FEATURE STORY

Security Interests: They're Only Half The Story

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In today's competitive lending market, weakened loan structures and relaxed covenants have become the norm—leaving lenders with fewer safeguards when trouble arises. This article explores practical, asset-specific strategies to preserve collateral value and strengthen exit options, from inventory and receivables to real property and equity interests.

For decades, increased competition among banks and other lenders to deploy debt capital has led to a creeping relaxation of loan structures across numerous financing segments. The proliferation of private debt has not slowed this progression, sometimes described as a "race to the bottom".

Veterans of our industry have witnessed a retreat from the documentation and underwriting convention of multiple financial covenants in favor of a single financial covenant in most transactions. Moreover, the evisceration of the defined terms that inform calculation of the remaining covenant (by virtue of the allowance of exclusions and exceptions) can render it meaninglessly easy to satisfy. In ABL agreements, the single such covenant is often an Excess Availability covenant. While that covenant might have greater value than a fixed charge or leverage covenant in assessing the ongoing health of an ABL credit, is it really a financial covenant in the traditional sense at all?

Since lenders lack the commercial power to stem the tide of declining lending standards, it is both prudent and timely to refocus efforts on the measures that can help preserve and optimize exit strategies involving the liquidation of particular pools of assets. In other words, perfected liens only take lenders so far. In both the underwriting and documentation processes, lenders and their counsel should consider and discuss how best to address the prospect of practical realization upon collateral value.

When a borrower files for bankruptcy protection, much of the analysis and many of the relevant issues flow principally from the question of whether the secured lender is undersecured, adequately secured, or oversecured. Outside the context of the federal bankruptcy process, however, agents and lenders may wish to exercise a range of available creditors' remedies against a defaulting borrower – including foreclosure on the various types of collateral discussed below, as to each of which there are important pre closing measures and post-closing considerations that deserve special attention.

1. *Inventory* – The inventory of Borrowers varies as widely as the range of their business models and industries. Different types of inventory are located, stored, and maintained in different ways. For example, the apparel on the shelves of a department store chain's locations is starkly unlike industrial co generation equipment or other heavy machinery at the locations of a heavy industrial borrower's lessees.

Lenders are prudent to insist on rights to access, move, and dispose of inventory that can be dealt with relatively easily. In this regard, we are all familiar with landlord agreements, warehouse agreements, processor agreements, and other forms of collateral access agreement. Of course, it is important to be practical in pursuing and negotiating these agreements, focusing on locations with the greatest dollar-value concentrations of inventory (such as distribution centers and warehouses) and insisting only upon access periods and rights consistent with liquidation models used in underwriting. Further, lenders often choose to concentrate their efforts in obtaining these agreements in locations in so-called "landlord lien states" – i.e., jurisdictions such as Pennsylvania, Virginia, and Washington, where a landlord has a statutory lien that primes that of a senior secured lender. In any event, in an asset-based loan transaction, a lender may elect to institute availability reserves rather than accept an agreement whose negotiated provisions may impose undue burdens relative to the rights they afford.

If a borrower is a manufacturer, access rights to its plant and equipment may be important where the prospect of the lender retaining an agent to complete work in process would be important to ensuring a full recovery of outstanding debt. Branded goods inventory may bear trademarks that have been licensed to the borrower. In that case, it is imperative that the lender obtain, directly from the licensor, a license in its favor to liquidate the goods with the trademarks in place, thereby preserving the full value that they add to the inventory[1].

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2. *Accounts Receivable* – In theory, most goods and services should convert to cash collections of a borrower; in cases other than C.O.D. sales, usually after first taking the form of an account receivable. But merely having a lien in A/R is rarely enough, alone, to enable an agent or lender to collect such cash and repay itself. First, if the music stops, how does the lender know the identities of the account debtors and how much each one owes? Linking back to our reference to access agreements, access to A/R data is imperative. This can take the form of a shared access arrangement with respect to borrower's computer and accounting data network and/or a right of physical access to the books and records of borrower (usually maintained at its headquarters).

Direct resort to A/R collections is further complicated where a third party provides invoicing and collections services to the borrower. In those cases, the lender should require an agreement that expressly allows the lender to assume the contract or otherwise compels the service provider to allow the lender or its designee to step into the borrower's shoes and have invoicing and collections services performed at the lender's instruction and for the lender's direct benefit.

3. *Cash and Cash Equivalents* – Handled properly, few species of collateral are as "money good" as actual money. That said, if

1. For additional reading on this topic, please see the following article: Lending to Manufacturers and Sellers Operating as Licensees (not Owners) of Famous Marks | Secured Finance Network (sfnet.com)

advances are being made against cash and cash equivalents, there is little flexibility in the standards that should apply to the lender's control over this collateral class.

Generally, the cash will consist of U.S. dollars only (eliminating exchange-rate risk) and cash equivalents (U.S. treasuries) subject to a deposit account or securities account control agreement, as applicable, in favor of the agent or lender.

Where cash is not included in the borrowing base, it is nevertheless a key collateral class, and lenders should not overlook the importance of customary springing or immediate dominion deposit account control agreements (DACAs) in their favor. Too frequently in the current market, lenders seem tempted to acquiesce in long post closing windows for the negotiation and implementation of DACAs and are encouraged by borrowers or their sponsors to allow generous "petty cash" sums to be kept outside the dominion of control arrangements. Lenders should take caution that if large sums of cash are left with the borrower in accounts without DACAs in place, and the borrower files for bankruptcy, the creditors' committee or U.S. trustee will likely assert a claim that such cash is not subject to a perfected lien in favor of the lender and therefore is available for the benefit of unsecured creditors and other stakeholders whose priority of repayment would otherwise be junior to that of a senior secured lender.

As a practical matter, DACA forms used by depository banks have become largely standardized over time and are rarely heavily negotiated; accordingly, insisting upon them is reasonable, customary, and serves an important purpose in the context of secured lending.

4. *Real Property and interests therein* – Although commercial finance transactions are usually viewed as representing a financing market separate from real estate finance, as such, real property collateral is a common component of secured commercial finance transactions. Working capital lines of credit can include a term loan component supported by real property, or the borrowing base in an asset-based facility can include a fixed asset component based upon eligible real property. Moreover, real property can serve as important "boot" collateral (i.e., collateral against the value of which advances are not directly calculated and made), thereby supporting an otherwise "un-bankable" credit.

Just as a filed UCC-1 financing statement is a mere starting point for exercising rights and remedies against the personal property assets discussed above, so too, a recorded mortgage serves as merely an analytical point of departure. Because stepping into the chain of title to a property creates risk of environmental liability under federal and state statutes, the money-center banks have demonstrated considerable reluctance to foreclose directly upon boot collateral real property assets, especially in the absence of satisfactory Phase I and Phase II Environmental Site Assessments – and perhaps environmental indemnities as well.

Accordingly, even where a term loan (or provision for fixed-asset availability in a borrowing base) sharply limits the value attributed to and advances made against real property, this asset class may nonetheless have critical value, especially in the context of a theoretical sale of a business as a going concern. This is particularly true when the sale is being effected under Section 363 of the Bankruptcy Code in an effort to limit environmental and other potential liability of a prospective buyer and/or afford defenses from successor liability, including environmental liability.[2]

Finally, interests in real property leaseholds that are priced significantly below market can constitute a valuable asset of an obligor. Real property leaseholds are outside the scope of Article 9 of the UCC, however, and may be perfected only by obtaining leasehold mortgages – a measure rarely taken. When a valuable leasehold interest remains unencumbered, it is frequently assumed by a bankruptcy estate and sold. A lender should have in mind that it might seek in the bankruptcy case (particularly where it is providing debtor-in-possession financing) to ask the Court to authorize the debtor to grant the lender rights in the proceeds of the disposition of such leasehold interests.

5. *Equity Interests* – A pledge of capital stock or other equity interests is another component of an all-asset lien. A unique strategic advantage of this asset class is that following the occurrence of a default, a lender with an equity pledge can shut off both a loan party's rights to retain dividends from its subsidiaries and the exercise of voting rights and other benefits inuring to a holder of equity. Obtaining a pledge of equity interests from a parent guarantor in the equity interests it holds in the operating company borrower is especially appealing. However, exercising the right to step into the shoes of the parent guarantor with respect to voting and similar rights is laden with implications.

Most pledge agreements provide that little or no notice to any loan party is required for the lender to cut off such loan party's voting rights. However, the lender still needs to follow rules prescribed in the governing documents of the subject entity, including with respect to setting record dates applicable to shareholders entitled to vote, as well as notice periods for the setting and holding of special meetings. On one hand, the failure to adhere to these requirements could render voidable any action taken in violation of them, on the other hand, the lender risks "tipping off" the loan parties as to its plans to take action (such as replacing the board of directors) by delivering the mandated notice. In such case, the lender could face a litany of defensive moves, such as injunctive litigation from the company as a means of trying to fend off unwanted lender actions (as well as, notably, filing for bankruptcy protection to benefit from the automatic stay). Accordingly, the lender should carefully consider its options and potential consequences prior to attempting exercise of voting rights in this manner.

Another option with respect to pledged equity interests, in lieu of exercising voting rights, is for the lender to foreclose on the equity pledge and become the owner of the company. While doing so would give the lender the control it may seek, the lender thereby assumes ownership of an entity that has both liabilities and obligations—crossing a line from mere lender to an owner of the entity. As with the voting rights issues discussed above, the foreclosure on and retention of the equity in an obligor is often a remedy of last resort. More likely (though still relatively uncommon in asset-based lending) is a lender might foreclose upon equity in a special purpose vehicle concurrently with the sale of such equity to a third party, therefore converting the pledge to

2. This subject is nuanced and demands careful consideration of applicable provisions of The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), also known as Superfund, the availability of Bona Fide Prospective Purchaser (BFPP) status thereunder, the availability and merits of environmental insurance, among other issues outside the scope of this Article.

cash that pays down the loan.

In cases where there are multiple lenders in complex debt stack, typically a revolving lender holds a first lien on working capital assets and a term lender has a first lien on equity, intellectual property, real estate and other fixed assets, with "swapping second" liens. Under that structure, a revolving lender may want to take control of the borrower, to direct the process of liquidation of its collateral. However, the term lender (as the senior lienholder in equity interests) would have prior rights to take enforcement actions in respect of its first-lien collateral. Lenders should be careful to review the applicable intercreditor agreement to ensure that any steps they take comport with its terms.

6. *Equipment* – In most instances, a borrower's equipment has significant value not to be overlooked by a lender. That said, lending on equipment, or relying on it as collateral, comes with its own set of challenges. First, many types of equipment are large and heavy and therefore are difficult to move from one place to another. Second, like inventory, equipment may be at widely dispersed locations. The lender may not have access rights to all locations, perhaps because no collateral access agreement is in place, or because the equipment in question inherently is only useful where it has been used and is located.

Third, equipment lending is particularly susceptible to valuation risks. Lenders should routinely engage professional liquidators having experience with the equipment at issue.

Third, equipment lending is particularly susceptible to valuation risks. Lenders should routinely engage professional liquidators having experience with the equipment at issue. Such experts are best able to anticipate prospective value fluctuations and the costs and expenses that lenders or their agents will incur in conducting a liquidation; these considerations must be factored into any accurate understanding of true liquidation value. Finally, not all equipment is equally marketable – lenders must consider that some assets may not be broadly salable, but instead are customized for use in specific businesses and/or only by entities licensed or approved by regulation—thereby narrowing the universe of potential purchasers.

7. *Contract Rights* – Easily perfected as general intangibles, contract rights present subtle issues whose implications merit attention in the underwriting process. Specifically, material contracts should be assessed on at least two interrelated fronts: i) their assignability, and ii) the ability of the obligor business to effect "cover" (i.e., promptly engage a substitute counterparty) as to the services, manufacturing inputs, or other benefits afforded by the agreement. The loss of material agreements is often an event of default in credit agreements; the impact on the credit is inadequately addressed if lenders have not evaluated the remedial implications. Where critical agreements are readily assumed, lenders can utilize the contract rights to maximize returns on the collateral affected by those agreements. Of course, even where contracts purport by their terms to be unassignable, the Uniform Commercial Code facilitates commerce by allowing rights to payment to be assigned, even in the face of anti-assignment clauses.[3]

Finally, critical agreements between an obligor and a third party can be a fundamental lynchpin of a borrower's business operations (examples can include web hosting arrangements for an e-commerce business, exclusive supplier arrangements for a key component to the manufacturing of a product, or offsite distribution services (picking, packing, sorting, and shipping of orders)). In these cases, lenders should give serious consideration to negotiating triparty agreements with the obligor and its contractual counterparty to ensure that the lenders can receive performance of the key agreement in order to deal with collateral and preserve and realize upon its full value.

While lending standards vary over time, and sometimes in cyclical fashion, the U.S. debt market has experienced a protracted and continuing era of ready capital. This climate demands that each lender hew to market standards in both underwriting and documentation to compete successfully. Nevertheless, in collaboration with diligent and experienced counsel, lenders can remain focused on the range of measures outlined above that optimize remedial flexibility, including with respect to foreclosure upon collateral of various types. In so doing, lenders can achieve enhanced confidence that one of their traditional exit strategies, selling obligor assets to repay the obligations, is more than a theoretical option.

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3. Under Uniform Commercial Code (UCC) Article 9, specifically Section 9-406, terms in an agreement between an account debtor and an assignor that prohibit or restrict the assignment of accounts, chattel paper, payment intangibles, or promissory notes are ineffective.