MBitesize
SERIES: DOCUMENTATION

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Reserves

BACKGROUND

Committed ABL/RF facility agreements invariably contain detailed eligibility criteria for each asset class being funded. The financier will monitor and adjust the eligibility criteria throughout the life of the transaction with a view to ensuring that it 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.

However, there will inevitably be priority claims, liabilities and dilutions which may need to be paid ahead of the financier and which would limit the amounts recoverable, even on "eligible" assets over which the financier has security or which it has purchased.

To mitigate these known priority claims, liabilities and dilutions, it is usual for financiers to apply "reserves", which reduce the available funding that can be achieved against the affected eligible assets, the intention being to put the financier in the same economic position as it would have been had there been no such priority claims, liabilities or dilutions.

WHAT ARE RESERVES AND HOW ARE THEY APPLIED?

Reserves will typically be defined in the facility agreement as amounts to be established from time to time by the financier to reflect priority claims, liabilities or dilutions.

The definition may refer to specific examples or categories of reserve, but will usually not be limited to the stated items and will include a discretion for the financier to review and include additional reserves. This discretion may be unqualified or qualified by reference to the financier "acting in good faith", "acting reasonably" or "acting in its Permitted Discretion".

The amount of the reserves will be deducted from the amount which would otherwise be available for funding under the facility. In both a receivables purchase and a secured borrowing base structure, reserves will generally be deducted after applying an agreed percentage rate (prepayment percentage/advance rate) to the value of eligible receivables/assets.

WHAT TYPES OF RESERVES ARE TYPICALLY INCLUDED?

Reserves can be broadly split into the following categories:

Insolvency reserves

- **Statutory insolvency waterfall:** If the financier is relying on floating security (e.g. in respect of inventory), its claim on a winding up will be subordinated to (i) fixed security holders, (ii) if the Corporate Insolvency and Governance Act 2020 applies, moratorium debt and priority pre-moratorium debt (within the meaning of that Act), (iii) insolvency expenses, (iv) ring-fenced amounts for preferential creditors (e.g. HMRC in respect of certain taxes (from December 2020), pension scheme contributions and certain employee wages), and (v) the "prescribed part" (an amount carved out of the floating security realisations for distribution to unsecured creditors).

  As such, the financier will apply reserves in an amount estimated to be equivalent to the amount of the claims of all creditors which would have priority to the amounts recovered by the financier under its floating security.

While the list of items with priority in insolvency generally remains static, it can change (the Corporate Insolvency and Governance Act 2020 and the pending reintroduction of Crown preference with respect to VAT and PAYE being two recent examples) and so financiers should ensure that the lists of items it is reserving against is reviewed and reconsidered on a regular basis (along with the amount reserved).

- **Set-off:** If the financier is relying on security over receivables or an undisclosed purchase of receivables, amounts owed by the customer to its debtors will be subject to mandatory insolvency set-off against those receivables in the event of the customer's insolvency.

  Therefore, a financier may apply reserves for things such as contractually agreed rebates between the customer and its debtors.

Reserves to account for amounts payable to extinguish third party rights over financed assets

- **Landlord liens:** Where financed inventory or plant & machinery is stored or located in a warehouse leased to the customer, the landlord will have a right by operation of law to detain the assets until any rent arrears, charges and other costs are paid (i.e. a possessory lien). It is also possible for such a lien to be expressly agreed in the lease (i.e. a contractual lien).

  While it is possible for a financier to come to a contractual arrangement with the landlord in relation to access and waiving its lien, it is more common for a financier to instead apply a rent reserve (usually to the value of 3 months' rent and charges), thus giving the financier the option to settle amounts due to the landlord and gain access to the relevant assets if the landlord ever proposes exercising its lien.

- **Goods in transit:** Similar to landlords, hauliers and shippers can also have a lien over goods they are transporting to secure their fees and charges.

  To the extent any goods in transit are to form part of the borrowing base, a financier may apply reserves in respect of any customs or haulier/shipping fees and charges payable to a third party in respect of such assets so that, in an enforcement scenario, the financier could use the reserve to pay and discharge any unpaid customs or haulier/shipping fees and charges and gain free possession of the assets upon their arrival at the relevant destination.

Reserves to allow the customer to access funding against assets which would otherwise be "ineligible"

- **Dilutions:** To the extent the underlying contract between the customer and debtor contains terms which may potentially dilute or even extinguish the value of a receivable, (e.g. discounts for prompt payment, ability to extend credit terms, rebates for volume purchases, product guarantees, indemnities or warranties providing for defective products to be replaced), as an alternative to deeming the receivables arising under such contract as ineligible, the financier may set appropriate reserves. Such reserves may relate to historic or pre-agreed levels of dilutions while others may arise from time to time during the course of the transaction and have to be dealt with under the permitted discretion referred to above.

- **Assets in excess of eligibility thresholds/limits or operational covenants:** If eligibility thresholds/limits (e.g. in respect of debtor or export concentrations) are exceeded or covenants breached, the affected assets may be designated as ineligible for funding or the financier may have the option to apply the value of the affected assets as a reserve instead.

- **Retention of title (ROT):** The facility agreement will usually contain eligibility criteria requiring that title to any inventory forming part of the borrowing base is owned by the customer. This will not necessarily be the case if the customer has ROT provisions within its contracts with its suppliers.

To address this, a financier may provide for a reserve in respect of any inventory which could be subject to supplier ROT and/or receivables which may be subject to extended ROT with the amount of such reserve commonly being the amount owed to the relevant supplier(s) at any time.

OVERSEAS RESERVES

Financiers should note that different or additional statutory or customary priority claims may apply in jurisdictions outside England and Wales. For example, in Germany, administrators are entitled to a lump sum of (usually) 9% of the available receivables, machinery, equipment and inventory, plus payment of disbursements and expenses, and landlord liens can secure up to 12 months' rent arrears. Appropriate reserves should be considered and implemented to mitigate such local priority claims on cross-border transactions.