Drafting Your Factoring Agreement to help achieve a “true sale”

International Factoring Association Webinar
June 30, 2015
TOPICS WE WILL DISCUSS TODAY INCLUDE:

- How “modern” factoring developed
- Risks that a commercial factor does and does not accept from its client
- Factoring accounts on a non-recourse, partial non-recourse, partial recourse and a full recourse basis
- Contractual language by which factors assume credit risk
- Contractual language by which factors shift risk to their clients
- “Old-line factoring” – how the term developed and what it means
- What courts look for in determining if there was a "true sale“ of accounts
- Terms which might bolster "true sale" treatment;
- Terms which could damage "true sale" treatment;
- Terms which courts may (or may not) view as inconsistent with a "true sale" of accounts;
- Importance of the contractual “choice of law” in full recourse factoring
DRAFTING TO HELP ACHIEVE A TRUE SALE

Requires knowledge of, among other things:

• Risks which commercial factors in America have “traditionally” assumed;
• Contract language which evidences the factor’s assumption of these risks;
• Whether, how and why these “traditional” assumed risks help create a “true sale” of accounts under American law;
• The ways modern American factors have reduced and varied the levels of risk “traditionally” assumed and the impact thereof on the “true sale” analysis;
• Risks that commercial factors in America do not assume and how this impacts the “true sale” analysis;
• How full recourse factoring developed, historically, and the extent to which it resembles both: (1) “traditional” factoring and (2) commercial loan transactions;
• How “factoring” has been defined by American courts; and
• The various facts and circumstances which American courts weigh in their “true sale” legal analysis.
FACTORING SERVICES (Historic and Modern)
Factoring services

At common law, factors were commissioned sales agents and took credit risk

Under English common law, from 1300 or so to the late 1800s, commercial factors were sales agents for their principals, often sellers of raw materials, agricultural products, or manufactured goods. In consideration of a sales commission the factor:

- Stored consigned client inventory, often on-site;
- Provided sales, styling and marketing advice to the client;
- Provided financing to the client, by discounting accounts receivable and making post-sale advances to the client thereon, say, at 50-80% of the sale price, prior to actual collection; and
- Performed bookkeeping and collection functions associated with these services.

Moreover, in consideration of a supplemental *del credere* commission, often 2.5-5% of the market price, common law factors:

- On shipped goods, accepted full “credit risk” that the account would not collect at maturity due *solely* to the account debtor’s financial inability to pay.
- The factor’s principal, the seller, still keeping risk of non-payment due to “quality” issues.

1. Foreign sellers demanded their local factors take a *del credere* commission to avoid credit losses from selling into foreign markets. Factors, being local, could gauge the customer’s ability to pay and were better positioned to take the credit risk.

2. If a factored account did not collect at maturity, due *solely* to the customer’s inability to pay, the factor paid its client the invoice price and took the full credit loss (net of the *del credere* commission received). Upon this payment, the factor’s position ripened from being surety for the legal owner of the account (the factor’s principal) to full owner of the account (via subrogation).

Factoring came to America with the Pilgrims (see AFL Ch. 1) and has been a form of commercial finance here since that time.

Factoring died out in England in the late 1800s, only to be re-introduced to England by CIT in 1960. See AFL 2013 Cumul. Supp. Ch. 1
Factoring services
Provided by “modern” factors, depending on the particular agreement

“Modern” factoring arose in America between 1889 and 1905

- Marketing and sales advice were dropped from the factor’s services
- Moreover, over time, American factors no longer stored inventory on-site for their clients

Modern American factors still provide several client services, including:

- **Credit protection (and credit analysis)** in “traditional” non-recourse factoring facilities, in consideration of the client’s payment of factoring commissions (aka discount fees).

  Credit protection is also provided, in lesser degrees, via other modern factoring products as well. See below.

- **Financing for the client** in certain forms of factoring (i.e., advance factoring), by a cash “advance” to the client when the subject accounts are purchased, often at 70-95% of the purchase price;

  **NOTE 1:** In “advance factoring” some factors expressly treat their advances as interest-bearing loans, repayable via set-off against the factor’s obligation to disburse the full purchase price when due. Others treat their advances as non-interest bearing partial prepayments of the purchase price.

  **NOTE 2:** In “maturity factoring” no client financing is provided; rather, the factor pays the full purchase price to the client on [the average] maturity of the subject accounts purchased that month (or for those accounts purchased on the particular schedule/batch);

  **NOTE 3:** In “collection factoring” no client financing is provided; rather, the factor pays the full price to the client at collection of the subject accounts.

- **Billing services** (in certain factoring contracts);
- **Collection services** (in notification factoring and, after default, in non-notification factoring also); and
- **Sales administration** (ledgering purchased accounts and collections thereon)

**NOTE:** Some modern factors also provide **non-factoring services**, such as asset-based loans, letters of credit, purchase order and supply chain finance, etc.
RISKS TRADITIONALLY ASSUMED BY COMMERCIAL FACTORS
Factors traditionally assume ONLY full “credit risk”

Defined, traditionally, as the account debtor’s “financial inability to pay”

- At common-law, del credere factors accepted just ONE risk – full credit risk that a factored account would not timely collect when due. In consideration of the client paying a supplemental del credere commission, 2.5 - 5% or so of the purchase price.
- Del credere commissions came to New York City from the Continent around 1800, imposed by European textile makers.
- “Modern” factoring arose from 1895-1905. Modern factors bought accounts “without recourse” and, as before, assumed full credit risk. If a factored account was not collected at maturity due solely to the “financial inability to pay” of the account debtor (client customer) obligated thereon the factor thereupon paid its client the invoice amount and suffered an associated credit loss (net of the discount fee received, and whatever the factor could later collect from the account debtor). Traditional nonrecourse factors still take this same full credit risk today, under maturity, collection and advance factoring facilities.
- “Financial inability to pay” – is not defined in the case law. But, generally, it looks to the legal or practical inability of the account debtor to pay on a purchased account. “Financial inability” includes an account debtor’s failure to pay due to its:
  1. bankruptcy (voluntary or involuntary);
  2. making an assignment for the benefit of creditors;
  3. being placed in receivership;
  4. foreclosure/seizure of its assets by a secured lender, landlord, tax authority, or other creditor under: (i) a writ of execution; (ii) a writ of attachment; (iii) a levy, or some similar remedy;
  5. being equitable insolvent (in the sense of not being generally able to pay on its accounts when due);
  6. acceptance of a compromise among its creditors;
  7. voluntary liquidation or dissolution;
  8. for governmental account debtors – appointment of a government control board or similar body which freezes payments on accounts, or an inability to pay rooted in a government shutdown or budget freeze, or rooted in a failure to appropriate the necessary funds,
  9. etc.

Note: Balance sheet insolvency is not stated to be “financial inability” as companies whose liabilities exceed their assets, as fair valued, can often keep paying on their debts for quite some time.
Factors “traditionally” assume ONLY full “credit risk”

The effect of accepting full credit risk

1. The principal effect of a nonrecourse factor assuming full credit risk as to purchased accounts is that if a purchased account does not timely collect due solely to assumed credit risk, the account is nonetheless “deemed” to be collected by the nonrecourse factor.

2. Upon “deemed” collection the factor has to make a “balance payment” to its client, “as if” the purchased account(s) had actually collected.

3. For this purpose, the factor’s “balance payment” equals the difference between the purchase price of the subject account(s), less any initial advance(s) thereon, less factoring fees and commissions due.

4. When this “deemed collection” occurs is a matter of contract:

   - Most factoring agreements of the very large old-line factors (Wells Fargo, CIT, Rosenthal & Rosenthal, Capital Business Credit, BB&T, Sterling Factors) state that if a purchased account does not collect within an agreed time, say, 120 days from invoice, the lag is deemed to arise from the financial inability of the account debtor to pay (so is within an assumed risk of “financial inability to pay”). Whereupon the account is deemed collected and the factor makes its balance payment to the client at that time, subject to the factor’s later right to recover the payment if it is subsequently shown that the delay in collection occurred for some reason other than assumed credit risk, such as due to the account debtor disputing the quality or quantity of goods and services delivered to it by the factor’s client. Some smaller nonrecourse factors factor in just this manner also. [Note that four of the “big six” nonrecourse factors today are bank owned, with only Rosenthal & Rosenthal and Capital Business Credit still being privately held.]

   - Other smaller nonrecourse factors and their clients contractually reverse the presumption. They agree that if a purchased account does not collect within the agreed period, say, 120 days from invoice, the delay in collection is “deemed” to arise because the account debtor disputes its obligation to pay on the account, whereupon it is charged-back absent reasonable proof sent by the client to the factor at this time, or within ten days or so thereafter, establishing that either: (1) the account is not disputed and will soon pay (perhaps evidenced by a reaffirmation letter from the account debtor so stating and promising to pay quickly) [in which case the account is not charged-back and the factor’s ownership and full credit risk both continue] or (2) the account did not yet collect due solely to credit risk assumed by the factor [in which case the factor treats the account as “deemed” collected and thereupon makes its balance payment to the client].
Factors traditionally assume ONLY full “credit risk”

Purchasing Accounts with full credit risk creates a “true sale”

• Factors who purchase accounts and accept full credit risk thereon, unlimited by time, assuming their agreement is otherwise consistent with the requirement to find a “true sale” (such as, for example, a stated intent to create a true sale, control over the collected proceeds of the purchased accounts, right to re-sell or pledge the purchased accounts, etc.), can expect the court to recognize the transaction as a “true-sale.”

• See e.g. *American Factoring Law* Ch. 1.IV.B, Ch. 4.II.E.


> “The core of the Factoring Agreement, however, is SunTrust’s purchase from Matrix of ‘certain accounts receivable created by [Matrix’s] sale of goods to….customers approved by’ SunTrust, clearly including Jolie. (See P1.) The purchase and sale of accounts is ‘without recourse to [Matrix] for insolvency or nonpayment, after the goods…have been actually delivered to and finally accepted without claim or dispute by [Matrix’s] customer.’

> All of the evidence points to a sale of the accounts without recourse and SunTrust’s ownership and control of the account.”

The decision also states: “A review of the Factoring Agreement between Matrix and SunTrust Bank reveals a traditional factoring agreement in which ‘the factor acts as the insurer only of its client’s customers’ insolvency…not the quality of its client’s goods. (See Bonnie & Co. Fashions, Inc. v. Bankers Trust Co., 945 F.Supp. 693,700 [S.D.N.Y. 1996]).’” Id. at **9.
Factors traditionally assume ONLY full “credit risk”

SAMPLE language whereby a factor assumes full credit risk [with presumption that delay in collection is rooted solely in the account debtor’s inability to pay]

ALL ACCOUNTS AS THEY ARISE; OLD-LINE FACTORING; ADVANCES TREATED AS LOANS:

1. **Sale of Accounts.** You sell and assign to us, without recourse, as absolute owner, all accounts arising from your sales and delivery of goods and services, including those under any trade names (collectively, the “Accounts”, each individually an “Account”), both those now existing and those hereafter arising.

2. **Credit Risk and Approval**

   2.1 Requests for credit approvals on all orders and deliveries shall be submitted by you to us via computer, by electronic batch transmission or, in the event that is not available, by fax or in writing. All credit decisions by us (including approvals, declines and holds) will be sent to you electronically on a Credit Decisions Report, which report shall be our sole manner of communicating such decisions. Credit approvals will be effective only if shipments are made or services are delivered within thirty (30) days from the completion date set forth in our credit approval. Credit approvals on any Account may be withdrawn by us at any time before delivery is made or services are rendered by you.

   2.2 We will assume the Credit Risk on each Account approved in the Credit Decision Report. “Credit Risk” means the failure of your customer (aka the account debtor) to pay the Account in full when due on its longest maturity solely because of its financial inability to pay. If there is any change in the amount, terms, shipping date or delivery for any shipment of goods or delivery of services (other than accepting returns and granting allowances as permitted hereunder), you must submit a Change In Terms Request to us and, if it pertains to a Factor Risk Account, then we shall advise you in writing of our decision either to retain the Credit Risk or to withdraw our credit approval. Accounts on which we bear the Credit Risk are referred to collectively as “Factor Risk Accounts” and, individually, as a “Factor Risk Account.” Accounts on which you bear some or all of the risk as to credit are referred to collectively as “Client Risk Accounts” and, individually, as a “Client Risk Account.”

   2.3 We shall have no liability to you or any other person for declining, withholding, or withdrawing credit approval. If we decline credit approval on any order or furnish to you any information with respect to the credit standing of any customer you shall hold such information in a confidential manner and agree not to reveal the same to such customer or any of its agents, or any other third party, without our prior written consent.

   2.4 You further agree that we have no obligation to perform, in any respect, any contracts you have relating to the Accounts.

3. **Invoicing.** You agree to place a notice (in form and content acceptable to us) on each invoice or invoice equivalent that the Account has been sold and assigned and is payable only to us, as the owner thereof, and to take all necessary steps so that payments and remittance information are directed directly to us. All invoices or their equivalents will be promptly mailed or transmitted by you [unless the factor wants to mail the invoices itself, as some still do] to your customers at your expense. You will provide us with copies of all invoices or their equivalent (if the invoices are sent electronically), confirmation of the sale of Accounts to us, and proof of shipment or delivery of your goods and services, as we may request from time to time. If you fail to provide such invoices, backup or proofs as we request, we will not bear any Credit Risk as to those Accounts.

M. **Advances** [if applicable]. At your request, and in our sole discretion, we may advance to you on the date of purchase, prior to collection, up to 80% of your Factor Risk Accounts. In addition, we will establish a discretionary line for you of up to $____ outstanding at any time for Ledger Debt (meaning, indebtedness for goods and services purchased by you from any party whose accounts receivable are factored or financed by us). This line will be available provided (a) this Agreement is in full force and effect, without Default and there is no deterioration in your credit worthiness, in our reasonable opinion. We have the right to hold such reserves as we deem necessary as security for these advances and your other indebtedness and Obligations to us, all of which are payable on demand.
Factors traditionally assume ONLY full “credit risk”

SAMPLE contractual language to assume full credit risk, cont’d

N. Purchase of Accounts. We shall purchase the Accounts for the gross amount of the respective invoice, less our discount fees and other factoring charges, trade and cash discounts allowable to, or taken by, your customers, credits, cash on account and any other allowances (the “Purchase Price.”) Our purchase of the Accounts will be reflected on the Statement of Account (as provided for herein) which we render to you, which will also reflect all credits and discounts you make available to your customers.

O. Payment.

O.1 All payments received by us on the Accounts will be promptly applied and credited to your account with us. In exchange for such application, we shall charge your account monthly with the cost of three (3) additional business days on all payments received by us at the interest rate provided in Section ___ below on debit balances. No checks, drafts, or other instruments or payments received by us will constitute final payment of an Account unless and until such items have actually been collected by us.

O.2 The Purchase Price of any Factor Risk Account which remains unpaid will be deemed to be collected by us and will be credited to your account as of the earlier of the following dates:

(a) the date of the Account’s longest maturity, if a proceeding or petition is filed by or against the customer under any state or federal bankruptcy or insolvency law, or if a receiver or trustee is appointed for the customer, or if there occurs some other event of Credit Risk which we assume under this Agreement; or

(b) 120 days after the Account’s longest maturity if such Account remains unpaid and uncollected as of said date without the occurrence of any of the events specified in clause (a) above.

If any Factor Risk Account credited to you is discovered not to have been paid for any reason other than Credit Risk we assume, we shall reverse the credit and charge your account accordingly, and such Account shall thereupon be deemed to be a Client Risk Account.

P. Customer Claims and Chargebacks.

P.1 You must notify us promptly in writing of any matter affecting the value, enforceability or collectibility of any Account and of all Customer Claims. You agree to promptly issue credit memoranda or otherwise adjust the customer’s account upon accepting returns or granting allowances. You agree to send duplicate copies of all invoice credit memoranda to us and to confirm their assignment to us. You may continue to do so until we advise you that all such credits or allowances on Factor Risk Accounts require our prior written approval. We shall cooperate with you in the adjustment of Customer Claims, but we retain the right to adjust Customer Claims on Factor Risk Accounts directly with customers, on such terms and conditions as we in our sole discretion may deem advisable.

P.2 We may at any time chargeback to your account the amount of: (a) any Factor Risk Account which is not paid in full when due for any reason other than Credit Risk assumed by us hereunder; (b) any Factor Risk Account which is not paid in full when due because of an act of God, civil strife, or war; (c) anticipation (interest) deducted by a customer on any Account; (d) Customer Claims and (e) any Client Risk Account which is not paid in full when due for any reason, and (f) any Account for which there is a breach of any representation or warranty made by you to us. We shall also immediately charge any deduction taken by a customer to your account with us. Chargebacks shall not release our security interest in any Account charged-back to you until such account is paid and collected by us in full.
Factors traditionally assume ONLY full “credit risk”

SAMPLE contractual language to assume full credit risk, cont’d

P.3 We may at any time charge to your account the amount of (a) payments we receive on Client Risk Accounts which we are required at any time to turnover or return (including, without limitation, as a result of preference actions brought under Section 547 of the Bankruptcy Code); (b) all remittance expenses (including incoming wire charges, currency conversion fees, and stop payment fees), other than stop payment fees on Factor Risk Accounts; (c) expenses, collection agency fees and attorney’s fees incurred by us in collecting or attempting to collect any Client Risk Accounts or any indebtedness of you to us, including indebtedness arising from our Advances to you and from your other Obligations to us, and (d) our fees for handling collections on Client Risk Accounts which you have asked us to collect for you under our Client Services Agreement.

Q. Handling and Collecting Accounts; Returned Goods.

Q.1 As owner of the Factor Risk Accounts, we have the right to (a) bring suit or otherwise enforce collection, in your name or ours; (b) modify the terms of payment as we see fit; (c) settle, compromise or release, in whole or in part, any amounts owing thereon, as we see fit, and (d) issue credits thereon, in your name or ours, in our discretion. To the extent applicable, you waive any and all claims and defenses of suretyship. If monies are due and owing from a customer on both Factor Risk Accounts and Client Risk Accounts you agree that payments or recoveries [which cannot otherwise be specifically identified] shall be applied first to any Factor Risk Accounts. Any checks, cash, notes, or other documents, proceeds or property received by you with respect to the Accounts shall be held by you in trust for us, separate and apart from your own property, and immediately turned over to us with proper endorsements. We may endorse either your name or ours on any such check, draft, instrument, document or other property.

Q.2 As owners and assignees of the Accounts and all proceeds thereof, upon our written notice you will, at your expense, set aside, mark with our name and hold in trust for us, any and all returned, rejected, reclaimed and repossessed inventory (collectively, “Returned Goods.”). Further, upon such notice, you agree to promptly notify us of all Returned Goods and, at our request, either to deliver the same to us, or to pay us the invoice price therefore, or to sell the same for our account.

Other terms as appropriate including, among other things:

- Grant of Security Interest by the Client to the Factor
- Interest;
- Factoring Fees and Charges;
- Defaults and Default Remedies;
- Termination; and
- various other provisions.

CAUTION: The above is SAMPLE language and comments thereon for illustrative purposes, only. It is not intended to be applicable to any particular situation. This presentation is not intended to give legal advice to participants who should each consult with their respective legal counsel as to all matters discussed in this Webinar.
RISKS NOT ASSUMED BY COMMERCIAL FACTORS
Risks that commercial factors DO NOT accept

Any dilution in purchased accounts other than from credit risk assumed

- No commercial factor accepts risk of, and a commercial factor has “quality recourse” to its client for:
  1. Client diversion of the collected proceeds of purchased accounts;
  2. Client discounting or settlement of a purchased account without the consent of the factor;
  3. Non-payment rooted in disputes raised by an account debtor as to goods and services received from the factor’s client, whether in good faith or otherwise;
  4. Breach of client representations and warranties with respect to any purchased account (or, as to other matters);
  5. Reductions in amounts payable on a purchased account because of allowances granted by the client, discounts granted by the client, returns, performance discounts, recoupments and set-offs;

- Case law is clear that the factor’s retention of “quality recourse” does not hurt “true sale.” See American Factoring Law Ch. 4.II.C, discussing United Virginia Factors Corp. v. Aetna Casualty & Surety Co., 624 F.2d 814 (4th Cir. 1980)
  - Some courts and commentators which do not understand factoring still get this wrong - so, you will need to educate them.

- Full recourse factors accept no “credit risk.” If a purchased account does not timely collect for any reason it is charged-back.
Risks that commercial factors DO NOT accept

Contract language which shifts un-assumed risk back to the factor’s client

Factor’s shift risks which they do not assume back to their client via:

- chargebacks;
- indemnities;
- etc.

SAMPLE chargeback language [in full recourse factoring]:

“In the event that any Purchased Account is not paid and collected within 120 days of invoice for any reason whatsoever, including, without limitation, any defense, counterclaim, recoupment, offset, dispute or other claim (real or merely asserted) arising from or relating to your sale of goods or delivery of services to the account debtor, or arising from or related to any other transaction or occurrence, then in such event Factor shall have the right to chargeback such Account to Seller. Seller acknowledges that all amounts so charged back to Seller’s account under this Agreement create related indebtedness of Seller to Factor for the full uncollected invoice amount thereof, bearing interest at 18% and payable on demand. Chargebacks shall not release Factor’s security interest in the accounts so charged back until the chargeback is paid in full to Factor in good funds.”
Old-line factoring

Is a term rooted in marketplace confusion

- As asset-based lending grew in America in the 1920s and 1930’s, businessmen began to refer to traditional nonrecourse factors as “old line” factors.

- To distinguish them from these newer commercial financiers. A 1943 text states:

  “[i]n the nineteenth century the factor was primarily associated with sales in the United States by foreign textile mills and later assumed a major role in financing domestic mills and in marketing their product. Because of the importance of the import mills in textiles, and particularly because of their roles as selling agents, factors early established themselves in Boston and New York. With the greater growth of New York in importing and merchandising, factoring companies generally centered in that city. The tendency for those companies to locate on Fourth Avenue, in close proximity to one another, has led to their being referred to as ‘Fourth Avenue houses.’ More recently they have been designated as the ‘old-line’ or ‘straight’ factors, in distinction from the newer open accounts financing companies.”

FULL RECURSE FACTORING
Full Recourse Factoring

Full recourse factoring arose to compete with asset based lenders

- Full recourse factors (most of whom are smaller factors today; larger factors also factor on this basis, on occasion) do not assume credit risk of any kind. Meaning, that if a purchased account does not timely collect, for any reason, it can be charged-back to the client.

- While commercial factoring is rooted in the business practices of textile factors in medieval England, “modern” nonrecourse (old-line) factoring arose in New York City between 1895 and 1905.

- Asset based lending secured by accounts came in 1908-1920 (CIT/Heller).

- Full recourse factoring arose in the early 1940’s at James Talcott, Inc., a large old-line factoring company in New York City, as a way to compete with the new asset-based lenders/financiers. In a speech Talcott’s CEO reported:

  “James Talcott, Inc., in 1944, was still primarily an ‘old line factoring’ company; it became in the years that followed the ‘Second World War,’ a firm which reached far out beyond this field into many diverse areas of credit and finance....Mr. Talcott was the first of the old-line factors to make the move directly into the commercial finance field, a move which has since been emulated by many others. Starting in a small way in the early 1940s, when it began to advance money against accounts receivable with recourse to the borrowers, the Company under Mr. Talcott has greatly expanded this commercial finance activity.” American Factoring Law (BNA/Bloomberg 2009), Ch. 1.IV.A.12, pg. 76, quoting a Feb. 8, 1962 speech by Herbert Silverman to the Newcomen Society in North America.
Full Recourse Factoring

Full recourse factoring and nonrecourse old-line factoring distinguished

- No credit risk is assumed in full recourse factoring; and
- Full recourse factoring (at least originally) was done only on a non-notification basis, whereas nonrecourse old-line factoring was done on a notification basis, with account debtors told to pay the factor directly.
- In a 1962 speech, Herbert Silverman, CEO of James Talcott, Inc., distinguished traditional old-line and full recourse factoring as follows:

  “Our business today is conducted in five operating divisions. These are our Factoring, Commercial Finance, Industrial Time Sales, Rediscounting and Leasing Divisions. Each is separately staffed...

  Both our oldest division – the Factoring – and the Commercial Finance Division deal in providing working capital funds. In the former, receivables are purchased outright [naming various industries]. Talcott assumes the credit risk for the sellers and generally buys the accounts with notification to the debtors to pay Talcott directly. If the customer is unable to pay for financial reasons, Talcott assumes the loss.

  Interestingly enough, almost forty percent of our Factoring volume today comes to us from clients who have adequate working capital funds through the establishment of normal lines of credit with their banks. They use Talcott’s services only for the elimination of customer credit risk to themselves; we pay for these receivables at maturity.

  But there is more to our factoring service than this. Our clients also have at their disposal our highly trained staff of experienced credit professionals. These men, experts in their particular trades, with a ready exchange of credit information among their fellows in banks and other factoring institutions at their fingertips, are there with counsel and guidance on matters of credit to our clients at all times....

  Receivables of our clients in the Commercial Finance Division are assigned to Talcott solely for working capital purposes. Although we have available credit advice for these clients, such receivables are acquired by us with recourse to them. In addition, this division’s receivables are taken without notification to the customers.”

Full Recourse Factoring

Full recourse factoring and asset-based lending are distinguished by:

1. the greater level of services (sales/credit administration, ledgering, and billing and collection services) that a full recourse factor provides to its client, as opposed to no such services being delivered to a borrower by its lender in a typical asset-based loan facility (at least prior to default);
2. notification of the account debtors in a full recourse facility, with the factor making direct collection of the accounts (or, at least, otherwise controlling the collected proceeds). Whereas, in an asset-based loan the borrower typically collects the pledged accounts and freely uses the collected proceeds (subject, perhaps, to certain financial covenants) prior to default;
3. the client is sometimes (not always) obligated to “sell” all accounts to its factor in a full recourse factoring facility. Whereas, in asset-based lending the client need not borrow against all eligible receivables collateral, and
4. in form, the full recourse factor “purchases” the subject receivables, subject to a right to chargeback (“put”) the receivables back to the client (which must repurchase them) if a purchased account does not timely collect. Whereas here in America, in form, in an asset-based loan the borrower remains in full ownership of accounts pledged to the lender under the terms of the loan agreement (unless and until the lender forecloses on such accounts, by public sale or by notice to account debtors of default on the loan, with a demand to pay over to the lender).

- The industry has struggled with the distinction for many years. For example, In his book *The Law And Practice of Credit Factoring* (Butterworth’s 1975), Peter Biscoe, presently an appellate judge in Australia, distinguished full recourse factoring and “invoice discounting” (a form of asset-based lending in England) as follows:

“Recourse factoring is a hybrid between old-line factoring and invoice discounting. Which one it bears a closer resemblance to is a moot point. Recourse factoring resembles old-line factoring in that, with the exception of the assumption of credit risk, it has the same functions. However, its non-financial functions – credit control (including collections) and sales ledger administration distinguish it from invoice discounting, as it has traditionally been conducted, that is, as a purely financial facility without the non-financial element. On the other hand, the fact that credit risk remains with the client makes recourse factoring comparable to invoice discounting. If the view is taken, as it generally is in America, that the cardinal ingredient in ‘factoring’ is the assumption of credit risk by the factor, the inevitable conclusion is that “recourse factoring” is a misnomer and that it should be classified as ‘invoice discounting with services’, or the like. Recourse factoring….is entrenched in Canada and in a number of European countries and the general view outside of America is to accept it as a species of factoring.

...Factoring should be carefully distinguished from invoice discounting, which is purely a financial facility without the non-financial elements of factoring. Regrettably, the distinction is blurred and confusion caused by the practice, in some quarters, of calling invoice discounting ‘confidential factoring’ which, as stated earlier, is the form of non-recourse factoring which bears no relation to invoice discounting apart from the common element of non-disclosure to customers…..

In form, an invoice discounting agreement resembles a factoring agreement in that the financier purchases the debt and the client makes much the same warranties concerning their validity and enforceability. However, the similarity goes little further. The main differences are [that in invoice discounting]: (a) the purchase is always with recourse to the client; (b) the notice of assignment is not given to customers, although the financier reserves the right to give notice if he feels his security is imperiled; (c) the client collects the debts as the financier’s agent and remits collections in specie to the financier; (d) the client usually has a discretion as to the frequency of assignments, unlike factoring, where the client is normally obligated to assign all debts – consequently the discounting client can use the facility whenever he chooses, turning it on and off like a tap; (e) the financier provides no non-financial services to the client whatsoever – the arrangement is pure financial.” (Quoted in *American Factoring Law*, 2013 Cumul. Supp. Ch. 1.IV.A.13.a (BNA/Bloomberg 2009)
Full Recourse Factoring

Full recourse factoring and asset-based lending distinguished cont’d

- Even earlier, in 1936, an article in the *Columbia Law Review* [discussing maturity factoring] stated:

  “The factor says he ‘buys’ the account instead of loaning against it as security. But so too does the banker when he discounts a draft and the assignment of accounts to a finance company at least reads like a present sale. The measure of truth in the factor’s statement, however, lies in the extent to which recourse is reserved against his client. The banker takes an indorsement, the finance company an express contract – thus putting the ultimate risk in each case on upon the client – but the factor agrees to take this risk himself. A very broad difference indeed! What has happened is that the ‘del credere contract’ of the factor – spelled out slowly and at great pain and costs by the courts – has been carefully reworded. The ancient argument of whether it constitutes a guaranty of payment or of collection is gone; the factor undertakes to advance the full purchase price of the receivable at maturity, whether the receivable is paid or not, and conversely may ‘charge back’ the entire account at any time prior thereto in the event of a merchandise default.”

  See *American Factoring Law* Ch. 1.IV.B, citing Roscoe T. Steffan & Frederick S. Danzinger, *The Rebirth of the Commercial Factor*, 36 Colum. L. Rev. 745,772 (1936). And, to the same effect, a 1943 finance text:

  “The position of the financing institution depends on whether the open accounts are purchased or taken on assignment as collateral security for an extension of loan credit; and ultimately this distinction depends on whether or not the accounts are taken with or without recourse to the client. The procedure of buying open accounts under a purchase and sale agreement, without recourse for credit losses on the vendor of accounts is recognized as providing the purchaser with unquestioned title to the accounts; it is this procedure which is used by factoring companies. Commercial finance companies doing a non-notification business are divided in their procedure; some take receivables on assignment as collateral against a loan balance but the great bulk of this type of financing is done under the purchase and sale type of agreement. However, the fact that trade debtors are not notified and that collections must be made by the client makes it necessary for the financing institution to have recourse on its client for credit losses on purchased receivables; this fact of recourse has generally led to the transaction being construed by the courts as a loan rather than a purchase.”


- Note that more recently full recourse factoring agreements governed by Texas and Louisiana law are respected as “true sale” if that is the parties’ intent. See *American Factoring Law*, Ch. 4.V.B. Moreover, courts in Arkansas and in certain other places have ruled the same way. *Id.*
As is evident from the foregoing, historically, American courts have found a factor’s assumption of “credit risk” as key evidence which helps distinguish a “true sale” of accounts, on the one hand, from a secured financing agreement (i.e., a secured loan), on the other hand.

However, more recently, full recourse factoring agreements governed by Texas and Louisiana law are respected as a “true sale” if that is the parties’ intent. See American Factoring Law, Ch. 4.V.B.

Moreover, the Arkansas Supreme Court, as well as certain other courts, have also ruled the same way. Id.

American courts today which find full recourse factoring to be a “true sale” of accounts generally have no discussion of their rationale; rather, the full recourse agreement is merely attached to a court order in which the parties stipulate, and the court finds, the deal to be a “true sale.” These courts might:

1. place primary emphasis on the mutual intent of the parties to create a “true sale”;
2. place primary reliance on the transaction being (properly) governed by Texas or Louisiana law;
3. be swayed by the fact that while a recourse factor can, in its discretion, “put” uncollected accounts back to the seller, the client cannot “call” (repurchase) uncollected accounts, at the client’s option, simply by repaying open advances;
4. look, by analogy, to the fact that securities repurchase transactions are, under New York law, treated as “true sales”;
5. find persuasive that in many (not all) countries overseas full recourse factoring is treated as a “true sale,” if that is the parties’ mutual intent;
6. look to the fact that a few other courts (outside LA and TX) have treated even “full recourse” factoring as a “true sale” which passes title.

Or, for a contrary view, misunderstood factoring law, with which they have little experience. Or, relied on counsel to the parties (with the same problem).

The clear “majority rule” in American jurisprudence (outside TX and LA, and maybe AR) is still that full recourse factoring is simply a disguised secured loan.

This said, some of the reasons stated in recent court decisions finding a particular transaction not to be a “true sale” are simply wrong. When, for example, the court refers to the factor’s right to charge-back disputed accounts, or accounts which breach seller warranties, as being evidence against a “true sale.”

See the discussion in Chapter 4 of American Factoring Law (including the 2013 Cumulative Supplement) as to this point.
MODERN FORMS OF FACTORING WHICH REDUCE TRADITIONAL ASSUMED CREDIT RISK
Modern forms of factoring which reduce assumed credit risk

Variant one: agreements which cut-back the traditional definition of credit risk

1. Some factors today reduce assumed “credit risk” by modifying the traditional language which defined “credit risk” in terms of the account debtor’s “financial inability to pay.” And, in this way, contractually assume a narrower range of “credit risk.”

   For example, I have seen factoring agreements which define credit risk to be only:
   - the account debtor’s bankruptcy, alone; or
   - the account debtor’s “insolvency,” alone.

2. Can a factor who limits assumed credit risk in this manner still claim “true sale”?
   - A client or a court might question whether the factor’s assumed credit risk is so small that it justifies being disregarded, as a matter of law, in the “true sale” analysis.
   - However, a factor who limits assumed credit risk in this fashion still has reasonable grounds to argue that it purchased the subject accounts in a “true sale.” Among other things it can argue:
     (i) the parties almost certainly agreed in the factoring agreement that both intended the deal to be a “true sale,”;
     (ii) the parties freely contracted with respect to the degree of credit risk assumed, and the client would have paid higher discount fees had greater credit risk been assumed;
     (iii) the court should not re-write the business deal if the factor, in fact, assumed the full credit risk it agreed to take;
     (iv) even nonrecourse factors limit their credit risk. For example, by taking full credit risk only on large large account debtors relatively unlikely to default (as in a single-customer credit-approved factoring agreement, reverse factoring/supply chain finance and spot factoring transactions, and in other deals.) Everyone is aware “Enron’s” occasionally happen.
     Which is why some clients, to eliminate what might even be a rather low risk, to the factor, still decide to get credit protection by factoring accounts to a nonrecourse factor.
     (v) courts (in a specialty factoring) have respected the factoring of Medicare and Medicaid receivables as a “true-sales” where the risk of non-payment assumed by the factor is rooted in a possible government budget dispute or a shut-down [i.e., very low credit risk but, again, not non-existent; e.g. California Medi-Cal in 2008. See AFL Ch. 5.1.B.1 pg. 410, n.61].
     (vi) if the account debtor in fact goes bankrupt, despite perceived low risk, the client is entitled to its balance payment (which no asset-based lender would, in contrast, be obligated to pay);
     (vii) asset-based lenders, at least on accounts receivable collateral, alone, generally assume NO credit risk whatsoever [recognizing that some real estate loans are nonrecourse]; and
     (viii) there is no fixed maturity date, principal payments, stated interest, etc. which the law typically looks for in order to find a “loan.”
   - Still, there is risk of a contrary result because, among other things:
     (i) there are no judicial decisions I am presently aware of regarding whether or not factoring agreements which limit credit risk by definition this way create a “true sale” or not, and
     (ii) a judge or jury uncomfortable with factoring might be incentivized to re-characterize the deal to treat it as a “more familiar” loan.
Partial nonrecourse factors – accept full credit risk, but, the factoring agreement says, limited by time; e.g., the factoring agreement says the factor accepts the credit risk that a purchased account will not collect within an agreed time (say, 120 days from invoice) due solely to an account debtor’s financial inability to pay occurring within that time. What happens then?

- As a practical matter, a partial nonrecourse factor will generally promptly chargeback to its client, once the agreed period (120 days in this example) lapses, any purchased accounts which did not collect within the agreed period except those which the factor did not collect within this time due solely to credit risk assumed by the factor (which factor-risk accounts, given the factor’s express assumption of credit risk thereon for the first 120 days, will thereupon be “deemed collected” with the factor to make its balance payment to the client thereon).

- However, the partial nonrecourse factor may elect not to immediately charge back particular open accounts which did not collect within the first 120 days other than solely due to reasons of assumed credit risk. Perhaps because either: (1) the client is weak and is not likely able to immediately satisfy the charge-back, or (2) the factor feels that the account debtor remains a good credit risk and expects the open account to collect relatively soon [perhaps with the factor to continue to earning factoring fees until then also, depending on terms of the factoring agreement.] What then?

- One view (and the better one) is that unless and until the partial nonrecourse factor actually charges back uncollected purchased accounts after 120 days time the factor remains the legal owner thereof, even after 120 days. The rationale being that since the factor came into full legal ownership on the first date of purchase (by virtue of the factor being at full credit risk as of that time), the factor should stay in legal title until there is an actual charge-back of the subject accounts after 120 days. Rather than be divested of its legal title and ownership after 120 days by an unexercised right of charge-back.

- An alternative view might be that the business deal was transformed automatically into a secured loan via a “deemed” charge-back, at 120 days from invoice, for all accounts which did not collect by then for reasons other than an assumed event of credit risk occurring within 120 days. However, this competing view would violate the terms of the parties’ agreement if, as is typical, the factoring agreement gives the partial nonrecourse factor the right, but not the obligation, to charge-back purchased accounts which did not collect within 120 days for reasons other than due to assumed credit risk. [Clearly, as noted above, the deal should not be treated as a loan initially, given the factor’s assumption of full credit risk for 120 days time in this example.]

- Which view prevails? American Factoring Law, Ch. 3.XI.E.3 says likely the first. Does the factor’s credit risk continue past 120 days in this example? The contract language says no.

- Most rulings treat partial nonrecourse factoring as a “true sale.” But, the case law is split. See American Factoring Law Ch. 3.XI.E.5; see also AFL Ch. 4.III.B
Modern forms of factoring which reduce assumed credit risk

SAMPLE language for partial nonrecourse factoring

1. **Assignment and Sale of Accounts.** Factor hereby, without recourse, buys and Seller hereby sells, transfers and assigns, all of Seller’s right, title and interest in and to those specific accounts receivable as set forth on the assignment forms provided by Factor (the “Assignments”), together with all rights of action accrued or to accrue thereon, including, without limitation, full power to collect, sue for, compromise, assign, or in any other manner enforce collection thereof in Factor’s name or otherwise. Seller’s accounts receivable and contract rights which are presently or at any time hereafter assigned by Seller and accepted by Factor are collectively referred to as the “Purchased Accounts”, with each being a “Purchased Account.” Factor shall own all right, title and interest to each Purchased Account and the mutual intent of the Parties is that the purchase and sale of such accounts shall be a “true sale” thereof.

2. **Advances.** Upon Factor’s receipt and acceptance of each assignment of Purchased Accounts Factor shall pay to Seller eighty percent (80%) of the Purchase Price thereof (as hereinafter defined), as a partial prepayment of such Purchase Price and not as a loan (the “Down Payment,” variously, the “Advance.”) Anything herein to the contrary notwithstanding, Factor’s uncollected Advances shall at no time exceed $_______ (the “Funding Facility Limit.”)

3. **Discount Fees.** In consideration of Factor’s provision of billing, collection, ledgering and sales administration services to Seller with respect to the Purchased Accounts, and Factor’s acceptance of the Credit Risk thereon from the date of Factor’s purchase thereof until that day which is one hundred and twenty (120) days from the date of the respective invoices, Seller’s purchase shall be at a discount, as follows: for accounts collected by Factor in good funds within thirty (30) days of invoice the discount fee shall be 2.5%; for accounts collected between 31 and 45 days of invoice the discount fee shall be 4.5%; for accounts collected between 46 and 60 days of invoice the discount fee shall be 6.0%; for accounts collected between 61 and 75 days of invoice the discount fee shall be 7.5%; for invoices collected between 76 days and 90 days of invoice the discount fee shall be 9%; for accounts collected between 106 and 120 days of invoice the discount fee shall be 10.5%, and for accounts collected after 120 days from invoice the discount fee shall be 12%.

4. **Reserve.** Factor will hold in reserve the difference between the Purchase Price and the Advance in an unallocated bookkeeping reserve (the “Reserve”). Provided there are no outstanding chargebacks, disputes, or fees and costs due to Factor, Factor will pay the reserve withheld as to each account to Seller on the Friday following the week that such account has been collected in good funds (or deemed collected, as to any Purchased Accounts not collected due solely to Credit Risk assumed by Factor hereunder).

5. **Purchase Price.** The Purchase Price shall be the face value of each Purchased Account, less Factor’s discount fee under paragraph 3, less all returns, credits, allowances, trade and cash discounts, and other sums which Seller’s customers take or are entitled to claim.

6. **No Recourse.** Factor shall have no recourse to Seller if any Purchased Account is not collected by Factor due solely to the occurrence of an event of assumed Credit Risk occurring, as to any Purchased Account, between the date of Factor’s purchase and one hundred and twenty (120) days from the invoice date. For this purpose, Credit Risk means the account debtor’s (variously, a customer’s): (i) bankruptcy, (ii) the appointment of a receiver over all or any part of the assets of Seller; (iii) sale of assets of the account debtor under a writ of execution or if a writ of attachment or execution shall have been returned unsatisfied, (iv) the account debtor shall have absconded; (v) the account debtor’s assets shall have been sold under levy by any taxing authority or landlord or (vi) the account debtor is otherwise financially unable to pay on the subject account.

7. **Chargebacks.** In the event that any Purchased Account is not collected within 120 days of its invoice date for any reason whatsoever (other than solely due to an event of Credit Risk assumed by Factor thereon), including, without limitation, any alleged defense, counterclaim, offset, dispute or other claim, real or merely asserted, whether arising from or related to Seller’s sale of goods and delivery of services, or arising from or related to any other transaction or occurrence, then in any such event Factor shall have the right to chargeback such account to the Seller. All accounts charged back to Seller shall create indebtedness of Seller to Factor in the amount of the uncollected Purchase Price thereof, payable on demand and bearing interest at the rate of 18%. Chargebacks do not release the Factor’s security interest in the accounts charged-back until the chargeback is paid to Factor in full, in good funds.
Modern forms of factoring which reduce assumed credit risk

SAMPLE language for partial nonrecourse factoring

Sample language for partial nonrecourse factoring:

8. **Settlements/Alienation.** As sole owner of the Purchased Accounts Factor shall have the right to settle any dispute with respect to any Purchased Account and to sell or pledge Factor’s interest in the Purchased Accounts, without the consent of Seller. Without limitation thereof, Seller shall advise Factor of any disputes arising with respect to any Purchased Account and Seller may, without the further consent of Factor, settle the same within the following parameters [detail].

9. **Proceeds to be held in Trust.** Seller will hold in trust, as the sole property of Factor, in a segregated manner and not commingled with any other assets of Seller, any collected proceeds of Purchased Accounts received by Seller and Seller shall turn the same over to Factor within one (1) business day of Seller’s receipt of the same.

10. **Notice of Assignment.** All invoices for each Purchased Account shall state clearly, in language acceptable to and pre-approved by Factor, that such Account has been sold and assigned by Seller to, and is payable only to, Factor. Such notice of assignment shall direct the account debtor to make payment thereon only to the following lockbox address: _________.

Representations and Warranties
Covenants
Books and Records
Treatment of Transaction as a sale on Seller’s records for purposes of GAAP and tax
Miscellaneous Terms, etc.
Partial recourse (aka split risk) factoring – here, the factor accepts credit risk but shares it with the client on the purchased accounts. For example, the factoring agreement might:

- Split credit risk 80/20 on all accounts, with the factor bearing 80% of the risk and the client 20% of the risk; or

- Split credit risk only on certain accounts; for example, 50/50 only on purchased accounts for which the account debtor is located overseas; or

- Assumed credit risk might be capped at the amount of the factor’s initial advance [meaning that if a “purchased” account is not timely collected due solely to assumed credit risk, the factor loses its initial advance but is NOT obligated to make a “balance payment”, as when full credit risk is taken].

NOTE: Even nonrecourse factoring agreements of the very large old-line factors today are, in some sense, split risk, in that the Factor will assume full credit risk on credit-approved accounts (“Factor Risk Accounts”) and less or none on others (“Client Risk Accounts.”) The term “split risk” in this outline refers only to accounts where credit risk is split on the particular account.
FACTORING DEFINED
(in American case law)
Factoring Defined (in American case law)

First, a more expansive “traditional” definition:

A relatively sophisticated (and traditional) definition is found in *Desert Beauty, Inc. v. Platinum Funding, Inc.*, 519 F. Supp. 2d 410, 413-414 (S.D.N.Y. 2007):

- “Factoring is a type of accounts receivable financing characterized by ‘the discounting of acceptable accounts receivable on a non-recourse notification basis.’ A factor purchases accounts receivable at a discount from the invoice amount. In return for the right to collect on the invoice and retain the difference between the invoice amount and the discounted purchase price, the factor assumes the ‘credit risk on the accounts, defined as the financial inability of the account debtor to pay.’ The factor typically retains recourse to the account seller in case other risks result in nonpayment, ‘such as the risks of disputes (e.g. nonpayment due to nonconforming goods.’ The size of the discount is related to the factor’s assessment of the overall credit risk on the accounts purchased. As owner of the account, the factor is typically entitled to receive payment directly from the account debtor, and to undertake collection activities.” [Note that here the factor was very sophisticated and bought accounts on a traditional basis, with a principal who was a lawyer].

Key takeaways:

- Refers to the level of credit risk accepted by the factor (here, by referencing a nonrecourse purchase);
- Broad, traditional credit risk accepted (the “financial inability to pay”);
- States there was notification to the account debtor that the factor purchased the accounts, consistent with [but not always required for] a “true sale”;
- Definition correctly notes that the Factor retains “quality” recourse in the event of disputes, etc.

Weaknesses in the definition:

- Does not refer to factoring as involving the purchase and sale of “trade” accounts receivable;
- Suggests there must always be notification to achieve a true sale (non-notification factoring can be a true sale if the factor controls the proceeds via segregated lockboxes then swept, etc.);
- Does not defined assumed credit risk by reference to accounts being uncollectible due “solely” to the financial inability of the account debtor to pay thereon;
- Does not consider factoring agreements governed by Texas and Louisiana law where even “full recourse” factoring agreements can create a “true-sale” if that is the express intent of the parties.
Factoring defined (in American case law)

Second, a very sparse definition from recent case law

A more limited (albeit modern) definition was recently found in *Wisconsin Staffing Services, Inc. v. ARA, Inc.*, Case No. 14-CV-1803, 2015 U.S. Dist. LEXIS 71649 (D. Minn. June 3, 2015):

- “ARA is a “factor,” a business that purchases accounts receivable at a discount in exchange for immediate payment of the discounted amount. The difference between the full value of the account and the discount price is called an ‘administrative fee.’”

Key takeaways:

- Very barebones and not really sophisticated, but at least recognizes that factors purchase accounts at a discount.

NOTE: Your factoring agreement should define the purchase price as the invoice amount, less allowable discounts, etc., LESS the factor’s discount fee/commission. Surprisingly, I have seen many agreements, even today, which fail to subtract the “discount” in defining the factor’s “purchase price.”

Weaknesses of the court’s definition:

- No discussion whatsoever of whether or not this factor assumed credit risk or not, and how, why or if this impacted “true sale”;
- Fails to recognize that factors purchase only “trade” accounts receivable;
- Does not define what “full value” means;
- Most factoring agreements would refer to the difference between full value and the discounted price as being a “discount fee” or a “factoring commission” rather than an “administrative fee.” Moreover, part of the difference might also be things such as trade allowances available to the account debtor, even if not taken; i.e., matters beyond just the discount fee/factoring commission itself.
Factoring defined (in American case law)

Third, from a factoring treatise

The authors of *American Factoring Law* (Bloomberg/BNA 2009) defined factoring as follows:

- “The sale of trade accounts at a discount, where title to the accounts passes to the factor as a matter of law *ab initio* (i.e., in a true sale). Under prevailing U.S. jurisprudence, this generally occurs where a factor purchases accounts without recourse to its client if a purchased account is not timely collected due solely to the bankruptcy, insolvency or other financial inability to pay of the account debtor; in other words, the factor assumes full credit risk. Texas and Louisiana, as a matter of state law, and a minority of courts in other states also recognize accounts purchased by a factor with full recourse as “true sales.” Typically, there is notice to the account debtor of the sale to the factor and a direction to the account debtor to pay the account only to the factor. The terms is also used in the industry to refer to the purchase of accounts at a discount in form, even though the legal characterization of such transactions, other than those governed by Texas or Louisiana law, may be other than a true sale.”

- From Glossary, pg. 794.

Key takeaways:

- “Without recourse” (meaning, the factor accepted credit risk); also, the factor’s broad assumption of that “credit risk” (being the “financial inability to pay.”)
- Recognizes that assumed credit risk is triggered, and factor pays its balance payment to the client, when that is “solely” the reason a purchased account does not collect.
- While noting that most factoring is on a notification basis, uses “typically” to leave room for non-notification factoring transactions in proper form to also create a true-sale;
- Recognizes, by saying that “generally” full credit risk is taken, that lower assumed credit risk, such as, for example, in partial nonrecourse factoring, can also create a true-sale.
- Recognizes that agreements governed by Texas and Louisiana law can create a “true sale” even if there is full recourse, if that is the express intent of the parties, as the law in these two states will support the transaction being recognized as a “true sale” in such circumstances, even if no credit risk at all is assumed, as in full recourse factoring.
- Recognizes that in a “true sale” the factor must be treated by the court as the owner of the purchased accounts, as a matter of law;
- References that factoring involves the purchase and sale of “trade” accounts receivable. [Other forms of commercial finance, such as purchases of credit card receivables, personal injury and workers comp claims, for example, may involve the putative “sale” of these assets to a putative “factor” but are not, properly considered, forms of “factoring.”]
- Recognizes that many financiers, for over 100 years as noted above, describe themselves as “factors” if *in form* they “buy” or “purchase” accounts with full recourse, even if applicable state law might say otherwise (at least outside transactions of this nature governed by TX and LA law).
FACTOR’S OWNERSHIP OF PURCHASED ACCOUNTS, UNDER AMERICAN LAW
Factor’s ownership of accounts under American law

Evidence/Indicia of factor ownership which American courts look to:

- The express stated intent of the parties to accomplish a “true sale” of accounts, by the client to the factor;
- Factor’s assumption of credit risk [and, perhaps, the extent thereof; see discussion above];
- Notice to the underlying account debtors (by factor and/or client) that the factor has purchased and owns the subject accounts, directing payment to be made only to the factor. [Note: the factor can also purchase accounts in a true-sale on a non-notification basis also];
- Factor’s control over the collected proceeds of the purchased accounts [collected by the factor; if not, lock-boxed and not liened or commingled, with a quick sweep over to the factor];
- Factor’s ability to sell or pledge the factor’s interest in the purchased accounts without the consent of its “client,” the seller of accounts;
- Client’s lack of any “equity of redemption,” namely, no right of the client to regain ownership/control of the factored accounts by simply repaying the factor’s open advances [including if the factor’s advances were treated as a partial pre-payment of the factor’s contractual purchase price for the subject accounts, as opposed to be considered a loan];
- Factor’s right to any surplus in collections on the Purchased Accounts, over the factor’s contractual purchase price;
- Treatment of the transaction as a “true sale” of the accounts by all parties for both GAAP and also their federal income tax returns, and on the website of the factor;
- Adequacy of the factor’s purchase price;
- Size of reserves held by the factor and whether or not the factor has the right to unilaterally raise reserves withheld;
- Nature and extent of third party guarantees held by the factor (i.e., Validity Guarantees, or a full Guarantee that includes non-payment due to credit risk)
- Etc.
SUGGESTIONS TO BOLSTER YOUR LIKELIHOOD OF ACHIEVING “TRUE SALE”
Suggestions to bolster the likelihood of a “true sale”

Contract terms which will bolster chances of “true sale”

- State the express intent of the parties to accomplish a “true sale” of accounts, by the client to you, the factor;
- Assume as much credit risk as you can and be sure to state that you buy accounts without recourse (except as otherwise stated);

--- Yes, this requires some good underwriting by you about the risk of account debtor insolvency, challenging, for smaller account debtors. But, it is more manageable than you might think.

- Define “credit risk” very carefully. You have most assurance of a true-sale if it is defined broadly, as the “financial inability to pay”;
- Give notice to the underlying account debtors that you as the factor have purchased and own the subject accounts and direct payment thereon to be made only to you (or as you direct);

- not merely that the facility is a “working capital” facility, or that you have a “security interest” in the accounts [You do, and a “security interest under the UCC includes both the security interest of a factor, as owner of purchased accounts, and the security interest of the factor as lender, as to non-purchased accounts still owned by the client and in any other assets pledged to you by your client as security for the client’s monetary and non-monetary obligations to you under the factoring agreement. But, judges and juries may get confused].
- in a non-notification deal, require that collections be paid only to a segregated lockbox that you control or, if it is in your client’s name, that it has no commingled client-owned assets or proceeds, and have a Deposit Account Control Agreement over it under which the bank waives liens. Be sure the account and proceeds can’t be pledged or liened by the client, and that you sweep collected funds from the lockbox account daily;

- Be cognizant about how you use “collateral.” Under the UCC, the term means property subject to a security interest and includes both (1) accounts purchased by a factor, in its capacity as owner and buyer, as well as (2) non-purchased accounts and other property still owned by the client which have merely been pledged to the factor, in its capacity as lender, as collateral security for the client’s monetary and non-monetary obligations to the factor. Judges and juries can get confused as they will commonly think of “collateral” just in terms of the latter.
- Consider filing two separate UCC-1s, one, as to purchased accounts, marked to show you as buyer, and one as to non-purchased accounts and other assets pledged to you as collateral for the client’s monetary and non-monetary obligations to you under the factoring agreement.
- Keep the express ability to re-sell or pledge your ownership interest in purchased accounts without the consent of your “client,” the seller of accounts;
- Keep control over any settlements of uncollected purchased accounts;
- Be sure your client has no “equity of redemption.” Give the client no contractual right to regain ownership/control of the factored accounts by simply paying your uncollected advances;
- Keep the right to any surplus in collections on the purchased accounts over your contractual purchase price [most likely to be an issue only in certain industries, like healthcare, where the factor’s purchase price is set equal to the estimated net collected value and is less than the face value of the account, due to significant contractual/managed care discounts]
- Treat the transaction as a sale on your books as factor under GAAP, on your federal income tax return, and on your website. And, have your client covenant to treat the deal as a “true sale” as well, both for GAAP and tax;
- If you take a third-party guarantee, limit it to being a Validity Guarantee and expressly carve-out from that guarantee any accounts not collected due solely to credit risk you assume.
- If you treat your advances as loans, state a reasonable interest rate, less than usury rates, say, 18% or less, and cut the discount fees for buying the accounts down to a flat 1-2% or so.
- If you treat your advances as prepayments of the purchase price, consider capping discount fees at 120 days or so. It helps show your advances are not loans (loans bear interest until collected)
- Don’t refer to yourself as a “lender” on your website (unless you are very clear that this refers to advances which are treated as interest bearing loans, only, and not as to accounts you buy)
- Be clear as to how non-purchased accounts and collections thereon (non-factor amounts) are handled;
- Keep track of developments in factoring law and update your factoring agreement accordingly;
- Get good legal counsel, experienced in both factoring and business litigation;
- If you factor without full credit risk, and especially with full recourse, choose Texas or Louisiana law as the governing law if at all possible (see below) and
- Don’t be greedy (hogs get fat, pigs get slaughtered).
Suggestions to bolster the likelihood of a “true sale”

Contract terms which will reduce chances of “true sale”

- Factor accounts on a “full recourse” basis with no credit risk assumed of any kind (except in deals governed by Texas and Louisiana law, and perhaps Arkansas law).

- Include language in your contract which entitles you to recover from the client your legal fees to collect “purchased” accounts. If you bought in a “true sale” this is your cost. Limit this sort of language to the costs of collecting non-purchased accounts.

- Take a full third-party guarantee of collection which covers and extends over even nonpayment due solely to credit risk you assume under the factoring agreement.

- State that representations and warranties about the account debtor not being known (to you) to be bankrupt or insolvent on the purchase date are continuing, beyond the purchase date.

- Include language which says that you, as factor, cannot re-sell or re-pledge the Purchased Accounts in your discretion.

- Fail to state that you are buying accounts “without recourse.” (Unless you intend to be a full recourse factor).

- Do not require your client to represent that it will book the transaction as a sale itself, for both GAAP and tax purposes.
Suggestions to bolster the likelihood of a “true sale”

Contract terms which may, or may not, reduce chances of a “true sale”

- Language which says that, upon default, all uncollected purchased accounts are charged-back.

My present sense is that this language should not extend to those purchased accounts which had not collected physically, when default was declared, due solely to an event of assumed credit occurring prior to that time, but, properly viewed, releases assumed credit risk only as to later events. I say this because assuming such an earlier event of assumed credit risk earlier occurred, prior to the date of the later notice of default under the factoring agreement, the subject account(s) would thereupon have been immediately “deemed” to have collected, in full, as a matter of factoring law [see discussion of balance payments above]. Therefore, as to such accounts, having been so “deemed” to be collected, they should no longer be treated as being “uncollected” accounts when you, as factor, later declared default under the factoring agreement. Meaning, that the later declared event of default did NOT eliminate your assumed credit risk as to events of assumed credit risk occurring prior in time to the date of the default. And, that you will still owe your balance payment to the client as to any such account previously “deemed” collected account in such circumstances, notwithstanding the later default notice. Meaning, I would argue, that properly viewed language of this sort only releases the factor from a later occurring event of credit risk which might occur after notice of the event of default; i.e., operate to relieve assumed credit risk only prospectively. Rather than, as it might first appear, the language operating to relieve credit risks which had already taken place, before notice of default and the associated charge-back of “uncollected” accounts took place. In short, that this language, properly viewed, would not appear to relieve a nonrecourse factor from any such past credit risk. And, not be reason to deny a “true sale.”

This said, a court or jury that does not understand factoring law might be confused and mistakenly think this language eliminates the factor’s assumed credit risk arising from events occurring prior in time and, for that reason, mistakenly think that the language supports finding that the transaction is not a “true sale.”

Moreover, a smattering of judicial decisions suggest that courts do not seem to like this sort of clause. Perhaps because they do not appreciate the points made above. Do you want to incur the risk of the effect being misperceived, and the cost to convince the court of the merits of the argument raised above, that the language is not inconsistent with a true sale?

- Warranties that account debtors, on accounts offered for sale to the factor, to the knowledge of the seller, have never declared bankruptcy and are not, on the date of sale, unable to pay. This warranty should not hurt “true sale”, but only so long as it speaks just to the client’s knowledge on the date the account is first sold to you, alone, and is not a continuing representation that, in effect, no account debtors will ever go bankrupt, post-purchase.

Here, again, however, a few cases suggest that courts are not comfortable with this language, even if the representations are not “continuing.”

- Discount fees which continue to rise until purchased accounts are collected unless, under the business deal, the factor expressly treats its advances as separate loans, at non-usurious interest interest rates. [If the factor’s advances are treated in form as partial prepayments of the purchase price and are not capped, after an outside date, it makes the factor’s initial advances look more like loans and creates greater risks of re-characterization. Whereas if discount fees are fixed and capped, at least after 90-120 days or so, it looks less like a loan because in a loan transaction interest will continue to accrue until the loan is collected, if that collection date is after the date on which discount fees are capped.]

American Factoring Law cites a case, found to be a true-sale, where the factor capped its factoring fee at 15% after 90 days. Perhaps for this reason. See n.179, p. 223, citing Desert Beauty, Inc. v. Platinum Funding Corp., 519 F. Supp. 2d 410, 414 (S.D.N.Y. 2007)

This said, several courts have respected as “true sales” transactions where the factor’s discount fees rise until the purchased account collects without such a cap.
IMPORTANCE OF THE CHOICE OF LAW IN YOUR FACTORING AGREEMENT TO A “TRUE SALE”
Factors who buy accounts on a “full recourse” basis with no credit risk assumed of any kind will generally want to have Louisiana or Texas law govern their factoring agreements, to bolster the likelihood of achieving a “true sale.”

The Uniform Commercial Code of both states has non-uniform language, found in these two states, alone, under which the stated intent of the parties to achieve a “true sale” governs the legal character of the relationship and, in effect, forces a true-sale if that is the stated intent.

Consider also states, Virginia being one example, that set no interest limits on loans to commercial borrowers, of any size.

Look to whether factoring law in the chosen state is well developed (as in New York, for example). And, to what that law says.

That said, the parties’ choice of law must bear a “reasonable relationship” to the transaction or it will not be respected.

- For example, if a factor formed under GA law, with its only office in NC, contracted with a client whose office is in AL, formed under MS law, a court would not likely to respect language in the agreement which says that Texas or Louisiana law governs.

- On the other hand, if a factor formed under LA or TX law also has its sole office in that state, the choice of the law of TX or LA by the parties as the governing law in the factoring agreement would seem likely to be upheld, as a general rule.

Even then, a client, guarantor, account debtor or creditor located or formed in another state might argue that the choice of TX or LA law is contrary to the public policy of another state whose law, but for the parties choice of law, would apply. So, it will be argued, the choice of law should not be enforced. Case law is not uniform but, increasingly, courts will accept the parties’ choice of law even if the transaction would be usurious if the laws of another state, not the chosen state, were to govern.
THE RUBBER MEETS THE ROAD – TREATMENT OF FACTORING AGREEMENTS IN RECENT BANKRUPTCY CASES
## Recent Bankruptcy Cases -- True Sales Developments

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<th>Case No.</th>
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<tr>
<td>14-10833, In re Gridway Energy Holdings, Inc.</td>
<td>Bankr. D. DE</td>
<td>2014</td>
<td>Lender (and factor also) is Vantage Commodities Financial Services I, LLC</td>
<td>N/A; debtor seeks post-petition loan</td>
<td>N/A</td>
<td>Unwind; Term loans portion of facility made to “purchase” receivables factor from itself factored under a pre-petition Receivables Purchase Agreement dated Jan. 11, 2013</td>
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<tr>
<td>13-10027, In re Greenwood Forgings, LLC</td>
<td>Bankr. D. DE</td>
<td>2013</td>
<td>Bridgeport Capital Funding, LLC</td>
<td>N/A; debtor merely seeks to use “lender” cash collateral</td>
<td>NO</td>
<td>Pre-petition Accounts Receivable Purchase and Security Agreement dated July 29, 2010 between Debtor and Bridgeport “purchased” accounts with full recourse; factor stipulated deal was a loan; Alabama law governed</td>
</tr>
<tr>
<td>Case No. 8-09-71715, In re Greystone Staffing, Inc.</td>
<td>Bankr. E.D. N.Y.</td>
<td>Interim Order entered April 22, 2009</td>
<td>Prestige Capital Corporation</td>
<td>Partial Nonrecourse</td>
<td>Apparently YES. No express statement in the Order to the deal being a true-sale. However, the Order says that Debtor can continue to factor with Prestige on the terms and conditions of the pre-petition factoring agreement (which says expressly, in par. 10, that purchased accounts and their proceeds are the sole property of Prestige)</td>
<td>Under Purchase And Sale Agreement accepted March 18, 2004, Prestige has no recourse if a purchased account does not collect within 90 days of invoice due solely to the account debtor’s (i) bankruptcy; (ii) receivership; (iii) being subject to writ of attachment or a writ of execution; (iv) the debtor absconding or (v) being subjected to a levy.</td>
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<tr>
<td>12-27566, In re National Litho, LLC</td>
<td>Bankr. S.D. Fl.</td>
<td>Final Order filed Oct. 3, 2012</td>
<td>ExpoCredit, LLC</td>
<td>Split Risk</td>
<td>Not entirely clear but might be NO as later orders refer to ExpoCredit as the “DIP Lender”, plus no express statement that a “true sale.” Factor granted post-petition lien under 11 USC 364 on “purchased” accounts</td>
<td>Post-petition Factoring Facility dated July, 2012; broad credit risk assumed. Factor has recourse to client on credit-approved accounts only to the extent the amount owing exceeds right to recover for non-payment under Euler Credit Insurance Policy</td>
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<td>15-70120, In re Perfetti Trucking, Inc.</td>
<td>Bankr. W.D. PA</td>
<td>Final Order entered April 8, 2015</td>
<td>JD Factors, LLC</td>
<td>Nonrecourse; flat discount fee of 8%</td>
<td>YES</td>
<td>Debtor-in-Possession Factoring And Security Agreement. Broad definition of credit risk as “financial inability to pay”, bankruptcy or account debtor making an ABC. No recourse to client if nonpayment is solely as a result of any such events</td>
</tr>
<tr>
<td>04-12075, In re U.S. Wireless Data, Inc.</td>
<td>Bankr. D. DE</td>
<td>Final Order entered April 15, 2004</td>
<td>Platinum Funding Corp.,</td>
<td>Nonrecourse; floating discount fees cap at 15%</td>
<td>YES</td>
<td>Accounts purchased on a “batch” basis in factor’s discretion under Post-Petition Factoring Agreement. No Seller recourse other than (i) breach of representations as to accounts or (ii) reduction in amounts paid due to offsets, allowances, discounts, returns, or performance defenses. No express definition of credit risk but assumed within the “no recourse” language as stated</td>
</tr>
<tr>
<td>08-41701, In re Industrial Control Solutions, Inc.</td>
<td>Bankr. D. Mass.</td>
<td>Final Order entered June 26, 2008</td>
<td>Universal Funding Corporation</td>
<td>Full Recourse</td>
<td>NO</td>
<td>Purchase And Assignment Agreement dated effective Jan. 12, 2008; full recourse to chargeback accounts not collected within the longer of (i) 90 days from invoice date or (ii) 60 days from purchase date</td>
</tr>
<tr>
<td>14-24874, In re Cloudeeva, Inc.</td>
<td>Bankr. D. NJ</td>
<td>Final Order entered August 20, 2014</td>
<td>Prestige Capital Corporation</td>
<td>Full Recourse</td>
<td>NO</td>
<td>Purchase And Sale Agreement effective March 13, 2014 allows factor to chargeback all accounts not collected within 90 days of invoice for any reason [Prestige’s usual partial nonrecourse language paragraph omitted]</td>
</tr>
<tr>
<td>10-11728, In re Rock &amp; Republic Enterprises, Inc.</td>
<td>Bankr. S.D.N.Y.</td>
<td>Final Order entered March 26, 2010</td>
<td>CIT</td>
<td>Nonrecourse</td>
<td>YES</td>
<td>Broad definition of Credit Risk assumed, on credit-approved Factor Risk Accounts, as the failure to pay solely because of the account debtor’s financial inability to pay at the account’s longest maturity</td>
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<td>13-27663, In re Numira Biosciences, Inc.</td>
<td>Bankr. D. Utah</td>
<td>Final Order entered August 21, 2013</td>
<td>Porter Capital Corporation</td>
<td>Full Recourse</td>
<td>YES</td>
<td>Recourse Purchase &amp; Security Agreement dated August 29, 2012 gives factor the right to chargeback accounts not collected within 90 days of invoice OR due to an “Insolvency Event” (defined to be nonpayment due to a (i) petition for relief or liquidation under federal or state law or (ii) any failure of an Account Debtor to pay a Purchased Account within 90 days of invoice, so long as such failure to pay was not the result of a dispute.</td>
</tr>
<tr>
<td>11-15696, In re BP Clothing, LLC</td>
<td>Bankr. D. DE</td>
<td>Final Order entered Jan. 5, 2012</td>
<td>FCC, LLC, d/b/a First Capital Western Region</td>
<td>N/A, DIP Factoring Agreement expressly structured as a loan</td>
<td>N/A</td>
<td>FCC, LLC stated to be the “DIP Lender”; post-petition Factoring And Security Agreement dated Dec. 13, 2011 and related documents stated to be the “DIP Loan Documents”; debtor described as the “Borrower”. Liens granted under 11 USC 364 for $10 million facility. Factoring Agreement says that Factor pays if credit-approved accounts do not collect within 120 days due solely to the account debtor’s financial inability to pay, but also says that “Client hereby unconditionally promises to pay all Advances ad all other Obligations” on the earlier of (i) the date the client is no longer a DIP or (ii) June 8, 2012, with advances bearing interest at (i) LIBOR plus 4.75%, as to outstanding pre-petition advances and (ii) LIBOR plus 6.5%, as to post-petition advances</td>
</tr>
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</table>
THANK YOU FOR YOUR PARTICIPATION; THANKS ALSO TO THE IFA