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In many asset-based loan facilities provided to service oriented businesses, it is often the case that the primary (if not the only) collateral, and the primary source of loan repayment, are the receivables generated by the borrower's business. With respect to most of these credit facilities, there is no real property, no valuable intellectual property and, when dealing with a service oriented business, no inventory, equipment or other tangible personal property of real value which the lender can consider as security for its loans. The lender relies primarily on the accounts receivable generated by the borrower's business, which comes with some risk. There are many ways in which a lender can protect itself and minimize its risk when lending against accounts receivable, including (i) limiting borrowings to a percentage of eligible receivables, (ii) conducting customer reviews and requiring completed customer surveys, (iii) performing billing practice analyses and (iv) lending strictly against only those accounts receivable which meet certain eligibility criteria to be included within a borrowing base. The primary focus of this article will be on the eligibility standards and criteria most commonly used by lenders for lending against a borrower's accounts receivable.

The borrowing base and, in particular, advance rate limitations, provide a basic level of protection (and a collateral cushion) for lenders providing working capital and other asset-based loans secured by accounts receivable. After performing audits and conducting other due diligence (some of which were noted in clauses (ii) and (iii) above), a lender will determine the appropriate percentage for eligible receivables that it will lend against, almost always containing a cushion to address the inevitable fact that some receivables never get paid (or otherwise become uncollectable). Lenders who routinely lend to government contractors recognize that, at least historically, there is diminished risk of non-payment with respect to receivables owing from the government (although the level of government, i.e., federal, state or local, is a consideration in making such an analysis). For that reason, the advance rate for eligible government receivables is typically high (around 90-95%). The borrowing base percentage typically decreases significantly for general commercial receivables (normally around 75-80%), as the creditworthiness of a typical commercial customer is far less than that of the government. That, of course, may not always be the case, depending on the account debtor customer, but that is why audits, customer interviews, and contract due diligence exercises are very important undertakings prior to determining borrowing base percentages.

Although the borrowing base provides a cushion for the lender between the collateral value and the maximum borrowing capacity, this cushion will not have significant meaning if the underlying receivables do not have the intrinsic value on which the

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lender is basing its loans. A key component of any receivables financing is determining the eligibility of receivables and creating an extensive definition of the types of receivables that are deemed ineligible. Although credit agreements often provide lenders with flexibility and discretion to deem a receivable ineligible, lenders still need to be reasonable in exercising discretion (absent reserving the right to exercise its sole discretion). It is important to have a solid, objective baseline for determining eligibility within a credit agreement, to avoid disputes between the lender and the borrower over the collectability of a receivable or the reasonableness of the exercise of a lender's discretion.

A number of eligibility factors are the product of common sense. For example, a lender would not want to lend against a receivable owing from an account debtor who is bankrupt or insolvent, or if the receivable is generated from work or a product that violates applicable law, or if the receivable is the subject of a dispute, credit, adjustment, defense or counterclaim. Other eligibility factors, however, are less obvious.

Most lenders will declare ineligible any receivables for which the lender does not have a first priority security interest, or for which there may be barriers to collection. As a result, certain specified receivables, such as bonded receivables (subject to a first priority lien in favor of the surety) and receivables owing from foreign account debtors, are normally considered ineligible. Without a first priority lien, the lender has little comfort that exercising its remedies against collateral will enable it to collect all (or any) amounts owing with respect to such receivables. There are numerous risks relating to non-payment from a foreign account debtor, including currency fluctuations, and the inability to sue for non-payment due to international law and cross-border issues. A borrower with significant foreign receivables can eliminate this eligibility exception by obtaining credit support for those receivables in the form of an irrevocable letter of credit or other credit insurance satisfactory to the lender.

Should lenders allow borrowings against final invoices (i.e., the last invoice to be issued for contract work)? The eligibility of final invoices is very often the subject of dispute when negotiating credit agreements. It is typically the case that prior to payment of a final invoice, the account debtor will need some final contract approval. That creates increased risk of non-payment, as the required approval may be delayed, or may not come at all, rendering final invoice receivables less collectable. Similarly, with "at-risk" receivables, the borrower is doing work for which funding has not yet been approved or properly appropriated. A lender should carefully consider whether to take the risk of advancing funds based upon "at-risk" receivables given the inherent risk of their payment never being approved, making those receivables worthless.

Other typical eligibility carveouts include "contra-accounts" and receivables owing from affiliates. Contra-accounts, where the borrower is the account debtor under one contract and the customer under another related contract, are risky for the lender. When the borrower is both buyer and seller of a product or service (typically through a subsidiary or affiliate), there is significant risk that in lieu of paying amounts owing to the borrower, the affiliated account debtor will simply set off amounts owing to the borrower against amounts owing to such affiliated party. The lender will derive no benefit from an offset of a liability that the lender does not owe, and therefore the lender's inability to recover cash in the event it exercises its remedies against collateral is a problem for the lender. Affiliate receivables are typically attributed a lower value for several reasons. For example, when financial times are hard

(including in the event of a bankruptcy), the financial performance of the affiliate will likely be tied to the financial performance of the borrower, so the probability of payment from the affiliate will likely be the same as the probability of payment from your borrower. Additionally, there are fewer market controls on write-offs, forgiveness of debt, or penalties for the non-payment of receivables owing from or to a related party.

Lenders making asset-based loans need to very closely monitor their borrower's receivables and the customers who are responsible for honoring such receivables. If a customer has a long history of non-payment or slow payment, the lender should avoid funding against such uncollectable assets. A lender may impose reserves against certain receivables, or may, from the outset, deem as ineligible all of the receivables owing from a particular customer. Note that in the context of government contracts, since the customer can be broadly characterized as "the government", these evaluations are typically done on a contract by contract basis, rather than on an account debtor basis. If a certain percentage (typically 50% or more) of such customer's receivables are past due or otherwise deemed ineligible, this is often referred to as cross-aging when the ineligibility is based upon existing receivables being past due. If more than 50% of a customer's receivables are late or otherwise are uncollectable, the lender will not want to lend against the newer receivables, as the likelihood of those new receivables remaining unpaid is increased based upon the customer's payment history. From a credit risk standpoint, a lender has increased risk if too much of the borrower's receivables are concentrated with one or two large customers. Lenders prefer not to "put all of their eggs in one basket", wanting to spread the risk of non-payment. Therefore, a lender will typically deem as ineligible those receivables from a single (or a few) account debtors who comprise more than a specified percentage of the borrower's total receivables (known as a concentration limit).

Due to the unique nature of government contractor financing, when drafting loan documents, we recommend that lenders reserve the right to declare ALL receivables owing from the government to be ineligible, when a borrower has been debarred or suspended (or has been issued a notice of proposed debarment or suspension), or when a contract has been terminated for fraud or other criminal wrongdoing (or even if the borrower is the subject of an investigation involving allegations of fraud or other criminal wrongdoing). A debarment or suspension, or termination of a contract for fraud or other criminal wrongdoing, could have a profound effect on the borrower's ability to do business with, or collect from, the government, so the lender must be given broad flexibility in those situations to prevent it from being forced to lend against receivables which may ultimately prove to be worthless.

While a number of the aforementioned factors can be problematic for any lender, a properly documented and adequately monitored receivables – based credit facility will generally be repaid without issue after proper underwriting and analysis of the risk associated with the operating business and guidance from competent, experienced legal counsel.

If you would like further information on this topic, or would like to discuss receivables based financing generally, please do not hesitate to contact us.



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