BORROWING BASE INSIGHTS

In this edition of the Lender's Edge, we discuss the modern Borrowing Base: What the Documents Say and What Actually Happens

BY TYLER MULLEN

Asset-based lending ("ABL") has historically been considered a systematic form of secured credit. In an ABL deal, a borrower's availability corresponds to collateral value, and the borrowing base is the mechanism through which the parties determine availability at any given time. Credit agreements present availability as a simple formula: eligible accounts receivable and inventory (and in some cases other collateral types) multiplied by applicable advance rates, minus applicable reserves. The implication is that if a borrower can calculate its borrowing base, it can predict liquidity.

In today's market, that picture is incomplete. Many ABL facilities still begin with the familiar formula, but day-to-day management of availability often depends less on stated definitions and more on what lenders learn in real time. "Permitted Discretion", reserves, field exams, appraisals, and operational overlays increasingly determine the amount a borrower can actually borrow. The borrowing base has evolved from a purely formulaic construct into a dynamic risk-management tool, and the gap between what the legal documents say and what happens in practice matters for everyone involved.

The "On-Paper" Borrowing Base: A Formula with Guardrails

Most ABL credit agreements describe a borrowing base in familiar terms. The borrower delivers periodic borrowing base certificates showing:

1. Eligible Accounts Receivable, net of ineligibles (aging, disputes, offsets, concentration limits, governmental receivables, foreign receivables, etc.);
2. Eligible Inventory, typically conditioned on appraisal methodology and sometimes sub-limited by category (raw materials, work-in-process, finished goods, in-transit, etc.);
3. Advance Rates applied to each asset class; and
4. Reserves, deducted from the result to reach "availability."

On paper, this structure is meant to be objective and repeatable. Definitions are drafted to create bright-line eligibility outcomes and reserves are typically framed as a limited set of adjustments tied to known risks such as dilution, taxes, landlord liens, and third-party claims. Many legal documents provide for robust reporting covenants, audit rights, appraisals, and field exams to validate the borrower's self-reported inputs.

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If the story ended there, borrowers could treat availability as a predictable function of their collateral. In practice, however, ABL relationships are rarely governed by purely mechanical calculations, particularly in times of stress, operational change, market upheaval, or collateral volatility.

What Happens in Practice: The Borrowing Base as a Real-Time Risk Tool

Modern ABL documents embed meaningful lender discretion into the borrowing base framework, and that discretion increasingly drives availability. Lenders (or, in syndicated deals, agents) are typically authorized to implement reserves in their "Permitted Discretion" (i.e., a reasonable determination made from the perspective of a similarly situated secured lender), adjust advance rates based on appraisal outcomes, and even modify eligibility criteria in response to field exam findings. Of course, agents and lenders are obliged to act in good faith—changes impacting the borrowing base calculation must be based on reasonable concerns impacting collateral value. However, these discretion-based tools provide lenders and agents a practical avenue through which to quickly respond to risk without a formal amendment.

The most common tool for bridging the document-to-practice gap is undoubtedly reserves, which can be implemented quickly and are often drafted broadly. Even when the formula and definitions remain constant, a reserve can effectively act as an override. Common reserves include dilution reserves (when returns or rebates increase), landlord reserves (when access agreements are unobtainable), and inventory reserves (when operations are disrupted or liquidation profile changes).

From a borrower's perspective, reserves can feel like a moving target. From the lender's perspective, reserves are a fair and practical risk-control mechanism used to manage uncertainty without negotiating every scenario the parties cannot foresee at closing.

In addition to implementing reserves, lenders also manage risk by examining and verifying eligibility. Since borrowers self-report eligible assets, the resultant collateral value is only as reliable as the borrowers' reporting systems and processes. Field exams test whether those systems and processes produce trustworthy data—and field exam findings can sometimes be the moment when "eligible on paper" becomes "ineligible in practice."

Field exams can uncover inaccuracies in borrowing base reporting due to factors like offsets being improperly tracked, inventory classifications being inconsistent and receivables aging misaligning with eligibility requirements. A borrower may calculate a borrowing base believing that it complies with the literal terms of the credit agreement, but a field exam can lead to reduced availability based on a determination that the inputs are inaccurate or fail to consider commonly overlooked eligibility criteria.

While field exams focus on eligibility, appraisals focus on value and are the starting point for determining advance rates. While legal documents often specify appraisal frequency and methodologies (e.g., NOLV), appraisals do not always translate into borrowing capacity in a purely mechanical way. Agents and lenders may apply overlays based on factors an appraisal cannot fully capture in real time. Even where the appraisal supports a stated inventory advance rate, lenders may reduce effective availability through additional reserves or "temporary" adjustments, particularly when there is a mismatch between appraisal timing and current operational conditions.

Finally, as collateral pools become increasingly complex, more assets fall into a twilight zone—technically eligible, but practically discounted because the liquidation path is uncertain. Examples include:

- Licensed or branded inventory where trademark or distribution agreements may restrict the ability to sell through alternate channels, raising questions about liquidation value;
- Foreign accounts receivable that are technically eligible but operationally difficult to collect; and
- Inventory located at third-party locations where missing access agreements, commingling, or third-party claims create priority and control risk.

In a progressively more connected and global marketplace, these are no longer edge cases. They are increasingly common in ABL facilities supporting modern business models, particularly those built on brand licensing, multi-channel distribution, or cross-border operations.

Practical Takeaways: Drafting and Operating with Reality in Mind

Given the recognized gap between what the documents say and factors driving availability in practice, what are the parties to do?

For Lenders and Agents

- Treat reserves as core credit tools. If reserves are doing the heavy lifting, the documents should describe them clearly, operationally, and with workable reporting mechanics.
- Align field exam cadence with collateral risk. Rapidly changing collateral pools may justify more frequent exams and more transparent consequences.
- Communicate adjustments early and often. The fastest way to erode a borrower's trust is for availability to shrink for what appears to be no reason or without an understandable path to restoration. More than ever, ABL is a relationship requiring transparency and give-and-take on both sides.

For Borrowers

- Availability is not only math—it is trust. Strong systems, transparent reporting, and rapid remediation of exam issues preserve liquidity and help lenders help you.
- Expect overlays in gray areas. If collateral includes licensed inventory, high-return channels, foreign receivables, etc., plan for reserves and reduced predictability.
- Model liquidity with a cushion. Borrowers should forecast availability under "stressed" reserve scenarios, not only under the best-case formula.

For Counsel (and Deal Teams)

- Draft with the operational playbook in mind. If the agent or lender intends to manage risk through reserves, the agreement should make the mechanics clear and workable.
- Calibrate discretion. Overly broad discretion can create uncertainty while overly narrow discretion can force unnecessary amendments. The right balance depends on deal structure, collateral complexity, and sponsor sophistication.
- Stress-test the borrowing base definitions. At the documentation phase, determine where issues may emerge (returns, rebates, licensing constraints, cross-border collections, etc.) and build the document around those realities.

Conclusion: From Formula to Framework

The borrowing base is still the defining feature of ABL deals, but it has evolved from a formula that determines availability into a framework within which availability is managed. That evolution is not inherently negative; it reflects a market adapting to more complex collateral, faster-moving risk, and the need to react quickly without constantly renegotiating documents. The critical point is clarity and transparency. An ABL deal is, in many ways, less about formula and more about relationships and trust. Lenders, borrowers, and counsel should recognize the gap between the legal scaffolding and operational reality, and draft and operate accordingly.

We hope you enjoyed the column and are always interested in your feedback. If you have any questions or comments, please let us know at tyler.mullen@blankrome.com. And as always, whenever the structure matters and the stakes are real, the Lender's Edge is with Blank Rome.

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