KEY POINTS

- What security do asset-based lenders need?
- What transaction structures are available where there is an asset-based lending facility and a term loan in the debt stack?
- What are the key differences between receivables carve-out structures, bifurcated structures, first out structures and a unitranche from the lenders' perspective?
- How is enforcement likely to play out in the different alternative structures?

Feature

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Developments in intercreditor agreements with asset-based lenders

This article describes some recent developments in the approach to intercreditor agreements in transactions where there is an asset-based debt tranche in the debt stack. The article is based on the authors' observations of the UK market and is not intended to be prescriptive.

WHAT IS ASSET-BASED LENDING?

Asset-based lending (ABL) is senior secured lending to finance the working capital lifecycle of a business. It differs from single-asset financing because the lenders are able to advance loans against the realisable value inherent in all asset classes. ABL can be a particularly supportive and flexible form of financing for companies undergoing periods of change, including acquisitions, turnarounds and re-financings. Although enforcement is rare, it does happen, and most asset-based lenders include a preliminary assessment of the likely enforcement route and outcome in their original credit decision.

Until about 2010, ABL transactions in the UK were usually relatively small (typically £10,000,000–£50,000,000) and rarely used to finance acquisitions. If there was any other debt in the company's capital structure it would typically be deeply subordinated shareholder loans or, occasionally, equipment finance or finance leases for non-business critical mobile equipment.

> Key intercreditor drivers: First, more than one creditor. Second, the existence of various security interests either competing for priority over the same assets or competing for enforcement rights over different but equally essential business assets. Third, a borrower or sponsor who is seeking to maximise the financing efficiency from its assets and so has appetite to facilitate intercreditor agreement negotiations.

The first large syndicated ABL transactions in the UK (over £100,000,000) started to occur from about 2006. Around the same time the US lenders who were experienced in ABL planted operations this side of the pond. In the US, ABL is a substantial market and large syndicated transactions have been the norm for 20 years. As the US leveraged finance market and private equity firms realised that ABL could be a great way to get extra cheap debt into a target's capital structure (sitting alongside the traditional term debt) the unitranche market was born. Super-senior revolving credit facilities, which were traditionally provided by banks, became a tempting market for asset-based lenders who were geared up to provide daily liquidity to borrowers.

However, the US market operates against the backdrop of a tried and tested Chapter 11 procedure, whereas in the UK and Europe we have insolvency regimes which differ by jurisdiction and far fewer test cases of large corporates with a mix of debt (other than the straightforward deeply subordinated shareholder debt described above) going through an enforcement process.

WHAT SECURITY DOES AN ASSET-BASED LENDER REQUIRE AND WHY?

Asset-based lenders view collateral in two key categories. First: assets against which specific value can be attributed by valuers, appraisers or their own internal audit team and which comprise the borrowing base. It can be useful to think of this collateral as "active security" for the ABL loans and once the importance of the active security to the asset-based lender is understood you can see why the asset-based lender places primacy on the security interests over those assets, why the asset-based lender requires frequent and accurate information to enable it to monitor and control those assets and why the asset-based lender places such importance on being able to enforce its security over those assets without hindrance from other known creditors or priming by unsecured creditors who might otherwise have a priority position by operation of law.

Second: "boot collateral" ie assets which do not form an identifiable part of the borrowing base but which may have some value on enforcement. Non asset-based lenders or their lawyers often challenge the rationale for ABL lenders taking security over boot collateral, but it can be helpful to understand the lenders' perspective by considering this security as defensive security taken to prevent third parties from intervening in an enforcement process.

It is too simplistic to say that this "boot collateral" is what is therefore available to a term lender who agrees to sit alongside an ABL in the debt structure. The term lender has probably sized its debt on an EBIDTA (earnings before interest, tax, depreciation and amortisation multiple) and is looking at the enterprise value of the company, whereas the ABL has sized its debt based on the realisable value of the active security assets.

> Transaction structures: Receivables carve-out; Bifurcated structure; First out/Last out; Unitranche.

TRANSACTION STRUCTURES

Receivables carve-out

In this structure the company has a leveraged facility which provides that receivables can be assigned to an ABL or can be charged to the ABL to support an ABL facility against those receivables. The ABL debt size will be capped and often the capped amount is small relative to the overall debt amount – say 10%. The purpose of the carve-out structure is to avoid the need to have an intercreditor agreement between the leveraged lenders and the ABL.

What is the security position?

The leveraged lender will have an all-asset debenture and the ABL will have fixed security over the receivables. This fixed security requires the ABL to control the bank accounts into which the receivables are paid (generally known as the "collection accounts" or "blocked accounts"). Even if the ABL takes an assignment of the receivables instead of lending against a fixed charge the ABL will still need the fixed charge and control to cover "non-vesting debts" – ie receivables which, for one reason or another, are not effectively assigned to the ABL. The leveraged lenders' security will need to carve out the receivables and the collection accounts.

The ABL may have a second ranking floating charge over other assets so that it is a qualifying floating charge holder (QFCH). If so, the ABL may also be asked to agree to give consent to the appointment of an administrator by the leveraged lenders. For the leveraged lenders to be a QFCH and have the right to appoint an administrator they will need to have security over "substantially all the assets" of the company therefore they would take a second ranking charge over the receivables and collection accounts behind the ABL.

What happens on enforcement?

If an event of default occurs under the ABL facility agreement the ABL would ordinarily expect to be able to stop funding and to be able to collect out those receivables it has already funded. However, this effectively cuts off cashflow to the company and so it causes two issues: one, an immediate cashflow problem for the company and, two, a liquidity provision problem for the sponsors, who often cannot provide immediate liquidity to the company because of fund level timing constraints. Therefore the leveraged lenders and sponsors will want the ABL to stand still for a material period of time following the occurrence of the event of default and to continue funding new receivables. Generally the only exceptions to this are actual (rather than incipient) insolvency and fraud.

Enforcement is most likely to be by way of administration and the ABL will receive the receivables pursuant to its fixed charge. Another consequence of the ABL fixed charge on receivables is that the administrator will need to find another source of financing for the administration – if the receivables were only the subject of a floating charge then the administrator could use the company's cashflow to meet expenses.

In reality this may well mean that the ABL agrees to provide a funding facility to the administrator. In contrast to the situation where the ABL is the only or main debt in the structure (and has security over substantially all the assets of the company and can therefore provide the financing to the administrator with relative equanimity) the ABL will only provide a facility to the administrators if it is sure that either: (i) there are sufficient floating charge assets to enable this administration funding to be repaid to the ABL as an expense of the administration; or (ii) the leveraged lenders have given an indemnity to the administrator in respect of his or her expenses, including the ABL administration funding. Although it is common to include a buy-out option for the leveraged lenders to take the ABL debt out at par, in practice the leveraged lenders may in fact want the ABL to remain in place and provide the ongoing liquidity which is operationally far easier for the ABL to provide.

Bifurcated structure

A bifurcated structure is similar to the receivables carve-out structure in that two different lenders or classes of lenders have first ranking security over different classes of assets. Typically, however, the ABL will be funding receivables and inventory and the term lender will be lending against a first fixed charge on the Intellectual Property/brand value/goodwill of the business. There is therefore a more even balance between the two classes of lender than in the receivables carve-out structure.

What is the security position?

The ABL will take first fixed security over the receivables and first floating security over the inventory. The term lender will have first fixed security over the other assets. The ABL will take a second charge over the other assets behind the term lender to ensure that it is a QFCH, and the term lender may well seek a reciprocal second ranking charge behind the ABL.

What happens on enforcement?

Enforcement is most likely to be by way of administration and the administrator would be dealing with four key categories of creditor:

(1) the term lender, whose basic remedy is to seek consent to appoint a receiver/take possession of the term assets;

(2) the ABL, who will be looking either for a going concern sale of the business or a liquidation if a going concern sale is not feasible (because, perhaps, the term lender does not give its consent to the term assets being sold as part of such going concern sale);

(3) preferential creditors such as employees, whose claims will rank ahead of the floating charge recoveries from the inventory, and for whom the ABL will have allowed for (or "reserved") in sizing their facilities; and

(4) unsecured creditors, for whom the Enterprise Act introduced the Prescribed Part, and who will probably only recover a small percentage of the amounts owed to them. Note that pension schemes can also fall into this category if the pension scheme deficit is unsecured.

The administrator will seek offers for the business as a whole as his/her first option, but if such a sale is blocked by the term lender because they consider that the term assets are worth more than the value attributed to them by a purchaser on a going concern sale basis, then the administrator is likely to give consent to the term lender enforcing its fixed charge on the term assets. One caveat to this is if the going concern sale would create significantly more value for the unsecured creditors than the break-up alternative, then the administrator might go to court either for directions or, if the administrator's valuations indicate that the value breaks in one of the creditors who is refusing to release their security, then for a s 71 order for consent to dispose of the asset as if it were not subject to the security (subject of course to the secured creditor maintaining its priority in the proceeds of sale which it had in the asset).

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STRUCTURE	STANDSTILL	SHARED SECURITY	CONTROL OF ENFORCEMENT
Receivables carve-out	Probably, by ABL, but note a drawstop on non-payment enables the ABL to collect out	No	Term lender
Bifurcated structure	No	No	ABL (as QFCH)
First out/Last out	Depends on relative debt size: could be a standstill by the term lender or by the ABL	Probably	Term lender until the end of the ABL standstill
Unitranche	Yes, by ABL	Yes	Term lender

First out/Last out

The First out/Last out structure has been quite common in the US for a number of years. The ABL will be the First out lender and the term lenders will be Last out, so the term lenders expect to control enforcement. It is not uncommon for the first out lenders to have voting rights which enable them to block amendments or waivers, but this can be negotiated depending on the relative size of the two tranches of debt. There is likely to be a single facility agreement for the ABL and term debt, but there can be two separate facility agreements.

What is the security position?

Both the First out and Last out lenders will have security over all assets, but this can be shared security through a common security trustee or via separate security trustees. The key is that the waterfall will be set out in the intercreditor agreement or agreement among lenders and it is this waterfall which provides the ABL with their priority position across all assets.

What happens on enforcement?

An insolvency practitioner will realise the assets and the proceeds will be distributed in accordance with the waterfall set out in the intercreditor agreement or agreement among lenders.

Unitranche

While the unitranche position may be similar in effect to the First out/Last out structure (because the lenders rank their ability to recover not by virtue of the assets which secure the debt but across all recoveries in an agreed order) there is a single facility agreement with blended pricing, which all lenders are party to. This is quicker and easier for the borrower to negotiate and, although the blended pricing is likely to be higher than that for any of the other combined structures set out above, the speed and certainty can outweigh the pricing disadvantage.

Alongside the unitranche facility agreement is an agreement among lenders which sets out both the allocation of pricing paid by the borrower according to the risk undertaken by the respective lenders and the ranking either across assets or from the overall proceeds (ie either a bifurcated or a First out approach) to which those lenders are entitled.

What is the security position?

As above for First out/Last out.

What happens on enforcement?

The insolvency practitioner will realise the assets and the proceeds will be distributed in accordance with the waterfall set out in the intercreditor agreement or agreement among lenders.

STANDSTILL?

As you can see from the **Table** the very existence of a standstill is not a certainty in any of the structures we have reviewed. Many ABL lenders seek a standstill from the term lenders because this was common in the intercreditor arrangements they are accustomed to. However, if the transaction structure means that the term loan lenders bear the risk of default because the value is likely to break in their debt then it should not be surprising that those term lenders will want to control enforcement and require the ABL to stand still while they do so. Because the ABL will control the access to cashflow in most of these transactions the key question is whether the ABL is required to continue to fund while a major default is outstanding.

CONCLUSIONS

Looking at the intercreditor arrangements which have sprung up over the last 5–10 years we can see some common themes. First, the English courts have respected intercreditor arrangements for many years, and so we can take a fairly robust view of how likely the courts are to respect one of the many variants of these arrangements, no matter what it is called. Second, pricing is not always the driver of a structure. Third, US style valuation battles may feature more frequently if we see more bifurcated structures put into place as these will inform the purpose which an administrator chooses to pursue. And finally (and so almost certainly not finally!) the market participants will continue to innovate where they see opportunities to gain market share or drive additional leverage in structures capitalising on the different opportunities which leveraged lenders and ABL lenders, and the regulators in the UK, the US and continental Europe will continue to chase in the market. ■

Further Reading:

- ABL: beneficiaries of the credit crunch? [2007] 11 JIBFL 629.
- Intercreditor considerations for super senior lenders in unitranche financings [2016] 4 JIBFL 213.
- LexisPSL: Banking & Finance Practice note: Asset-based lending: specific security and intercreditor issues.