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Asset-Based Lending Credit Facilities: The Borrower's Perspective

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When negotiating a credit agreement, several factors, including the borrower's risk profile or credit ratings, impact the breadth of the affirmative, negative, and financial covenants imposed on the borrower. Some of the most burdensome credit agreements are asset based-lending (ABL) credit agreements. The heart and soul of ABL lending is the collateral; thus, ABL credit agreements often provide for intense lender monitoring and supervision because the borrowing base is tied to "eligible" assets. Under such a strict regime and without good advice from counsel, it is not uncommon for borrowers to trip an unintended default. The purpose of this article is to provide an overview of ABL credit agreements and lay out several best practices when negotiating ABL credit facilities on behalf of borrowers to help avoid unintended "foot fault" defaults.

What Is an ABL Credit Facility?

ABL literally means asset-based loan; thus, it is no surprise that the foundation of any ABL facility is the assets supporting the borrowing base. Unlike a cash-flow facility, where the lenders look to the borrower's future cash flow, availability of the loan in an ABL facility is driven by the quality and value of the "borrowing base assets," typically eligible inventory and eligible receivables (and sometimes eligible equipment). In these type of facilities, lenders tend to be keenly interested in ensuring that the assets against which it is lending are, in the case of inventory, of good quality and easily accessible and, in the case of receivables, likely to be collected. This focus can lead to detailed reporting requirements, both as to scope and frequency. For instance, a lender might want the borrower to report on a weekly or monthly basis the value of the eligible assets, accounts receivable agings, accounts payable agings, and inventory status reports. These requirements are burdensome for borrowers, many of whom have treasury staff stretched too thin. There are certain ways, however, for lawyers to help their clients build a culture of compliance to help avoid defaults. These techniques can be employed at the term sheet phase, during credit agreement negotiations, and throughout the life of the loan.

Term Sheet Considerations

Counsel to borrowers should advise their clients on potential compliance issues from the earliest stages of the financing—ideally when the company is negotiating a term sheet for a proposed credit facility. Term sheets typically list in summary fashion eligibility requirements, representations, notices, financial covenants, negative covenants, and events of default that a borrower can expect to see included in its ABL credit agreement. It is critical, therefore, that counsel focus a client's attention on key operational issues when negotiating a term sheet, especially when those restrictions likely are to be in place for the next four or five years. Counsel should suggest clients clearly define terms to be used in the calculation of availability, eligible receivables, eligible inventory, reserves, and other key provisions. Further, as may be expected, ABL facilities typically provide little flexibility for disposing of assets other than in the ordinary course of business. If the borrower has any asset sales reflected in its business plan, counsel should advise that these dispositions be expressly permitted in the term sheet. By discussing material business issues up front when negotiating the term sheet instead of after lender's counsel has drafted the credit agreement, the lender will have a clearer understanding of the borrower's key business drivers affecting the transaction terms, thereby making the processes of marketing the transaction and agreeing to the definitive documents much smoother. Because participating lenders in multi-lender facilities may not even see the full credit agreement until a few days before closing, it is critical to ensure linchpin business issues are vetted at the initial phase of negotiations to avoid credit approval issues popping up at the eleventh hour.

Avoid Defaults Going Forward

Although we often hear business people try to distinguish between "technical" and "real" defaults, as lawyers we know that any event of default—from a late notice to a breach of a financial covenant—gives rise to a lender's rights and remedies under the contract. Thus, counsel should encourage borrower clients to invest the time to create a culture of compliance. Defaults give lenders leverage, enabling them to renegotiate pricing and terms more favorable to them, and waivers and amendments are distracting, time consuming, and often costly.

Given that ABL facilities often contain detailed reporting requirements, a borrower should tie any notice requirements to a monthly or quarterly financial report. For instance, instead of requiring ten days prior written notice of a new collateral location, counsel could revise the covenant to require that the borrower provide notice of all new collateral locations with the monthly or quarterly financials/compliance certificate. Even better, add a materiality threshold to the notice requirement so that only locations with collateral over a material amount need to be disclosed. That way, the officer responsible for completing the monthly reporting package will be prompted to disclose all new material collateral locations. If counsel structures the ABL credit agreement this way, the borrower is less likely to forget to provide the required notice. This same approach can be used with other notices too (i.e., notices of new bank accounts, commercial tort claims, and intellectual property).

ABL credit agreements also tend to have events of default that a borrower might not see in other types of credit facilities. Keeping with the theme of collateral is key; a lender may include events of default tied to an important customer contract or a material amount of orders cancelled or receivables not collected. As counsel to the borrower, try to remove these provisions because these types of events would inevitably affect the borrowing base. If not, then counsel should try to negotiate the highest thresholds it can to avoid tripping a default. It is one thing for a lost customer to cause a decline in borrowing base availability, but another to have that loss cause an event of default under the ABL credit agreement.

This may seem obvious, but do not overlook the security agreement. Even though business people typically do not focus on the security agreement, there may be a myriad of issues hidden in an ABL security agreement. Oftentimes, lenders bury notice requirements and different, more burdensome covenants in the security agreement, especially related to receivables. For instance, a security agreement may prohibit the borrower from adjusting, forgiving, or amending any receivables. For many borrowers, that standard is too strict to work for their business. To increase compliance success, move all of the reporting requirements to the notice section in the credit agreement and ensure that the documents work together.

After the deal closes, create a compliance checklist for the borrower that summarizes in layman's terms what the borrower can and cannot do to remain in compliance with its ABL credit agreement. Include regular and occurrence-based reporting requirements as well as operating negative covenants. Including these requirements can be a valuable tool for borrowers as they navigate the sometimes overwhelming number of obligations contained in ABL credit documents. Further, counsel should consider maintaining a running list of compliance issues raised by clients. This list would be helpful to have before any amendment or refinancing to address any common or recurring compliance concerns.

On a final note, it can be helpful for counsel to emphasize to clients the value of building and maintaining strong relationships with their lenders. If the borrower forecasts a potential compliance issue under its credit facility, the borrower should consider alerting its primary banking relationship, such as the administrative agent on its facility. Doing so builds trust and, in the face of a default or other adverse developments, lenders are more likely to work with a company if they are not caught off guard.

Other Areas of Focus

Although we have provided an overview of best practices for counsel in negotiating ABL credit facilities, there are several other unique features of ABL credit facilities that merit additional scrutiny by counsel.

- **Reserves.** Lenders can institute reserves against availability to fence credit risk in many situations. For instance, a lender might institute a rent reserve equal to three months' rent if inventory is located at a location where the lender does not have a collateral access agreement with the landlord. In other words, the value of the inventory located at that location is reduced by the amount of the rent reserve, thereby reducing the available borrowing amount. As counsel to the borrower, it is critical to expressly state the amount of, or methodology for calculating, the reserves and the situations in which they can be used.
- **Reasonable Credit Judgment.** This can be a helpful standard to incorporate into a company's ABL credit agreement. As mentioned above, lenders oftentimes include the right to institute reserves on borrowing availability or make other decisions that affect borrowing availability. By holding the lender to an objective, "reasonable credit judgment" standard, you are helping ensure that your client will be treated by the lender in a similar manner as that lender treats other similarly situated borrowers. An example definition might read as follows: "Reasonable Credit Judgment" means, with respect to any Person, a determination or judgment made by such Person in the exercise of reasonable (in the business of secured asset-based lending) credit or business judgment and in good faith.
- **Eligible Inventory and Eligible Receivables.** Many ABL credit agreements define these terms in the negative, list-

ing everything that is not eligible. When dealing with eligible receivables, lenders typically limit the amount of receivables due from one customer (i.e., "concentration" limits) and exclude receivables due from affiliates of the borrower. If the borrower has any international customers, the lender may cap the receivables from those customers unless additional security (for instance, a letter of credit) or steps to perfect in collateral located abroad is provided. Counsel should study these definitions carefully to ensure they do not exclude assets that the borrower does not intend to be excluded. To that end, it can be very helpful for the borrower to submit to the lender a sample borrowing base calculation before closing to ensure that the business teams are using the same calculations in determining eligibility and the borrowing base.

- **Cash Management.** It is typical in an ABL credit facility for the lender to require the borrower to maintain its cash management functions with the lender. Certain institutions further insist on "full dominion and control" over the borrower's bank accounts, giving lenders the ability to sweep the cash in the borrower's operating account on a daily basis to pay down borrowings on the line of credit. The borrower then funds disbursements using proceeds of the revolving loans, and the cycle starts over again. Further, to the extent that the borrower maintains bank accounts with other banks, it will be required to enter into a tri-party deposit account control agreement with the depository bank and the lender. As counsel to the borrower, it is important to understand what types of bank accounts a borrower has, at which institutions those accounts are maintained, over which accounts a lender is seeking liens, and whether the lender's proposed control agreement is a full dominion agreement (i.e., the borrower cannot access the account) or a "springing" agreement (i.e., the lender cannot block access until after an event of default). Note that it is common to exempt from control agreements petty cash, payroll accounts, health care reimbursement, and other employee benefit accounts.

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Key ABL Credit Agreement Compliance Takeaways for Counsel

1. Ensure that the credit agreement and security documents work together.
2. Move all notice obligations to one place in the credit agreement.
3. Tie reporting requirements to monthly/ quarterly financial reporting.
4. Create a checklist of key compliance terms.
5. Encourage clients to maintain an open dialogue with their relationship bankers—it builds trust.