

Eligibility criteria and operational covenants

BACKGROUND

ABL/RF facility agreements will invariably contain eligibility criteria for each asset class being funded and may also contain operational covenants.

This note is focusing on eligibility criteria used in whole turnover receivables purchase facility agreements and secured borrowing base facility agreements. Eligibility criteria are also commonly used in selective debtor receivables purchase agreements, but that is outside the scope of this note.

WHAT ARE ELIGIBILITY CRITERIA?

The purpose of the eligibility criteria is to ensure that the financier is only advancing funds against assets in respect of which it is more likely than not, if the financier had to collect or sell them, to recover enough to discharge the amounts it has funded.

As such, eligibility criteria act as the quality control for assets being put forward for funding, with only eligible assets forming part of the funding calculations.

WHERE DO YOU FIND THE ELIGIBILITY CRITERIA?

The eligibility criteria will typically be documented as a list of criteria included within a definition, e.g. "Eligible Receivables", "Eligible Inventory", etc.

These lists are typically drafted on a carve-out basis (i.e. an asset will be eligible unless it does not satisfy one of the listed criteria) but can sometimes be drafted on a carve-in basis (i.e. an asset will not be eligible unless it satisfies the listed criteria) so care should be taken when reviewing to ensure that the correct form of any criterion is used.

The eligibility criteria for intangible or revolving assets (e.g. receivables and inventory) will typically be longer and more detailed, and the eligibility criteria for fixed assets (e.g. equipment and real property) will typically be shorter.

WHAT TYPES OF ELIGIBILITY CRITERIA ARE COMMONLY INCLUDED?

Eligibility criteria can be broadly split into the following categories (which overlap in certain cases):

- Criteria which include/exclude specific types of asset (e.g. assets needing to be subject to the financier's security, receivables evidenced by bills of exchange, equipment not contained on a specific list, etc.);
- Criteria relating to ownership or protecting against third party rights in the asset (e.g. bill and hold arrangements, retention of title rights, third party security, etc.);
- Criteria relating to factors which may devalue the asset or the likelihood of it being collected in full (e.g. disputed receivables, slow moving inventory, asset not insured, etc.); and
- Deal-specific criteria (e.g. excluding certain specified debtors).

In addition to the listed eligibility criteria, there will typically be a discretion for the financier to review and include additional eligibility criteria or declare that an asset is not eligible. This discretion may be unqualified or qualified by reference to the financier "acting in good faith", "acting reasonably" or "acting in its Permitted Discretion".

ELIGIBILITY CRITERIA THRESHOLDS AND/OR OPERATIONAL COVENANTS

A financier will typically monitor the make-up and/or performance of the intangible or revolving assets (e.g. receivables and inventory) either to ensure it is not over-exposed to particular sub-classes of those assets or to act as an early warning system that the customer is potentially becoming distressed.

To do so, a financier will either incorporate into the eligibility criteria certain thresholds/limits for certain sub-classes of assets (more common for secured borrowing base facilities) or include in the facility agreement formal operational covenants in respect of which the customer provides covenant certificates (more common for whole turnover receivables purchase facilities). Breach of an operational covenant can result in the affected assets becoming ineligible (i.e. the same effect as if a threshold/limit had been included in the eligibility criteria), a reduction of the prepayment/advance rate, or the value of the affected assets being applied as a reserve.

Common eligibility criteria thresholds/limits and/or operational covenants are:

- **Debtor concentrations:** The value of receivables due by particular debtors or debtor groups.
- **Export concentrations:** The value of receivables due from foreign debtors or particular jurisdictions.
- **Dilutions:** The value of dilutions over a specified period.
- **Debt turn/days sales outstanding:** The average number of days it takes for debtors to pay.
- **Goods in transit:** The amount of inventory not stored at warehouse.
- **Foreign inventory:** The amount of inventory stored overseas.