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Where Past is Prologue

Applying Lessons from the Past to Protect ABL Lenders in a World of Future Distress

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In this ever-changing lending landscape, attorneys from Skadden, Arps, Slate, Meagher & Flom LLP offer ideas on minimizing risks for lenders.

The financial world is actively monitoring the U.S. domestic and global economies, including lending markets, for indicators of potential distress. Many financial participants believe a downturn in the economy is forthcoming.

Today, U.S. borrowers are more indebted than ever before – U.S. non-financial corporate debt of large companies now stands at $10 trillion, or 48% of U.S. GDP, a 52% increase from its last peak in the third quarter of 2008.[1] Moreover, borrowers have become increasingly aggressive in using secured leverage, and in taking advantage of “cov-lite” loan documents to engage in creative (and sometimes controversial) transactions to transfer assets beyond the reach of existing secured lenders by way of distributions to shareholders or contributions to unrestricted subsidiaries and then utilize those assets to raise additional secured financing (i.e., J. Crew and Neiman Marcus). While the debt levels and cov-lite structures of leveraged loans may create risks for many stakeholders, lenders under asset-based loan facilities (“ABL facilities”) should be well-positioned to weather any storm.

ABL facilities typically offer lenders greater protections in a liquidation scenario. In addition, ABL facilities often are a critical lynchpin of debtor-in-possession financing facilities (“DIP facilities”) when borrowers are looking to effectuate comprehensive restructurings through chapter 11. As a result, lenders should position themselves to understand and use the chapter 11 process to ensure their debt claims retain, and even gain, protections in bankruptcy.

As a starting point, existing ABL lenders should regularly be (i) examining their current debt holdings (including analyzing their borrowers and the industries in which they operate) for signs of potential distress, (ii) proactively reviewing credit agreements for potential weaknesses, and (iii) engaging with their borrowers to identify and problem solve for issues while ensuring that their secured lending position is protected under all scenarios. This article briefly describes (1) important features of ABL facilities that protect lenders from loss, and (2) key tools ABL lenders use in order to safeguard their interests in distressed situations.

Key Protective Features of ABL Facilities

In the first instance, ABL facilities are structured to have an extremely low rate of loss given default (“LGD”). The low LGD produces favorable pricing, making ABL facilities extremely attractive to borrowers – especially those without a steady stream of EBITDA necessary to meet quarterly leverage covenants in cash flow revolvers.

ABL facilities typically are secured on a first-priority basis at a minimum by the borrower’s most liquid assets – inventory and receivables and the cash proceeds thereof – and the exposure under ABL facilities is typically capped by a monthly borrowing base consisting of an advance rate applied to a subset of the collateral defined as “eligible inventory” and “eligible receivables.” Moreover, the ABL facility typically allows the administrative agent to establish reserves to reflect any deterioration of the collateral. The cushion in collateral value provided by the combination of advance

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[1] *See Valladares, Mayra Rodriguez. “U.S. Corporate Debt Continues To Rise As Do Problem Leveraged Loans” Forbes July 25, 2019.*

Takeaways

1 There are several tools available to ABL lenders to protect their credit position in the event that a borrower finds itself in a distressed situation – these include reserves, imposing cash dominion and requiring more frequent collateral reporting and monitoring and eliminating certain baskets for investments, restricted payments and payments of other debt when certain minimum excess availability requirements are not satisfied.

2 In a chapter 11 case, secured lenders have a number of options to gain additional protection.

3 In bankruptcy, a secured lender may be able to "roll up" their prepetition debt and turn it into post-petition debt on a partial or full basis. ABL lenders have recently been successful in obtaining a full roll-up of their prepetition ABL facility at the first-day hearing in a bankruptcy case.

4 The creative secured lender may look for additional types of adequate protection payments including mandatory paydowns of the borrowing facility to remain within formula, required lump sum payments on specific dates, consent fees, and payments into an indemnification reserve account.

5 Requiring specific actions to be completed by specific dates (i.e., milestones), is another way for lenders consenting to the use of their cash collateral or providing a DIP facility to have some control over a chapter 11 case. Savvy lenders may use milestones and case controls to create a bespoke set of protections tailored to the unique facts and circumstances of a case.

rates, eligibility standards, reserves and limits on line usage to avoid springing a financial covenant should sufficiently protect lenders under an ABL facility in a liquidation.

In addition to this inherently safe structure from a credit standpoint, there are other structuring techniques that protect ABL lenders in distressed situations. First, notwithstanding the fact that many assets (i.e., general intangibles, intellectual property, equity interests in the borrower and subsidiaries, equipment and real estate) are not in the borrowing base for an ABL facility, ABL lenders often require "all asset" grants of collateral. This is beneficial even if only a second lien as the value of this additional collateral may help prove the ABL facility is over-secured. Second, ABL facilities typically contain tools to monitor the collateral as liquidity tightens, including: (i) "springing cash dominion;" (ii) a "springing financial covenant" or an availability block at 10% of the lesser of the commitments and the borrowing base; (iii) a trigger to weekly borrowing base reports; and (iv) a trigger to more frequent field exams and appraisals.

Finally, many ABL facilities have features that limit value leakage and protect lenders when the borrower's liquidity is challenged. For example, restricted payments, permitted investments and the ability to designate unrestricted subsidiaries are extremely limited unless minimum availability conditions are satisfied. Likewise, most ABL facilities limit the voluntary prepayment of other senior debt – a valuable feature that ensures the ABL facility is not used to prepay other debt (including pari passu senior debt) at a time when liquidity is tight. Finally, some (but not all) transactions require the borrower to reimburse the administrative agent for the cost of a financial advisor as well – another good protection for lenders in a distressed situation.

This combination of features should continue to make ABL facilities a valuable tool in the next economic downturn, without exposing lenders to significantly higher rates of LGD.

Protective Tools for Lenders in Chapter 11

If an ABL borrower does become a debtor in a chapter 11 case, lenders have a number of options to gain additional protection during the pendency of the bankruptcy case.

In the first instance, the needs of the ABL lenders often are addressed very early in a chapter 11 case. The borrower's need to use existing cash collateral and obtain working capital to finance, at least in part, the chapter 11 case with post-petition inventory and receivables often results in an ABL facility being refinanced or protected and continued. The following is a discussion of a variety of protections ABL lenders might seek when a borrower wishes to continue an ABL facility during a chapter 11 case.

Additional Collateral

An ABL lender without an "all assets" grant might try to expand its security package. While lenders often are advised to take additional collateral before a bankruptcy filing (if available), there may be a risk of potential claw-back actions. Such risks may be mitigated, particularly where the additional collateral is provided in exchange for lenders agreeing to an amendment or forbearance, but might not be completely eliminated.

Where sufficient risk exists, lenders may insist that the provision of additional collateral be approved as part of the DIP facility to eliminate claw-back risks. Approval as part of a DIP facility also has another benefit – automatic perfection of the lenders' liens and security interests by order of the bankruptcy court. Where the additional collateral spans multiple jurisdictions or is, by its nature, harder to perfect upon, the automatic perfection by order of the bankruptcy court can be a significant benefit.

There are many categories of collateral that may become available or more attractive to ABL lenders when a borrower becomes distressed, including intellectual property, real property, the proceeds of real property leases and the proceeds of avoidance actions. A borrower, however, may be reluctant to give up valuable assets that might be used to secure additional debt financing, or that might put management and the board in the crosshairs of actions brought by unsecured creditors.

There are creative solutions and structures that lenders might consider to provide a borrower with the flexibility they need, while at the same time giving the lenders greater security. Junior liens, marshalling rights, reverse marshalling structures and priority of payment concepts are just some things that ABL lenders can consider to strike the right balance between protecting their claims and allowing a debtor sufficient flexibility in its restructuring efforts.

Roll-Up of Prepetition Debt

In bankruptcy, a secured lender may be able to "roll up" their prepetition debt and turn it into post-petition debt on a partial or full basis, whether all at once or as a "creeping" roll-up over time. Roll-ups have become a common ask by ABL lenders, and some ABL lenders have recently been successful in obtaining a full roll-up of their prepetition ABL facility at the first-day hearing in a bankruptcy case (e.g., VER Technologies and Remington Outdoor). Although not as immediate, a creeping roll-up that converts prepetition debt into post-petition debt as it is borrowed and repaid on a revolving basis over time is often a strong fall-back option.

Post-petition debt status can provide significant advantages to ABL lenders, including: (i) eliminating cramdown risk (i.e., unless a lender agrees otherwise, the debt must be paid in full, in cash in order for the company to emerge from bankruptcy through a chapter 11 plan); and (ii) ensuring the validity and enforceability of all liens and claims. Moreover, as a post-petition lender, lenders almost always obtain various case controls and milestones for their benefit (as discussed below).

Protection of Bank Products and Cash Management Services

Care also should be taken to protect bank products and cash-management services – two catchall terms that can cover everything from letter of credit facilities to hedging to corporate credit card programs provided by lenders or their affiliates under an ABL facility.

A number of simple steps can be taken to ensure their protection, starting with careful monitoring. Understanding the size and scope of such programs allows lenders to determine how much may be at risk and how aggressively to pursue further protection, such as reserves against the borrowing base. Likewise, ensuring all such programs are properly documented and paid in the ordinary course can help mitigate risk.

In addition to making sure bank products and cash management services are continued as part of a DIP facility, such programs and services should be addressed (and authorized to continue) in the bankruptcy court order approving the borrower's cash management system. While such orders typically contain broad and general language to authorize all bank products and cash management services, important products and services should be called out specifically, and the language should be sure to cover all important categories of products or services. It is powerful to be able to point to specific language in a bankruptcy court order that clearly authorizes a product or service if it is challenged later in the case.

Thinking Beyond Traditional Adequate Protection Payments

While adequate protection for prepetition secured lenders almost always includes the payment of current interest as well as fees and expenses, the creative secured lender may look for additional types of adequate protection payments. For example, lenders have successfully negotiated for, among other things: (i) mandatory paydowns of the borrowing facility to remain within formula; (ii) required lump sum payments on specific dates; (iii) consent fees; and (iv) payments into an indemnification reserve account. While the ability to obtain such payments is often highly fact specific, lenders should not be skittish about seeking additional payments where necessary and appropriate.

Milestones and Other Case Controls

Requiring specific actions to be completed by specific dates (i.e., milestones), is another way for lenders consenting to the use of their cash collateral or providing a DIP facility to have some control over a chapter 11 case.

However, enforcement of milestones requires lenders to call an event of default and force a company into complete liquidation if a milestone is missed. Aggressive borrowers and their counsel may dare lenders to take such a drastic step in large and high-profile chapter 11 cases where thousands of jobs are at stake. On the other hand, milestones provide a clear timeline for all stakeholders to work towards completing important tasks, and also provide the bankruptcy court with a clear sense of the anticipated progress and timeline of a case. In other words, milestones can serve a valuable purpose even if they ultimately are adjusted outwards.

There also are other types of case controls that secured lenders may seek as a condition to allowing the use of cash collateral and/or for a new money DIP facility. Examples include: (i) consent rights over material asset sales; (ii) consent and/or consultation rights with respect to material business decisions and important court orders, including the approval of management incentive plans; and (iii) the right to select a liquidator in the event the borrower ceases operating.

In sum, savvy lenders may use milestones and case controls to create a bespoke set of protections tailored to the unique facts and circumstances of a case.

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