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Making Your Customer Receivables More "Financeable" for a Receivables Purchase Facility

Catherine Young Hagerty*

Receivables financing may be a more easily-obtained source of liquidity for a company facing a credit crunch, and, depending on the creditworthiness of a company's customers, may provide a less expensive source of financing for companies that do have access to credit. This article discusses ways that a company can make its receivables more easily "financeable," in order to qualify for a U.S. receivables purchase financing.

During times of financial market uncertainty, credit often tightens and companies may find it more difficult to obtain financing. Companies that previously borrowed under corporate cash-flow based loans may find that asset-based financings including receivables financing, or "factoring," are more readily available.

In a factoring transaction, like any other asset-based financing, the financier weighs heavily the value of the collateral and ease of liquidation for its credit decision. In particular, if a supplier of goods or services has a weaker credit profile than some of its customers, a financier may be more willing to purchase the receivables owing by the strong-credit customers, than it would be to extend a loan to the relatively weaker-credit supplier.

This article discusses ways that a company can make its receivables more easily "financeable," in order to qualify for a U.S. receivables purchase financing. In addition, a company that already has been factoring receivables may find ways to revise its form customer contract in order to make its factoring process run more smoothly.

A factoring transaction consists of a sale of accounts receivable ("Receivables") from a supplier of goods or services ("Supplier") to a bank/factor ("Bank"), rather than the Supplier's borrowing from the Bank of a loan secured by the Receivables. The Receivables arise under some kind of "Supply Contract" (which may consist of no more than a purchase order and invoice and any standard contract terms incorporated therein by reference, or a fully negotiated purchase agreement, or a combination of these) between the Supplier and its customer ("Customer").

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OVERVIEW

While a factoring transaction is styled as a sale, using the nomenclature of seller/buyer, the substance of the transaction (rather than the form) will determine whether the transaction constitutes a sale of Receivables for U.S. legal, accounting or tax purposes. If the substance of the transaction fails to qualify as a "true sale" of Receivables, the default characterization is that the transaction constitutes a loan secured by the Receivables.

Some attributes of a U.S. true sale factoring transaction are:

- The benefits and burdens of ownership of the Receivable are transferred from Supplier to Bank (such that, if Customer fails to pay the Receivable, Bank has *de minimis* recourse to Supplier);
- The Bank assumes credit risk of the Customer rather than the Supplier (such that if Supplier files for bankruptcy, payment of the Receivable to Bank should not be affected); and
- From an accounting perspective, a true sale is an "off balance sheet" transaction, with the purchase price proceeds treated as an asset, rather than debt, on Supplier's balance sheet.

This article discusses U.S. factoring transactions that are, in substance, true sales; in a factoring transaction that is not a true sale, the issues raised in this article are less important, as the Receivables constitute collateral for a loan rather than the sole source of repayment. Our discussion is limited to U.S. law and the Uniform Commercial Code ("UCC"); other jurisdictions and disciplines may weigh different factors in their relevant analyses.

EXISTING RESTRICTIONS ON SUPPLIER

Often, a company will layer in a factoring transaction to a capital/liquidity structure that already includes a credit facility. Credit facility documentation may include inadvertent restrictions on factoring facilities, regardless of whether a true sale; a borrower that wishes to maintain flexibility to increase liquidity through a factoring facility would be well advised to consider the following issues when negotiating or amending its credit facility.

Restrictions on Asset Transfers

Any restriction on asset transfers would need to be carefully considered to ensure that it does not forbid sales of Receivables. A customary carveout for transfers of assets in exchange for reasonably equivalent value should suffice. Alternatively, Supplier could request a more specific carveout to permit transfers of accounts receivable and related personal property in connection with true sale factoring transactions.

Restrictions on Liens

Most credit facility documentation contains restrictions on liens.

Financing Statements

Despite the fact that a true sale factoring transaction is not a secured loan, it is a "secured transaction" within the meaning of the UCC[1] and, as such, must be perfected. Therefore, any Bank buying Receivables in a true sale factoring rightly will insist on perfecting its purchase, which typically is done by filing a UCC financing statement against Supplier. This might inadvertently violate a credit facility's restriction on liens, if the credit facility's definition of lien is overly broad so as to include financing statements in addition to the liens that they perfect. A Supplier should ensure that its credit facility documentation does not contain a restriction on financing statements; a scrupulous lender should not object to this.

Precautionary Lien

Properly drafted true sale factoring documents will include a so-called "precautionary lien" provision, which provides that, while it is the intent of the parties that the transactions constitute a true sale of the Receivables, in the event that a court recharacterizes the transactions as a secured loan, Supplier grants a present lien in the Receivables to secure Supplier's obligations to Bank under the transaction. While surprising to some, this precautionary lien is customary and not troubling to knowledgeable counsel. A Supplier may wish expressly to exclude so-called "precautionary" liens granted in connection with true sale factoring transactions (and related financing statements) from any credit facility restriction on liens. Bank must ensure that it perfects this precautionary lien, in addition to perfecting its true sale purchase; this is accomplished the same way as perfecting true sale purchase—typically, by filing a UCC financing statement.

Deposit Accounts

Many factoring transactions require Supplier to deposit collections on the purchased Receivables, or direct Customers to make all payments on purchased Receivables, into a segregated bank account over which Bank has a perfected lien. A lien on a deposit account cannot be perfected by filing and may be perfected only via control, such as through a deposit account control agreement.[2] A credit facility's restriction on liens likely would limit Supplier's

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[1] *See* UCC §§9-109(a) and (d), which provide that Article 9 of the UCC "applies to . . . (3) a sale of accounts, chattel paper, payment intangibles, or promissory notes . . ." that is not " (4) . . . part of a sale of the business out of which they arose."

[2] *See* UCC § 9-312(b)(1).

ability to grant liens on bank accounts, or enter into control agreements. A Supplier may wish expressly to exclude from any credit facility restrictions, segregated deposit accounts that hold collections on Receivables sold in true sale factoring transactions, and related control agreements.

Conflicting Liens

Supplier will not be able to sell Receivables that are subject to a pre-existing continuing lien. If its credit facility is secured, Supplier should be certain that the lien of the credit facility does not continue after sale to Bank; this often is accomplished by a lien release provision that automatically releases a credit facility's lien on Supplier property once transferred in a transaction permitted by the credit facility (such as a permitted asset transfers carveout as discussed above). Further, the credit facility's collateral package should exclude segregated deposit accounts that hold collections on Receivables sold in true sale factoring transactions.

SUPPLY CONTRACT TERMS

Bank will perform due diligence on the Receivables (and the Supply Contract under which they arise) to understand what Bank is purchasing. The following are key issues a Bank will look for in its diligence process.

Assignability

Bank must determine whether the Receivables are assignable. At a minimum, the Supply Contract should not restrict Supplier's ability to assign Receivables generated under the Supply Contract; better, the Supply Contract should expressly permit Supplier to assign the Receivables to a third party; better yet, the Supply Contract should expressly permit Supplier to assign to a third party not only the Receivables, but also all rights of Supplier under the Supply Contract to the extent of such Receivables.

The third formulation described above is most preferable to Bank because it permits Bank to take advantage of all of the benefits of the Supply Contract, rather than solely the right to payment of the Receivable; this would include, for example, any lien Supplier takes under the Supply Contract on goods sold, to secure payment of the Receivable. Furthermore, a Customer will retain, after the sale of the Receivables it owes, any rights or defenses available to it under the terms of the Supply Contract; it is only fair that Bank receive all of Supplier's rights and benefits under the Supply Contract, as well.

In addition to the issue of assignability to Bank, Bank will prefer that the Receivables be assignable by Bank to a third party after Bank has purchased them from Supplier. Any Customer consent to assignment should flow to the

benefit of Supplier's assignees, so that Bank need not obtain further consent by Customer in the event that Bank wants to assign a purchased Receivable, or the entire receivables purchase transaction, to a third party.

The UCC[3] overrides anti-assignment provisions in Supply Contracts, by rendering invalid any contractual provision to the extent that it would prohibit, restrict or require Customer consent to any assignment of a Receivable. This UCC override may seem at first glance to lead a Bank not to be concerned about an anti-assignment provision. However, this UCC override applies only to explicit anti-assignment provisions (i.e., not provisions that form a practical barrier to assignment, such as confidentiality provisions, as discussed below) and applies only to the Receivable itself (i.e., the naked right to payment, leaving un-assignable other contractual Supplier protections such as a lien on the goods sold under the Supply Contract).

Confidentiality

Often, a Supply Contract will contain or otherwise be subject to confidentiality requirements that restrict Supplier's ability to disclose the terms (or even the very existence) of the Supply Contract. Such a confidentiality provision functions as an anti-assignment provision requiring consent of Customer to share the Supply Contract with Bank, as a Supplier cannot assign Receivables arising under a Supply Contract if Supplier is not permitted to disclose the terms of the Receivables. The UCC override described above is not effective to override a confidentiality provision; therefore, a Supplier should ensure that any confidentiality provisions in its Supply Contract forms are expressly subject to the Supply Contract's provision expressly permitting assignment.

Nature of Payment Obligation

Bank's review will evaluate the strength of Customer's payment obligations under the Receivables, both per the express terms of the Supply Contract, and as a result of the assignment to Bank.

Waiver of Defenses Against Assignees

Bank will look for a Supply Contract provision in which Customer waives, *vis-à-vis* any of Supplier's assignees (such as Bank), any defenses Customer may have to payment of the Receivables. This would not leave Customer without recourse in the event that circumstances would provide Customer with a defense to payment, but would redirect that recourse towards Supplier only (and away from Bank). The more robust the Supplier warranties in the Supply Contract, the more a Bank will want to see such a provision.

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[3] *See* UCC § 9-406(d)(1).

Absolute Payment Obligations

Bank will look for a so-called "hell or high water" provision in the Supply Contract, in which Customer agrees that its payment obligations are absolute and unconditional once fully earned. Such a provision would not prohibit Customer from pursuing a claim against Supplier arising from the Supply Contract, but would isolate any such claims from Customer's payment obligations.

(a) *Setoff/dilution.* Bank will look for any Supply Contract provisions that permit Customer to set off against one Receivable, amounts owing under another Receivable (such as for rebates, product returns, *bona fide* disputes, deemed contract damages, etc.). The more expansive these provisions, the less attractive the Receivables will be to Bank, resulting in less favorable terms to the Supplier under the factoring facility.

In addition to the terms of the Supply Contract, Bank will investigate whether Supplier has any customer programs that provide for rebates or discounts, or conditions on which Supplier will accept returns and issue refunds, all of which could "dilute" the Receivable. In order to achieve the best possible factoring terms, a Supplier should make any of these programs payable solely through check sent periodically from Supplier to Customer (which does not expose Bank to this dilution), rather than through credit memos or setoff against other Receivables.

(b) *Disputes.* Bank will investigate Supplier's historical levels of customer disputes, in order to discover how much recourse Supplier actually is providing in the event of a dispute and to understand the rights available to Customer and how this could affect Bank's purchased Receivables. If the Supply Contract contains "hell or high water" language, Supplier should make any recourse or dispute-related rights provisions subject to that.

(c) *Supplier performance risk*. Bank will carefully review any Supply Contract provisions related to the conditions under which a Receivable is deemed to be fully earned. Bank may be unwilling to purchase Receivables that are not fully-earned (whether because the underlying goods have not yet been delivered and accepted, or the underlying services have not been performed, or because any other Supply Contract conditions have not been met). In a true sale transaction, Bank will have very limited recourse against Supplier for Customer's nonpayment of the purchased Receivables, and may not have recourse to Supplier for Supplier's own failure to perform that results in the Receivable failing to exist or be enforceable.

Apart from investigation of Supply Contract terms, Bank will investigate Supplier's actual practices surrounding delivery and acceptance. If, for example,

a Supply Contract contemplates formal acceptance by Customer of the goods or services giving rise to the Receivables, but Supplier has not been diligent about obtaining or retaining these, Supplier should change its practices to make efforts to do so (and if the Supply Contract does not include such a mechanism, Supplier should incorporate that in its terms).

Bundled Supply Contracts

The analysis of the foregoing issues may yield different results for Receivables owing for goods purchased versus for services rendered. If a Supply Contract governs both the sale of goods and provision of services (such as for ongoing maintenance), Supplier should be careful to ensure that the goods Receivables can be distinguished from the service Receivables, in order to avoid losing the ability to finance any of them. It is best if the pricing for the goods and services are measured separately so that all parties can easily determine what amount of Receivables is owed for which Supplier performance obligation.

For example, if a Supply Contract's defenses to payment for services make service Receivables unattractive to Bank, Bank may only wish to purchase goods Receivables, or may require recourse to Supplier that makes it impossible for Supplier to receive off-balance sheet treatment for the factoring of the service Receivables. In this case, if the Supply Contract's pricing is "bundled" (i.e., does not make transparent what portion of a Receivable is for goods versus services), Supplier may not be able to sell the bundled Receivable in a true sale or off-balance sheet transaction.

Lien-related Issues

Often, a Supply Contract for the sale of goods will include a lien grant by Customer in favor of Supplier, with respect to the goods sold, in order to secure Customer's purchase price payment obligation. Such a provision may be formulated as a title retention clause (i.e., Supplier retains title until it receives payment); from a commercial law perspective, this is a lien. Regardless of formulation, Supplier should perfect this lien, typically by filing a UCC financing statement against Customer.

As noted above, Supplier's lien should be included in the bundle of Supply Contract rights that Bank purchases from Supplier in the receivables transaction. In the event of any nonpayment by Customer on an assigned Receivable, Bank would have the right to repossess the goods sold and remarket them for sale, generating proceeds to apply against the amount of the purchased Receivable. Bank will investigate whether Supplier has perfected its liens against its Customers, as Bank's lien on the goods—which is derivative of Supplier's—will be unperfected if Supplier did not perfect. Bank may expect to amend Supplier's financing statement to add Bank as an additional secured party.

If the Supply Contract is an agreement for the performance of services, there is no asset in which Supplier reserves a lien, and therefore Customer's payment obligation is unsecured. As a result, in the event of any nonpayment, Bank has no asset to remarket in order to recover proceeds to apply against the purchased Receivable.

If the Supply Contract is a lease of personal property, different rules will apply for perfection and other issues, as a lease of personal property constitutes "chattel paper" under the UCC, rather than an "account" (as with a sale of goods or services). Receivables consisting of lease payments are further complicated by the fact that a transaction styled as a lease may constitute a "true lease" (i.e., an operating lease) or, if it does not qualify as a true lease, a secured loan. In a true lease, the lessor owns the leased assets; in a secured loan, the lessee owns the leased assets and lessor's interest therein is in the nature of a lien. The terms of the receivables purchase transaction will differ depending upon whether the lease is a true lease or a secured loan, particularly given that the nature of Supplier's rights in the leased property (and which of those it can pass on to Bank) will vary greatly depending upon which structure applies. These issues are beyond the scope of this article.

Other Issues

Bank often will not buy Receivables that are:

- Subject to long payment terms (often, 90 days is a cutoff);
- The subject of any prepayment, deposit or other credit, or that represent a progress billing;
- Owing in currencies other than U.S. Dollars;
- Owed by a Customer that is a consumer, a government entity, a foreign entity or an affiliate of Supplier, or an entity that has raised a dispute with Supplier on another Receivable; or
- Health care insurance receivables.

Such common limitations are worth keeping in mind when considering whether a factoring transaction may be an appropriate source of liquidity.

CONCLUSION

Receivables financing may be a more easily-obtained source of liquidity for a company facing a credit crunch, and, depending on the creditworthiness of a company's customers, may provide a less expensive source of financing for companies that do have access to credit. Structuring a credit facility and Supply Contracts in advance to accommodate many of the receivables financing issues

described in this article may make eligible for receivables financing a Supplier previously unable to obtain receivables financing, or may improve the pricing on a Supplier's already-available receivables financing facility, or may smooth and accelerate the process of moving from term sheet to closing.