

Caribbean Regional Capacity Building Workshop on Factoring/ Receivable Discounting

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Caribbean Regional Capacity Building Workshop on Factoring/ Receivable Discounting:

Regional Legal Issues

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Factoring – Old Definition

- “...a continuing arrangement between a *factoring* concern and the seller of goods or services on open account, pursuant to which a factor performs the following services with respect to the accounts receivable arising from sales of such goods and services:

Factoring – Old Definition

- Purchases all accounts receivable for immediate cash.
- Maintains the ledgers and performs other bookkeeping duties relating to such accounts receivable.
- Collects the accounts receivable.
- Assumes the losses which may arise from the customer's financial inability to pay (credit losses)."

Factoring – Old Definition

Carroll G. Moore, ' Factoring – A unique and Important Form of Financing and Service',
The Business Lawyer (1959) Vol. XIV, No. 3

Factoring - Modern Definition

- “The purchase of debts (other than debts incurred for goods or services purchased by a debtor for his personal, family, or domestic use and debts payable on long terms or by installments) for the purpose of providing finance, or relieving the seller from administrative tasks, or from bad debts, or for any or all of such purposes.”

Freddy Salinger, *The Law and Practice of Invoice Financing*, Third Edition, UK

Advantages of Factoring

- Reduction of fixed cost overhead of staff and physical facilities.
- Conversion of expenses of credit, collection, and bookkeeping to variable expenses tied to sales.
- Availability of the expertise of competent and experienced personnel on an as needed basis.

Advantages of Factoring

- Improvement of financial ratios such as cash flow from operations, debt to equity, days sales outstanding, return on equity, return on assets, and earnings per share.
- Supporting growth without added debt or equity.
- Taking advantage of supplier discounts.

Advantages of Factoring

- Meeting inventory demands.
- Funding acquisitions or buyouts.
- Capitalizing on large opportunities.
- Meeting seasonal funding needs.
- Maintaining or improving credit ratings.
- Transferring credit risk.
- Ability to offer extended credit terms to customers.
- Collection services.

Advantages of Factoring

- Detailed management reports.
- Access to e-commerce and state of the art technology.
- Private labeling capabilities.
- In country presence.
- Local/industry knowledge
- Enhanced cash flow.
- No compensating balances required.

Types of Factoring Agreements

- Recourse and non-recourse factoring agreements
- Agreements for factoring with or without recourse to debtors
- Agreements for factoring with direct collection by factor or collection by client on behalf of factor
- Agreements which include or do not include the availability of finance by way of early payment by the factor
- Agreements whereby the factor pays for each purchased debt (less any earlier payments) on a fixed maturity date or when payment is received from debtor

Types of Factoring Agreements

- Agreements which themselves provide for assignment of debts or which provide for each debt to be offered to eth factor

Areas of Concern

Ambiguity

- As many factoring agreements combine features of some of or all of these differences, there are a large number of combinations and permutations in the forms of factoring offered by practitioners. The difficulty in the task of describing these different forms briefly is compounded by the absence of uniformity among practitioners in eth labels used for the same type of factoring and the provision by different practitioners of different types under the same labels.

Areas of Concern

- Lack of Regulation

The industry is not formally regulated which can be a good and bad thing

- Tax implications not as clear where ownership of assets passes to Factor (eg. factoring of taxable receipts or the creation of tax-deductible expenses in return for a lump sum that is not taxed as income)

Factoring Agreements

- Agreements are generally comprised of the following major components:
 - Definitions
 - Mechanics of Loans, assignment or advance etc.
 - Conditions Precedent
 - Representations and Warranties
 - Covenants
 - Events of Default
 - Assignment

Who is the Exporter?

- Prior to commencing drafting a factoring agreement, various fundamental structuring issues must be resolved.
 - Perhaps the most fundamental issue is the identity of the Exporter/Exporter
 - Is it a sole trader/ company or partnership?
 - It is often said that the best practice is to lend directly to the entity that will make use of the proceeds of the loan or to lend to the entity that owns a significant portion of the group's "hard" assets.
- This is an real issue in recourse factoring agreements

Terms- Factoring Agreement

- The sections in the factoring agreement that deal with the mechanics set forth the basic financial terms of the transaction:
 - Amount of the commitments
 - The availability period
 - Commitment fee and other applicable fees
 - Computation methods and interest payment dates, if any
 - Payment schedule and final maturity
 - Reduction or termination of commitments
 - Optional prepayments and mandatory prepayments (if any)
 - Increased cost protections

Terms - Factoring Agreement

- Conversion or sharing two factor system in different jurisdictions (i.e., base rate to LIBOR)
- Tax Gross-up Provisions
- Ratable Payment Provisions
- Two factor arrangement and payment terms
- Upon its effectiveness, the factoring agreement represents a legally binding obligation of the factor to make advances to the exporter in accordance with its terms.
 - As a result, the Factor may be liable to the Exporter for damages if they wrongfully refuse to advance funds.

Conditions Precedent

- Therefore, each credit agreement sets forth the conditions that the Exporter must satisfy prior to the Factor's general obligation to lend money becomes effective.
 - If any one of the conditions is not satisfied, the Factors have the legal right to refuse to make advances.

Conditions Precedent

- Typical conditions precedent include:
 - Completion of, and satisfaction with, the Factor's due diligence investigation
 - Absence of a material adverse change
 - Absence of material litigation
 - Confirmation that the facts known to Factors prior to their commitment remain true and correct in all material respects.
 - No new information has become available that is inconsistent in any material respect with the pre-commitment information or that is reasonably likely to have a Material Adverse Effect

Conditions Precedent

- Receipt of all governmental approvals and third party consents
- Receipt of promissory notes, customary corporate documentation and legal opinions
- Payment of fees and expenses of the Agent and the Factors

Representations

- Representations should be tailored to cover any matters that form the basis of the Factors' credit decision.
 - For example, if the business of the Exporter is dependent on a particular contract or government permit, a representation concerning that contract or permit should be included.
- Standard representations include the following:
 - Existence, qualification and power.
 - Corporate authorization, no violation of law, contracts or organizational documents and no governmental authorizations and third party approvals or consents.
 - Binding effect.
 - Financial statements and no material adverse effect.
 - No material litigation.
 - No Default.

Representations

- Insurance matters- credit insurance.
- Valid ownership of property and assets, free of liens.
- Tax matters.
- Subsidiaries and equity interests.
- Accuracy of disclosure.
- Perfection of any security interests.
- Intellectual Property matters.

Representations

- There is legal authority which holds that a contract which interferes with or causes a default under an existing contract may not be enforced or may subject the Factors to claims for tortious interference with contract; a party seeking to enforce such an “interfering contract” (like another provider of credit) may have to prove that it had no knowledge of the existing contract or that its absence of knowledge is not based on a willful refusal to ascertain the facts.

Representations

- Financial Statements and No Material Adverse Effect:
 - Representation as to accuracy of the financial statements upon which the Factors based their original credit judgment to extend credit.
 - Also contains the representation that there has been no material adverse change since a specified date (usually the date of the audited financials referred to in the representation).
 - Whether or not a material adverse change has occurred is subjective and depends on the relevant facts and circumstances.

Representations

- The Factor's decision not to fund as a result of a material adverse change, depending on the facts, could expose them to the risk that a court would find their refusal inconsistent with the implied duties of good faith and fair dealing and hold them liable for substantial damages.
- Despite the foregoing, because of the difficulty of foreseeing and defining all possible material adverse developments, this representation remains valuable, if applied with care.

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Representations

- No Material Litigation:
 - Requires the Exporter to confirm the absence of pending or threatened legal proceedings that affect the lending transaction or that can be expected to have a material adverse effect.
 - If the Exporter has disclosed certain material litigation prior to the closing and the Factors have agreed that such disclosed material litigation does not relieve them of the obligation to fund, the representation should also provide that there has been no adverse change in the status, or the financial effect on the Exporter, of such disclosed material litigation from that described to the Factors prior to closing.
 - The litigation representation refers to potential consequences of litigation because of the difficulty of predicting outcomes; therefore, the Exporter has the right to evaluate the likely outcome of a lawsuit and can make this representation if, in its reasonable judgment, it determines that the litigation will be won by the Exporter or will result only in immaterial damages.

Covenants

- Affirmative Covenants generally apply to the Exporter and all of its subsidiaries and generally include:
 - Compliance with laws
 - Payment of Taxes, VAT
 - Compliance with environmental laws
 - Maintenance of Insurance
 - Preservation of Corporate Existence
 - Visitation Rights
 - Keeping of Books
 - Maintenance of Properties
 - Transactions with Affiliates
 - Preparation of environmental reports
 - Reporting Requirements

Negative Covenants

- Negative Covenants generally apply to the Exporter and all of its subsidiaries (although the Exporter may attempt to negotiate a subset of subsidiaries to whom the negative covenants will apply). Negative covenants generally include restrictions on:
 - Liens
 - Debt
 - Mergers, etc.
 - Sales of Assets
 - Investments
 - Dividends, etc.
 - Change in Nature of Business
 - Accounting Charges
 - Speculative Transactions

Assignment Issues

- **Stamp Duty**
- The need to avoid the risk of the incidence of Stamp Duty has long been a significant inconvenience to the factoring and discounting industries.

Assignment Issues

- The importance of a legal rather than equitable assignment
- Vesting debts - when does the debt arise?
- Non-vesting debts and the prohibition against assignment
- The effect of notice to the debtor

Enforcement against the Exporter and Sureties

- The distinction between warranties, guarantees, indemnities and hybrids securities
- Recent cases on conclusive evidence clauses
- Conflicts with third parties, including priority disputes with competing assignees

Fraud and Asset Recovery

- Classic frauds faced by invoice financiers
- Proving damage
- The meaning and effect of the trust provisions
- When to rely upon the remedies of dishonest assistance and knowing receipt
- Proprietary remedies and tracing in insolvency
- Freezing injunctions and search orders

THANK YOU



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