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The rise and fall of an asset-based loan – from documentation and inception to work-out

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BY GARY W. MILLER AND TRENT L. ROSENTHAL

One might wonder which lender sleeps better at night. Would it be the cash flow lender that depends in significant part upon the quality and character of its borrower for repayment of the loan, or the asset-based lender that approaches each loan with a confident swagger, thinking that even if the debtor were to shut its doors tomorrow, the loan could be collected through liquidation of the collateral?

The answer might be that neither sleeps well when a good credit goes bad, but a disciplined approach to an asset-based loan can improve the odds for the lender. Documents that focus upon the collateral, as well as the availability of timely and accurate information with respect to the business of the borrower, will increase the likelihood that the lender will emerge with its shirt intact once the dust settles on an asset-based loan in a work-out or liquidation.

Focus on the collateral

While focusing on the collateral is critical in the documentation of all loans, it is front and centre in importance for asset-based loans. Often, the most important component of collateral is the accounts receivable. While a cash flow lender will typically allow its borrower to collect its own receivables, the asset-based lender should directly or indirectly take control of collections from the beginning. Under Section 9.406 of the Uniform Commercial Code (which, with certain "non-uniform" exceptions, is in effect throughout the United States), an account debtor may discharge its obligations by paying the borrower until the account debtor receives a notification that the amount due or to become due has been assigned and that payment is to be made to the lender. Once the account debtor receives that notice, the account debtor may only discharge its obligation by paying the lender. While this protection might not greatly benefit the lender where there are a large number of relatively small accounts outstanding, it can be of significant benefit where the account numbers are manageable and the amount of each account is meaningful. Even with smaller accounts (where it might not be efficient to seek recourse against an account debtor who disregards the notice), the receipt of notice from the lender is usually enough to convince the account debtor to send payments only to the lender.

Oftentimes, the business deal between the lender and its borrower will not tolerate a notice, prior to default, that accounts must be paid directly to the lender. In these situations, non-bank lenders can employ a "blocked account agreement" among the lender, the borrower and the borrower's bank. Under the blocked account agreement, the borrower is required to deposit all funds received from its account debtors into the blocked account. The agreement provides the lender with a security interest in the blocked account, prohibits the borrower from withdrawing money from the blocked account, and requires that all amounts in the blocked account be swept daily to the lender's account. Funds in the lender's account are then re-loaned to the borrower as appropriate. The blocked account might not protect the lender with respect to proceeds of accounts receivable that fail to make it into the account, but daily monitoring of the account by the lender can provide an early warning that either collections have taken a turn for the worse or the borrower is intercepting funds intended for the blocked account.

Tying up the collateral as tightly as possible is a hallmark of asset-based loans. In addition to landlord's waivers where required by law to maintain the lender's first lien ahead of any statutory landlord's lien, the asset-based lender often attempts to obtain a lien on every possible piece of collateral. It might start as a second lien on real estate or specific equipment that has been financed by another lender, but liens on types of collateral that are initially of secondary importance can be critical to giving the asset-based lender greater control in a work-out or liquidation scenario. In addition, intercreditor agreements between the asset-based lender and other existing lenders appreciative of the influx of new money can provide the asset-based lender with the opportunity to keep those other lenders from taking action against the borrower even in a default situation and allow the asset-based lender to maintain the status quo when in its best interest.

Flexibility and information for the lender

As compared to other types of loan agreements, asset-based loan agreements often provide greater flexibility to the lender and greater reporting requirements. For instance,

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the agreement may provide for a detailed description of what types of accounts receivable are eligible for inclusion in the borrowing base; however, it is helpful in an asset-based loan if this menu of acceptable accounts is just a guide, with the lender reserving the right to revise the standards of eligibility for accounts in its discretion. Another item of flexibility is the lender's right contained in the loan agreement to elect, at its discretion, not to make an advance.

While flexibility in the loan agreement keeps a lender's options open, it is the availability of information with respect to the business of the borrower that allows the asset-based lender to closely monitor its credit. The obligation of the lender to provide daily borrowing base reports in an asset-based loan, though labour intensive for both parties, may be critical to ensuring the lender's receipt of the most up-to-date information. Agreed direct access via the internet to all of the borrower's computerised sales and collections accounting systems also helps the lender keep abreast of the borrower's financial condition.

A good loan goes bad

Good documentation of an asset-based loan transaction does not guarantee recovery if the loan encounters problems. Asset-based lenders should monitor their loans daily for signs of trouble, including the borrower's violation of loan covenants or the borrower's defaults on other debts. While a borrower may have entered into the asset-based loan to restructure its business and return a previously unprofitable operation to profitability, the borrower's expectations are not always met, and the borrower may continue to experience significant losses from operations. Asset-based lenders should recognise the signs of early financial distress and should be prepared to aggressively pursue collection when necessary.

When encountering an asset-based loan in trouble, the lender should promptly engage counsel familiar with out-of-court work-outs, restructurings and bankruptcy. While the attorney who originally documented the loan can be helpful, the best legal team will include the transactional attorney who is familiar with the borrower and the work-out/bankruptcy attorney who can foresee what steps the borrower might take and can suggest appropriate action to protect the lender's interests.

Once it appears clear that a loan is in jeopardy, the asset-based lender should designate a team at its office to take primary responsibility for the work-out. The team should include a loan officer familiar with work-outs and bankruptcy, and other representatives familiar with experience in audit and collateral monitoring issues.

The work-out attorney should become the law firm's primary contact for the problem loan and should coordinate the efforts of other lawyers at the firm, including any litigation attorneys. Most complex work-outs today involve a number of specialised areas of the law, and the resources of attorneys familiar with these laws is helpful. An asset-based lender should be prepared to pursue a litigation strategy if an agreed resolution cannot be achieved or if the value of the collateral cannot be realised through non-judicial means in a work-out setting.

Develop a work-out strategy

While the work-out strategy can be adjusted as the facts and circumstances so warrant, the primary strategy of establishing control of the collateral should always remain in focus. A normal goal is to control the assets pledged to secure the loan so that the assets can be disposed of (liquidated or sold as a going concern) to pay the debt. The approach to collecting an asset-based loan is different from the collection approach for a cash flow loan. In an asset-based loan, the lender has already made the assessment that its primary source of repayment is the collateral securing the loan. The focus of the strategy should therefore be on obtaining possession and control of the collateral and the proceeds thereof. The following questions should be addressed in designing the strategy for a work-out:

1. What are the goals to be achieved? The obvious goal is repayment of the debt. The less obvious goals are the time frame for repayment and controlling risks associated with the collection effort. The lender should establish realistic goals.
2. What strategy can be used to achieve the goals? This would encompass an evaluation of whether the repayment can be achieved through an out-of-court or agreed work-out, or whether court intervention will be needed. A work-out may include a controlled liquidation and/or reorganisation. The borrower may be urged to find alternative funding sources or to sell the business and its assets as a going concern to raise money to satisfy the loan. By exercising various rights available to it under the loan documents, such as direct notification to account debtors and/or the posting of the collateral for foreclosure, a lender can effectively influence the borrower's actions by leaving the borrower with few options.
3. What collateral for the loans is the most easily accessible, and how does the lender obtain access to the collateral? For example, sending a notice of sale or other disposition of the collateral (i.e., foreclosure sale notice) will give the lender significant leverage over the process. The borrower will have to come to the table and deal with the lender to avoid the loss of its assets, or will have to take some legal action, such as filing bankruptcy, to delay the foreclosure sale. Additionally, if the lender has a security interest in accounts receivable and the right to notify account debtors to pay direct to the lender, this can be very effective and will force a pay-down of the debt. Since direct notification will also cut-off the borrower's source of funds, it may also force an involuntary liquidation (which may be in the lenders' best interest), or force the borrower to file bankruptcy to stop or delay the liquidation. If the asset-based lender has properly protected its position, a forced liquidation or bankruptcy may not be a bad option. If the liquidation is forced, the lender may be in the driver's seat, and the borrower will have to accede to the lender's demands if it wants access to any funding. Better yet, the borrower will have to pay off the lender to obtain control of its assets.
4. What risks are associated with each category of collateral, and which collateral is most easily liquidated for the highest values? What is the best method to liquidate the collateral to achieve the best value? Certain types of collateral deteriorate rapidly in value, such as perishable inventory. A well-advised asset-based lender will monitor collateral values daily and will react quickly. A lender hoping to obtain going concern value for the collateral may prefer that the borrower file bankruptcy and sell the collateral through the bankruptcy process. If the borrower files bankruptcy, there is substantial control over the borrower and its assets, and the court will be involved in the liquidation or reorganization process. In some situations, asset values can be maximised using the bankruptcy process to generate competitive bidding for the business. Maximising the value of the collateral is obviously in everyone's best interests.

By acting quickly and decisively, the asset-based lender can mitigate its losses and maximise its recovery. The focus of the process should be on the collateral. The lender should not delay in implementing the strategy. If it does, the value of the collateral might decline, transforming a loan that once was secured by adequate collateral into an under-secured loan. By taking a proactive approach from the inception of the loan and throughout any work-out, the asset-based lender that heeds these warnings will be best able to maximise its recovery. ■

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