury. This uncertainty requires the lender to tread carefully in making its borrowing base determination – and compels the borrower to scrutinize the lender's exercise of discretion, especially where the lender may be applying more rigorous standards than it has in the past.

► ***Mallon Resources***

An unreported case out of New York federal court briefly examined this very issue in the context of a borrowing base loan. In *Mallon Resources Corp. v. Midland Bank*, 1997 WL 403450 (S.D.N.Y. 1997), Mallon Resources obtained a revolving line of credit from Midland Bank. The maximum loan amount was \$15 million, subject to the bank's semi-annual determination of the borrowing base, and the initial borrowing base was set at \$10 million.

The term sheet for the loan stated that "Midland shall use [an engineer's reserve report] as one factor in determining the Borrowing Base, but will determine the Borrowing Base in its sole discretion based on such other factors as it deems appropriate." The credit agreement provided that:

Lender shall determine the amount of the Borrowing Base based upon the loan collateral value which it in its discretion assigns to the various items of Collateral at the time in question and based upon such other credit factors (including without limitation the assets, liabilities, cash flow, business, properties, prospects,

management and ownership of each Borrower and its Affiliates) as Lender in its discretion deems significant. It is expressly understood that Lender has no obligation to designate the Borrowing Base at any particular amount

Mallon borrowed the entire \$10 million, but following the first redetermination, the borrowing base was reduced to \$9.2 million. Mallon was required to pay the \$800,000 difference or go into default.

Litigation ensued, with Mallon bringing a number of allegations, including that Midland had breached the credit agreement by violating its implied covenant of good faith and fair dealing by its reduction of the borrowing base. Mallon brought various other claims, including a securities claim based on "the false pretense that the Borrowing Base would be determined in good faith."

Midland moved to dismiss the claims, and the court rejected each of Mallon's claims but one – the alleged breach of the duty of good faith and fair dealing.

Applying New York law, which was the choice of law under the loan agreement, the court reviewed Midland's argument for dismissal:

Midland contends that a party cannot violate a duty of good faith and fair dealing by exercising its rights under a contract. As a general matter this contention is accurate. However, although the Credit Agreement explicitly permits Midland to determine the Borrowing Base upon values assigned to Mallon's assets "in its discretion," Mallon's allegations that its business was successful and that its reserves had substantially increased . . . are sufficient allegations, for the purposes of this motion, that Midland may have assigned values to Mallon's assets not in its discretion but in bad faith. Midland's motion to dismiss the [breach of the duty of good faith and fair dealing] cause of action is thus denied.

Id. at *3. Thus, a fact question – potentially for a jury to decide – was created by the mere allegation that the redetermination was performed in bad faith,

In Mallon, a fact question was created by the mere allegation that the redetermination was performed in bad faith.

and the borrower's reserves were otherwise substantial. The record does not state how the case was ultimately resolved, but the survival of dismissal and the looming shadow of a trial certainly impacted the borrower's and lender's respective bargaining positions going forward.

► **Conclusion**

The *Mallon* case was, however, not decided in the midst of a sharp decline in energy prices. As with *Flying J*, in many cases the value of reserves has fallen simply because of the change in the market, and this will result in borrowing base redeterminations that set a much lower credit limit.

Given the current financial environment, a lender may feel justified in applying more conservative or restrictive standards in its determinations of borrowing bases, but it must be careful that its exercise of discretion – no matter how broad under the contract – does not indicate a lack of "good faith."

But, some of these redeterminations will be challenged in court, and in some instances – particularly those in which New York law applies – the lender's motivation will be scrutinized. This may be especially true where the lender's valuation has been impacted by factors that have not previously affected its determinations, such as the pressures created by the credit crisis. Given the current financial environment, a lender may feel justified in applying more conservative or restrictive standards in its determinations of borrowing bases, but it must be careful that its exercise of discretion - no matter how broad under the contract - does not indicate a lack of "good faith". Likewise, a borrower should scrutinize its lender's borrowing base redetermination in light of not only the loan agreement's express provisions, but also the standards to which the lender's actions are held under the law. ■

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