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LEGAL lines

Pitfalls and Benefits of Offering ABL Loans to Large Public Companies

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Lending to large, public companies can burnish an ABL lender's reputation and offer a unique opportunity to expand its business model. Lon M. Singer explains how to navigate through these complex and ultimately rewarding deals.

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The monumental changes in asset-based lending are beyond dispute. Asset-based lending, once the structure of last resort, historically limited to specific industries such as retail and manufacturing, has become a formidable tool used by a range of institutions, including the major banks and large regional banks that often dominate the market. This is most evident in ABL credit facilities favoring large, publicly-traded companies. These facilities represent opportunities and present novel issues that demand special consideration.

Due Diligence/Information Strategy

Information gathering and sharing are underwriting touchstones for structuring a proposed credit facility in favor of a large, publicly-traded company. The status of a publicly-traded company as a reporting company under U.S. securities law both simplifies and complicates the process from the standpoint of the lender and its counsel. On one hand, anything "material" from the perspective of a prudent investor, is, in theory, already publicly disclosed and available. However, the unique concerns of the ABL lenders' agent may be ignored by such reporting and prove to be an obstacle when the agent's counsel makes supplemental information requests.

The reality is, even when dealing with a large, reporting company, a non-disclosure agreement (NDA) will be required and should be negotiated and agreed upon upfront. The NDA will facilitate access to truly confidential materials and, from a legal standpoint, bridge the gap between only receiving the contracts material to investors and the additional contractual arrangements (such as web hosting, third-party picking, packing and sorting) fundamental to thoroughly assess potential exit strategies and approaches to the potential exercise of secured party rights and remedies.

Virtually every large credit facility includes a document precedent battle in the term sheet stage. The parties routinely quibble over which existing credit agreement should serve as the basis for documentation of their facility.

Corporate Organization & Ownership

One underwriting criterion is "who owns my borrower?" When the answer is a sponsor, continuity of ownership and/or control is a concern and may include preservation of specific material personnel (or approved successors) in particular roles. In the case of large, publicly-traded companies, it is customary to focus on an operating company subset of the borrower group. Since the ultimate parent is widely-held, and equity interests are freely traded, the agent tends to limit the change-of-control covenant and corresponding default provisions to the continued ownership of all of the other borrowers and guarantors by the top-level holding company in the obligor group. Given the complex corporate structure of many publicly-traded companies, it is imperative to obtain the identities of borrowers, guarantors and excluded entities at the onset. In some cases, it may also be possible to prohibit any one shareholder from acquiring a controlling interest in the lead borrower or obligor group parent entity (or an interest in excess of an agreed percentage of equity) without the prior consent of the agent and required lenders.

Financial Covenants

Even in the current "covenant lite" and single financial covenant environment, transactions in the large middle-market generally include one financial covenant. This remains true in the case of large, publicly-traded company borrowers. One of the threshold considerations in structuring the financial covenant(s), especially in the case of international conglomerates, is identifying the operative set of affiliates to consolidate and measure these covenants.

Companies of this type and size generally report their financial information on a top-down consolidated business for all affiliates — and may well do so under IFRS (International Financial Reporting Standards) as opposed to GAAP (Generally Accepted Accounting

Principles). An ABL lending group is often focused, however, on the entities with eligible assets against which funds will be advanced, and perhaps the immediate parent and its direct and indirect subsidiaries, both for purposes of crafting a borrowing base and for reporting purposes related to collateral and financial matters. Therefore, it is often necessary to assess the ability and willingness of the company to "back-out" of its consolidated financial reporting, a specified subset of its affiliated companies — again, this is a gating item to be explored and addressed in the term sheet stage of negotiations.

Affiliates and Affiliate Transactions

ABL lenders are generally wary of transactions between and among affiliates, particularly when evaluating eligible assets for borrowing base purposes. But even when affiliate receivables, for example, are excluded from eligibility, the extensive network of affiliated entities common among large, publicly-traded companies presents its own considerations.

Transactions conducted on an arm's-length basis are generally permitted without limitation; almost inevitably there will be "favorable" transactions within the group that do not meet this standard. It remains important to consider which entities benefit from the transactions not conducted on an arm's-length basis; specifically, if these transactions are accretive to the obligor group or if they constitute a leakage of value, liquidity or both. Inevitably, a borrower and its counsel will request the flexibility to continue transactions with affiliates consistent with past practice, whether or not on an arm's-length basis. This issue will require financial and legal due diligence to evaluate and navigate the attendant risks.

When the affiliates in question are foreign entities, lenders throughout the syndicate will need to comply with all know-your-customer, beneficial ownership and sanctioned entity issues and inquiries, as demanded by applicable laws and regulation and administered by each of their respective law departments.

Compliance and related formalities are generally non-negotiable and involve lead time that may vary significantly from institution to institution. These "top of the list" gating items should be addressed as early as possible in the documentation and negotiation process.

Foreign affiliates necessitate consideration of §956 of the Internal Revenue Code. The issue concerns availability of credit support in the form of guarantees, secured or otherwise, from controlled foreign corporations without incurring a taxable deemed dividend that might be materially detrimental to the consolidated group. The 2017 Tax Act, which was anticipated to potentially eliminate the deemed dividend problem, not only retained §956, but complicated the analysis of the deemed dividend issue — a matter beyond the scope of this article.

Documentation Precedent

Virtually every large credit facility includes a document precedent battle in the term sheet stage. The parties routinely quibble over which existing credit agreement should serve as the basis for documentation of their facility. Where large publicly-traded borrowers are involved, virtually every credit facility with a similar borrower and/or a borrower in the same industry ever filed with the SEC will be available to the public for review and comparison.

Despite the theoretical ability to redact provisions of the key documents, the broad syndication and dissemination of details surrounding these facilities means they are rarely redacted in any respect. Some borrowers' counsel will shop extensively for the most aggressive forms of agreement, often cherry picking among provisions in several distinct agreements in an effort to achieve virtual MFN (most favored nation) treatment on a point by point basis. Despite market pressures, experienced lender counsel will not lose sight of the fact that each borrower is unique — in terms of its size, market share, financial condition, assets, contractual relationships, prospects, risks and the relationship it represents for the agent and the other institutions.

Collapsed Borrowing Base; Bankruptcy Concerns

Even those in the ABL industry who were educated with the "lend to the assets" principle have learned to live with an environment where it is rare to see each borrower closing a multi-borrower credit facility based only on its own eligible assets. More routinely, co-borrowers are free to draw on the basis of the aggregate availability of all of borrowers. The concern remains that certain borrowers (and their assets) may be supporting other borrowers — to the detriment of the creditors of other members of the borrower group. Aggrieved creditors in a bankruptcy proceeding could theoretically void or re-characterize certain guaranty and related secured arrangements relating to a collapsed borrowing base.

One of the most heavily negotiated areas of credit agreements with large public borrowers involves the laundry list of exceptions to the negative covenants.

Draftsmen and underwriters try to mitigate this risk by conducting due diligence to determine the extent members of a consolidated group benefit from the obligations of one another, have common creditors, centralized legal and accounting services and infrastructure and are perceived by their customers, vendors and other creditors as a single enterprise. In the case of large, publicly-traded companies, these factual mitigants, and the corresponding representations, are more likely to be available for the benefit of the agent and the lender group — particularly where the relevant obligor group has been carefully isolated and identified.

Leakage

One of the most heavily negotiated areas of credit agreements with large public borrowers involves the laundry list of exceptions to the negative covenants. Increasingly, compliance with a particular financial or availability metric will afford these largest borrowers virtual *carte blanche* exception to the constraints of the negative covenants. When these metrics are not or cannot be satisfied, and the borrowers still wish to proceed down a particular path, they may need to rely upon an enumerated negative covenants exception — which may relate to one or more categories of activity and include constraints in terms of dollar amount, frequency, etc. The proliferation of agreements that afford the borrowers inordinate flexibility to aggregate covenant level baskets, while at the same time providing the borrowers with the power to designate and re-designate certain entities as residing within or without the obligor group. The resulting risk to the agent and lenders of leakage (the diversion of advances to unintended parties or purposes outside the obligor group) is substantial, and careful scrutiny is absolutely imperative to avoid unforeseen consequences. This area is so rife with traps and pitfalls that the adoption and implementation of alternative approaches, such as expanded baskets or more relaxed metrics, is often preferable.

Loans to large, publicly-traded borrowers can be the most precious jewels in a lender's loan portfolio and a source of high-profile branding that brings intangible value for institutions. Lenders can leverage these beneficially throughout the capital markets and into associated relationships. While the underwriting and legal issues involved in these transactions often will include matters common to large, syndicated credit facilities generally, there are also unique elements which necessitate an appreciation of distinct loan markets, industries and the related market approaches to special issues and documentation. anfj

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