FACTORING RECEIVABLES AND THE TRUE SALE OF THE ASSET
February 4, 2016

Moderator – Harvey Gross
Panelists–Deirdre M. Richards
John Bettex
Richard Simon
Special Guest – Craig McGrain

IN A FACTORING AGREEMENT WHAT IS A TRUE SALE VS. A LOAN

- The huge distinction between factoring and financing of accounts-receivable is that a factor purchases and owns the accounts, but the lender lends against the accounts and is granted a security interest in the accounts. In a lender's situation, the accounts continue to be owned by the debtor, but in a factoring situation, the factoring company purchases and owns the accounts outright. This is the same as if the debtor sold trucks, machinery or equipment.

FINEMAN Krekstein & Harris

- <u>What Facts Make A Transaction Pursuant to A Factoring Agreement More Likely To Be Considered a True Sale</u>: A list from leading authorities in this area:

FINEMAN Krekstein & Harris

INTENT OF THE PARTIES

I argued in a recent case that "All courts hold that the intent of the parties is an element to be weighed in deciding whether a factor's purchase of accounts was a true sale….Thus, a factoring agreement …. where the factor 'purchases' or 'buys' the accounts and the client 'sells' accounts, ***is evidence supporting a true sale***." I learned this from reading a fantastic book called American Factoring Law, by David Tatge and David Flaxman, BNA Books, Arlington, Virginia (2009), p. 340.

FINEMAN Krekstein & Harris

Distinction is Critical. In a bankruptcy case it is all important because a factor that has purchased pre-petition accounts on a "true sale" basis owns the accounts and can continue to collect on the accounts without bankruptcy court approval.

Whereas, a secured lender must seek relief from the automatic stay in order to realize on its collateral and apply the proceeds to its debt." *See* Review of American Factoring Law, by Mary H. Rose, American Bankruptcy Journal, p. 48, October 2011.

Thus, the Bankruptcy Estate cannot use the property that was sold by the Debtor over one year ago and now proclaim that it is part of the Bankruptcy Estate.

FINEMAN Krekstein & Harris

IT IS NONRECOURSE

You're looking at the extent to which the Factor assume the credit risk in the deal. If the Factor assumes all the credit risk, the transaction should be treated as a true sale.

FINEMAN Krekstein & Harris

FACTOR'S RIGHT TO RESELL/PLEDGE THE FACTORED RECEIVABLES

If you've got a loan, the lender doesn't sell the collateral, he'd sell the loan. If you have a sale, the factor can sell what he purchased, *i.e.* the receivables. Thank you David Tatge.

FINEMAN Krekstein & Harris

THE FACTOR'S RIGHT TO CONTROL COLLECTION FROM THE ACCOUNT DEBTORS

This supports a true sale because the factor as a purchaser can collect money for the accounts which he purchased.

FINEMAN Krekstein & Harris

NOTICE OF THE SALE OF ACCOUNTS TO ACCOUNT DEBTORS

This is related to the intent of the parties and shows that the parties intended a true sale because they intended that the factor would put the account debtors on notice to pay the factor.

FINEMAN Krekstein & Harris

WHAT ARE THE IMPLICATIONS OF A TRUE SALE VS. A LOAN

A purchase pursuant to a true sale in a nonrecourse agreement makes sure the accounts are not property of the bankruptcy estate of the seller upon bankruptcy.

Although the Bankruptcy Code creates a bankruptcy estate that includes all legal and equitable interests of the debtor in property as of the commencement of the bankruptcy case, the United States Supreme Court has ruled that courts generally look to nonbankruptcy law in order to determine whether and to what extent property of the debtor exists. Butner v. United States, 440 US 48, 59 (1979).

FINEMAN Krekstein & Harris

HYPOTHETICAL FACT SITUATION – THE PROS AND CONS OF A FACTORING AGREEMENT

FINEMAN
Krekstein
& Harris

COMPANY is a sales and use tax consulting firm that audits tax returns and assists clients in defending tax audits.

FINEMAN
Krekstein
& Harris

2011

BANK has a lien on all of **COMPANY's** assets. **BANK** files a financing statement for a lien on all of the assets, including the accounts of **COMPANY**.

FINEMAN Krekstein & Harris

2012

BANK realizes that **COMPANY** is defaulting on its loan(s) and introduces **COMPANY** to **FACTOR**. **FACTOR** enters into a NonRecourse Purchase Contract and Security Agreement ("Purchase Agreement") with **COMPANY** in July 2012. The Purchase Agreement between **FACTOR** and **COMPANY** is a typical agreement for a Nonrecourse factor wherein **FACTOR** purchases **COMPANY'S** accounts receivable.

FINEMAN Krekstein & Harris

THE TERMS OF THE PURCHASE AGREEMENT

"Upon purchase, FACTOR will assume the risk of non-payment on Purchased Accounts so long as the cause of non-payment is solely due to the occurrence of an account debtor's financial inability to pay."

COMPANY and **FACTOR** intended that the Purchase Agreement evidenced a true sale and that the term of the Purchase Agreement is twenty-four months.

COMPANY is referenced as "Seller" or "Client" and **FACTOR** is referenced as "Purchaser."

FINEMAN Krekstein & Harris

The stated purpose of the agreement is that Client desires to obtain a true nonrecourse sale of its accounts receivable to Purchaser.

"Account" is defined as "an account offered by Client to Purchaser for sale, which account Purchaser has reviewed and has, in its sole discretion; approved for purchaser in whole or in part."

FINEMAN Krekstein & Harris

If COMPANY receives proceeds from account debtors, COMPANY must hold the proceeds from the factored accounts “in trust and safekeeping.”

FINEMAN
Krekstein
& Harris

FACTOR may demand payment directly from the account debtor.

The Advance Rate is 75%

FINEMAN
Krekstein
& Harris

Other than payment default, the Factor can put back for any and all reasons, including over 90 days .

FINEMAN Krekstein & Harris

BANK reviews the Purchase Agreement prior to allowing **COMPANY** to enter the deal with **FACTOR**. **BANK** interlineates the Purchase Agreement mostly by adding the words "Purchased Accounts" when referring to the Accounts which **FACTOR** is agreeing to purchase. For example, **BANK** changed the definition of Account to read: "Account" is defined as "an account offered by Client to Purchaser for sale, which *"Purchased Account"* Purchaser has reviewed and has, in its sole discretion; approved for purchaser in whole or in part."

FINEMAN Krekstein & Harris

BANK also added a paragraph stating that "**FACTOR** acknowledges that **BANK** has a first and prior lien on all Collateral, including Accounts (other than Purchased Accounts) and Borrower shall not offer to **FACTOR** any Account for purchase without **BANK's** prior written consent to release its secured lien on such account, if the account is acceptable to **FACTOR.**"

FINEMAN Krekstein & Harris

BANK did not change the twenty-four month term of the Purchase Agreement. **BANK** did not change the definition of Account other than to indicate that the definition of Account meant "Purchased Accounts."

FINEMAN Krekstein & Harris

FACTOR reviews **BANK's** comments and because it knew that **BANK** had a prior lien on **COMPANY's** collateral was going to walk away from the deal unless **BANK** signed a subordination agreement ("Subordination Agreement").

FINEMAN Krekstein & Harris

The Terms of the Subordination Agreement

FINEMAN
Krekstein
& Harris

"**BANK** and **FACTOR** agree that **FACTOR** can purchase certain accounts receivable from **COMPANY** pursuant to the Purchase Agreement, which **BANK** has reviewed and commented upon prior to this agreement (the "Purchased Accounts").

BANK acknowledges and agrees to release the Purchased Accounts from its security interest, and acknowledges its consent to **FACTOR** placing a subordinate lien on **COMPANY's** assets.

BANK further agrees that it will not interfere with **FACTOR's** efforts to collect the Purchased Accounts."

FINEMAN Krekstein & Harris

BANK and **FACTOR** execute the Subordination Agreement.

FINEMAN Krekstein & Harris

FACTOR executes the Purchase Agreement with **COMPANY**, and the transaction closes with **FACTOR** paying money to **BANK** for past due interest payment and legal fees to cover **BANK's** legal bills for its outside counsel.

FACTOR files a UCC Financing Statement.

FINEMAN Krekstein & Harris

2013

COMPANY continued in furtherance of the Purchase Agreement to sell and assign certain accounts to **FACTOR** in at least three (3) Addendums which it executed and sent to **FACTOR**.

The Addenda each state that it is between **FACTOR** and **COMPANY** and "is made a part of and supplements the Purchase Agreement." Each Addenda also states that "In consideration of the purchase price set forth below, Seller hereby sells and assigns to Purchaser the following described accounts."

FINEMAN Krekstein & Harris

2014

FACTOR sends the account debtors notice under UCC 9-406 to pay **FACTOR** and not to pay **COMPANY.**

BANK sends **FACTOR** a letter stating that **BANK** has a first lien on all the assets and **FACTOR** must cease and desist.

FINEMAN Krekstein & Harris

2015

COMPANY files a bankruptcy case under Chapter 11 of the Bankruptcy Code.

FINEMAN Krekstein & Harris

COMPANY files an emergency motion to use Cash Collateral.

FACTOR is not properly noticed, and does not file an objection to the language in the proposed Cash Collateral Order. In fact, the language in the original proposed order may not have been problematic.

FINEMAN Krekstein & Harris

BANK and **COMPANY** attend the emergency hearing and obtain approval of the use of Cash Collateral.

However, **BANK** and **COMPANY** inform the court that **BANK** has a first lien on **COMPANY's** assets and that includes accounts, and that there is a lienholder named **FACTOR** who is trying to take **BANK's** collateral.

FINEMAN Krekstein & Harris

After the hearing **COMPANY** and **BANK** propose a new proposed order to the court which states that – –

"any person, company or other legal entity that is obligated to make a payment to the Debtor for services provided by the Debtor prior to February 13, 2015 (Prepetition Account Debtor") is directed to submit any and all payments on account of such prepetition obligation ("Prepetition Account Payable") directly to the Debtor, and not to any of the secured parties pending further Order of this Court…"

FINEMAN Krekstein & Harris

FACTOR files a Motion to Reconsider the Interim Cash Collateral Order, which is denied.

FACTOR files an Objection to Final Cash Collateral.

FINEMAN Krekstein & Harris

During **COMPANY's** bankruptcy case, account debtors from the July 2012 Purchase Agreement pay **COMPANY** and do not pay **FACTOR**.

FINEMAN Krekstein & Harris

After a deposition taken of **BANK,** it cannot point to a written consent by **BANK** to the initial factoring by **FACTOR.**

At trial, **BANK** also cannot point to a written consent to the initial factoring of the two invoices by **FACTOR.**

FINEMAN Krekstein & Harris

You are before the bankruptcy court and the bankruptcy court has just ordered (at the Debtor's and the bank's request, and unbeknownst to the factor) as part of the cash collateral order that the account debtors must pay the Debtor, not the factor.

FINEMAN Krekstein & Harris

HOW THE BANKRUPTCY COURT RULED ON THE FACTOR'S OBJECTION TO THE FINAL CASH COLLATERAL ORDER IN --

IN RE: DRYDEN ADVISORY GROUP, LLC

FINEMAN Krekstein & Harris

After two days of trial, Judge France from the Middle District of Bankruptcy Court ruled that the Non-Recourse Purchase Agreement was a true sale of receivables and should NOT be recharacterized as a financing agreement.

FINEMAN Krekstein & Harris

She also ordered that the accounts transferred by the Debtor to the factor more than 90 days before the filing of the bankruptcy petition are not Property of the Estate under Bankruptcy Code Section 541(a).

The Court also ruled that the Court lacks subject matter jurisdiction under 11 U.S.C. Section 1334 to determine the relative rights of the Banks and the Factor in the transferred accounts.

FINEMAN Krekstein & Harris

What did the Court look at to make its ruling?

"SALE"

The fact that the Agreement described the transaction as a sale.

However, she also said during the hearings that what the parties called the deal was not the only thing she would look at.

Considering that the Agreement was flooded with the words SALE she couldn't really ignore this.

FINEMAN Krekstein & Harris

"TRUST"

The fact that the Agreement made it clear that the Debtor was required to hold proceeds of the factored accounts, if an account debtor paid the Debtor, in trust and safekeeping such that the proceeds from the account debtors would not be commingled with the Debtor's assets.

FINEMAN Krekstein & Harris

FACTOR'S DEMAND DIRECTLY FROM ACCOUNT DEBTORS

The judge looked at the fact that the Agreement provided the factor with the ability to demand payment directly from the account debtors.

FINEMAN Krekstein & Harris

FACTOR ABSORBED RISK OF NON PAYMENT

The Agreement stated that the factor had the risk that the account debtor's would not pay (Non-Recourse), but the Debtor had the risk that the account debtors had a defense to payment.

FINEMAN Krekstein & Harris