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Four Tips for Improving ABL Diligence Before the Next Market Downturn

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By Jeffrey W. Bieszczak
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In today's highly competitive lending environment, asset-based lenders face elevated pressure to protect their turf and shield valued borrowers from a new lender's wiles. To incentivize retention, asset-based lenders are offering more competitive pricing, relaxed covenants and, in many instances, extended or increased credit commitments. While the prospect of fast tracking a renewal or commitment increase may be appealing, prudent asset-based lenders will exercise restraint and ensure that they have not sacrificed sound diligence practices in the interests of expediency. Having a thoughtful, adaptable diligence protocol is a good idea for lenders of all stripes, but it is critically important for asset-based lenders, who depend heavily on having an accurate and complete picture of their borrowers' operations and asset profiles. A quality diligence protocol combines thoughtfully selected diligence requirements applicable to all borrowers with targeted areas of further investigation tailored to a borrower's specific circumstances.

The following four due diligence practices are intended to supplement an existing baseline diligence program and better arm asset-based lenders with the information they need to make informed lending decisions and prepare for the next market downturn.

1. **Request Updated Perfection Certificates**. Many asset-based lenders require borrowers to prepare a perfection certificate (sometimes referred to as a due diligence questionnaire or administrative questionnaire) at the outset of an asset-based lending relationship to gather basic information regarding the borrower's current operations and asset profile. However, as a borrower's business gradually evolves, its operations and asset profile may also change. Requesting an updated perfection certificate can give a lender a concise snapshot of changes in the borrower's affairs that may affect the bank's collateral position or the broader lending relationship. This is critical for protecting the bank's lien on certain types of collateral (e.g., motor vehicles, bank

accounts and commercial tort claims) that are subject to special UCC lien perfection rules requiring the lender to obtain and act on detailed information regarding such assets. In many cases the existing credit agreement will give a lender the right to require the borrower to periodically update its perfection certificate, which can provide useful leverage with borrowers that are resistant to making those changes.

2. **Verify Lien Perfection**. Once armed with current information regarding their borrowers' assets, lenders can swiftly confirm that they have taken all necessary steps to perfect and protect its lien on those assets. These steps can include updating or supplementing UCC financing statements, obtaining control agreements covering new deposit or investment accounts, or taking possession of new, valuable tangible collateral such as certificated stock and notes payable. Updated information regarding a borrower's operations may also highlight the need to pursue agreements with third parties to protect the bank's lien. For example, the disclosure of a new third-party processing arrangement can indicate the need to pursue a collateral access agreement with the processor.
3. **Order Refreshed Diligence Searches**. Many lenders require a refreshed UCC search on their borrower in connection with a proposed credit commitment increase or extension, but far fewer require (or even consider) updates to other customary diligence searches. Updated local and federal litigation searches can reveal previously undisclosed lawsuits filed by or against a borrower, while judgment and tax lien searches can highlight potential competing liens on the borrower's assets – which can be particularly valuable where the tax lien primes a lender's prior perfected lien under applicable law. As the ongoing COVID-19 pandemic forces borrowers to make tough decisions regarding their relationships with trade creditors, lenders and employees, lenders must stay abreast of when those tough decisions result in adverse legal or financial consequences affecting the strength of the credit.
4. **Critically Reassess Borrowing-Base Calculations**. Asset-based lenders depend on the delivery of timely, accurate borrowing base calculations. In certain industries, borrowers may seek to boost their borrowing capacity by taking advantage of methods of valuing or counting their inventory that are inconsistent with industry standards or contrary to a lender's expectations. This can be particularly problematic where the borrower's method relies on assumptions (for example, the average weight or length of a unit of inventory) that are not customarily disclosed or tracked in a borrowing base certificate or revealed in a field examination. Periodically reassessing assumptions regarding a borrower's asset valuations can identify potential inconsistencies and disputes before the credit becomes distressed.