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Trade Receivables Finance Update

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Speakers

David Ciancuillo practices banking law, with an emphasis on securitization, asset-based lending, trade and supply chain finance and other structured finance products. He regularly represents banks, borrowers, investment vehicles and other finance companies in various transactions, including: asset-based lending facilities; subscription facilities; securities offerings; and the purchase and financing of trade receivables, student loans, mortgages, equipment and automobile loans, insurance related products and a variety of other assets.

David has a great deal of experience in reviewing, negotiating and helping clients to create complex financing, refinancing, cross-border and investment programs designed to address a wide variety of legal issues and strategic goals, including matters relating to secured lending; global trade and supply chain finance; insurance related products; and accounting and regulatory matters.

Massimo Capretta is counsel in Mayer Brown's Chicago office and a member of the Banking & Finance practice. Massimo's transactional practice focuses on representing both financial institutions and companies across a broad spectrum of domestic and international financing transactions.

Massimo has particular experience with domestic and cross-border trade receivables securitization, asset-based finance, factoring, supply chain/vendor finance, trade finance and other receivables monetization strategies. He regularly advises clients on the creation and management of bespoke receivables finance transactions.

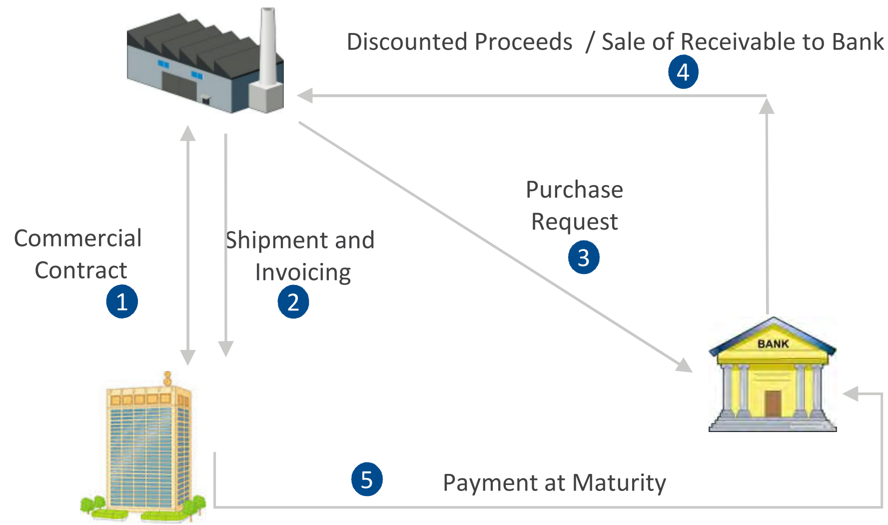
Agenda

- Background
- Recent Trends/Observations
- Typical Documentation
- Participation Agreements
- Accounting Issues
- True Sale Basics
- Financing Foreign Receivables

Non-Recourse Receivables Purchase
(FACTORING)

Basic Transaction Overview:

1. Buyer purchasing department purchases goods or services from a Supplier under a standard purchase contract
2. Supplier ships goods and sends invoice to Buyer
3. Supplier sends the bank a purchase request
4. An Investor purchases the receivable in a “true sale” and sends the Supplier the discounted proceeds of the receivable
5. The Buyer pays the receivable on its maturity date as instructed by Supplier (to the Investor or the Supplier)
6. If the Buyer pays the Supplier, the Supplier transfers the proceeds to the Investor



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Non-Recourse Receivables Purchase
(FACTORING)

- Recent Trends/Observations:
  - Lots of interest in financing non-US receivables
  - Increased familiarity in the US with/interest draft/note discounting programs
  - Increased use of hard purchase commitments and “soft” commitments
    - Short term commitment
    - Ratings flex
    - Pricing flex

Non-Recourse Receivables Purchase
(FACTORING)

- Recent Trends/Observations continued:
  - A lot of interest in financing "out of the box" assets (e.g. IP licenses, service contracts, long term energy contracts, etc.)
    - Non-traditional assets lead to non-traditional risk (e.g. performance, regulatory, etc.)
    - More esoteric assets often lead to more securitization-like structures
  - High interest in finding ways to combine the flexibility of securitization / ABL structures with the simplicity / certainty of factoring
    - Pool structures, etc.
  - Transaction volumes are having a meaningful downward impact on traditional trade receivables securitization and ABL products

Non-Recourse Receivables Purchase
(FACTORING)

- Recent Trends/Observations continued:
  - A lot of new players --- especially among smaller and regional banks.
  - Lots of interest in credit insured receivables.
    - Implementation risk
    - True sale analysis is complex

Non-Recourse Receivables Purchase

(FACTORING) TYPICAL DOCUMENTATION

- Receivables Purchase Agreement (true sale)
- Parent **Performance** Guaranty
- UCC Financing Statement
- For pro rata deals, multi-purchaser RPAs are common
- For non-pro rata deals (i.e. 100% participations in specific invoices), participation agreements are the most common.
- More sophisticated documents
- LSTA concepts becoming common
  - But with receivables specific characteristics!

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Non-Recourse Receivables Purchase

(FACTORING) TYPICAL DOCUMENTATION

- Segregated bank accounts are ideal to avoid intercreditor issue but not always possible.
- Payment Dominion
  - Collections directly to Bank
  - Collections directly to Supplier with springing control agreement
    - Automatic stay
  - No dominion
    - Automatic stay
    - Tracing

Participation Agreements

- Most common in non-pro rata syndications (i.e. supply chain)
- They can be used in pro rata deals but become more difficult to work with as the purchaser group increases in size
- Generally, participation agreements in this area will provide for fewer rights to the participant than loan participations
- Typically structured as “true participations” so as protect the participant from FDIC receivership claims

Participation Agreements

TYPICAL TERMS

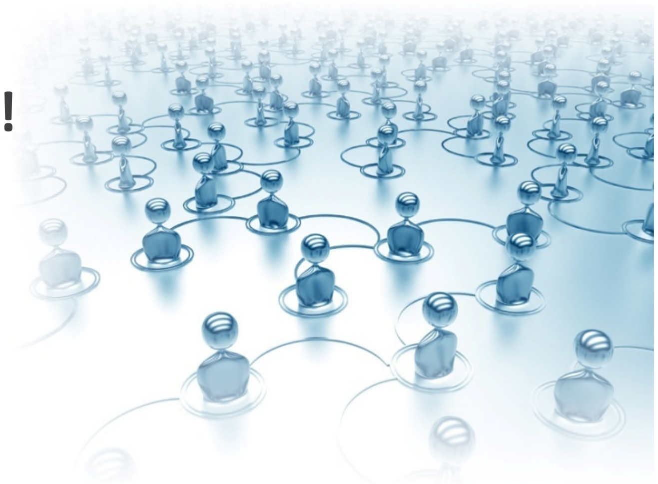
- Usually uncommitted (no obligation to sell or buy) but not always
- Trade confirmation / certificate
  - Moving to electronic
- Participation in revenue *and* costs
- Limited elevation rights
- Limited obligor default rights
  - Information sharing/cooperation
  - Taking title to receivable

Participation Agreements

TYPICAL TERMS

- "All lender" level consent rights
  - Amount, tenor, guaranties, etc.
- Limited information sharing
  - Defaults
  - Other information
  - Obligor notice

Lead bank is not an agent/fiduciary!



Accounting Considerations (Seller)

- Three Part Test under Paragraph 9 of FAS 166 / ASC 860.20
  - Legal isolation [¶ 9(a)]
    - Legal true sale
  - Free assignability [¶ 9(b)]
  - No “effective control” [¶ 9(c)]

GAAP Accounting Sale Treatment Continued

- **Legal Isolation Analysis.** ¶ 9(a) - The transferred assets have been isolated from the transferor and its creditors – i.e. put beyond the reach of the bankruptcy trustee for the transferor and its consolidated affiliates typically, a **true sale opinion.**
- For purposes of 9(a) isolation:
  - Must sell individual asset in its entirety (or group of individual assets) or "participating interest" in individual asset
  - "Participating interest" — primarily designed to permit pari passu, pro rata pay participations that are like typical bank participations
  - No subordination of transferor interest or recourse to transferor or consolidated affiliates other than for customary breached

GAAP Accounting Sale Treatment Continued

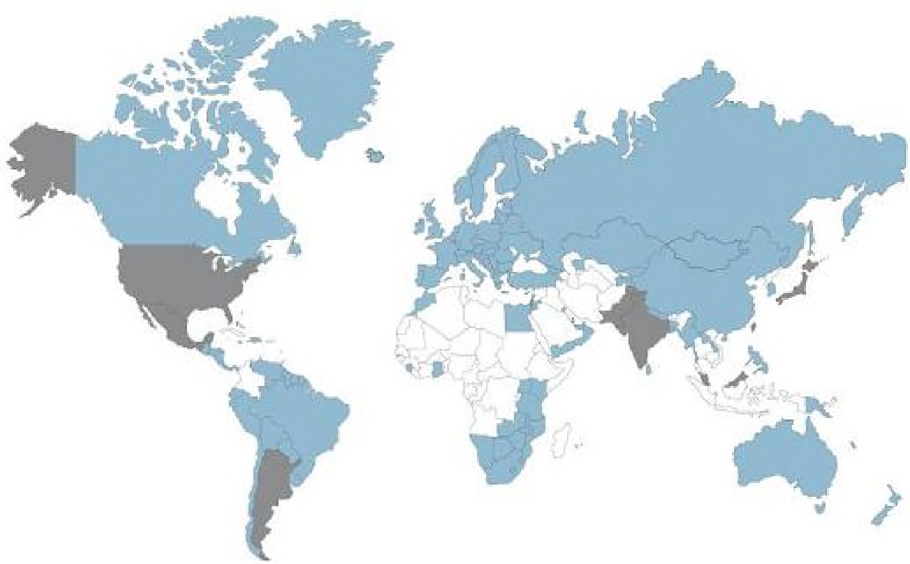
- **Free Assignability.** ¶ 9(b) - Transferee must have right to pledge or exchange asset (the ability of the buyer to pledge or exchange shows surrender of control by transferor)
  - Inconsistent auditor focus
- **No "effective control."**¶ 9(c) - Not permitted:
  - An agreement that both entitles and obligates transferor to repurchase assets
  - An agreement that entitles the transferor to the return of a specific asset and provides some benefit for transferor (other than clean up call)
  - An agreement that obligates the transferor to repurchase assets at option of transferee at price so favorable that option exercise is probable

IFRS Accounting - Who Uses It?

IFRS adoption and use around the world (Source: www.iasb.org)

More than 100 countries now require or permit the use of IFRS or are converging with the International Accounting Standards Board's (IASB) standards.

The picture below shows the level of IFRS adoption at present. Blue areas indicate countries that require or permit IFRSs. Grey areas are countries seeking convergence with the IASB or pursuing adoption of IFRS.



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IFRS Accounting at a High Level

- Derecognition principles (IAS 39)
  - Applied to transferor’s consolidated group
  - True sale opinion not required
  - Standard based on considerations of risk and reward and control
    - Has there been a transfer or pass-through of cash flows?
    - Has there been a substantial change in the exposure to the risks and rewards?
    - Has there been a transfer of control?

Accounting vs. Legal

- Whether a Seller is using US GAAP or IFRS, balance sheet derecognition does NOT automatically equal a legal true sale!
- A transaction can be derecognized for accounting purposes but still not be a legal sale (and vice versa).

“True Sale” - Legal Aspects

- Insolvency law is a U.S. federal law scheme - it is the same in each state.
- If an account (i.e., an invoice) has been transferred via a “true sale,” that account and its proceeds will be excluded from the “bankruptcy estate” of an insolvent seller.

"True Sale" - Legal Aspects Continued

- **But:**
- U.S. Bankruptcy courts are courts of **equity** (there is no 100% assurance that any court will follow any specific precedent on any day).
- Whether or not a true sale has occurred is a matter of **state** law and varies from State to State.
- New York law/jurisdiction is almost universal

"True Sale" - Legal Aspects Continued

- U.S. true sale analysis focuses on two broad themes:
  - Intent of the parties
    - "[w]here the parties' intention is clearly and unambiguously set forth in the agreement, effect must be given to the expressed intent." To ignore the affirmative intent of the parties "would inject unpredictability and insecurity" into the manner in which credit is obtained. Granite Partners*, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275 (S.D.N.Y. 1998).
  - Lack of credit recourse to the seller (or any seller-related party)
    - "[w]here the lender has purchased the accounts receivable, the borrower's debt is extinguished and the lender's risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor." *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, 67 F.3d 1063 (2d Cir. 1995).

Intent / Control Over Receivables

- A guiding principle, but not the end of the inquiry
  - Intent should be expressly stated in the receivables sale agreement.
  - Intent should be reflected in the language of the agreements (Seller/Buyer vs. Debtor or Borrower/Secured Party)
- Limited control by the buyer/ excessive control by the seller evidences intent not to truly sell the asset.
- There should also not be excessive restrictions on the ability of the buyer to deal with / dispose of the receivables.

Intent / Control Over Receivables Continued

- **The seller can not have a unilateral right to repurchase (e.g. call) the receivables.**
  - There are very few scenarios where this would be acceptable.
- All post-sale transfers by the buyer back to the seller must be made at fair market value at the time of such subsequent transfer.
  - Remember that fair value of some defaulted receivables may be zero!
- Buyer must have the right to remove the seller as servicer under specific circumstances.
- Commingling of collections with the seller's general funds is always a bad fact but usually not fatal so long as collections are identifiable.

Forms of Credit Recourse

- Guaranties (Parent or Otherwise)
  - OK, so long as guaranty does not cover credit recourse or other forbidden items.
  - The guarantor may not guaranty to do what the seller may not itself do.
  - Customary to have a specific carve-out for credit recourse.

Forms of Credit Recourse Continued

- Puts
  - The buyer should not have a unilateral right to sell (e.g. put) the receivables back to the seller.
  - All post sale transfers back to the seller should be made for “fair market value” at the time of such subsequent transfer.
  - Some limited put rights (e.g. puts of performing assets after servicer default) *may* be OK.

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Forms of Credit Recourse Continued

- Potential Hidden Forms of Credit Recourse:
  - Representations and warranties (e.g. continuing eligibility, continuing solvency of the account debtor, etc.)
  - Indemnities for credit recourse
  - For servicing retained transactions, a lack of a servicing fee or a subordinated servicing fee.

What is not Recourse?

Seller Responsibility For:

- **Dilutions:** Credits, rebates, credit memos, discounts, charge-backs, warranty claims, etc.
- **Disputes:** A bona fide defense, set-off, retention, abatement, counter-claim or contra account raised or alleged by an account debtor or its representatives.

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Purchase Price Rules

- Purchase price must be determinable at the time of sale via a fixed amount or formula.
- Purchase price of already sold receivables may not be changed after the fact.
- Purchase price of future receivables must not be changeable unilaterally by the buyer.
- If possible, it is always preferable to avoid having the purchase price look like an advance rate / borrowing base mechanism (e.g. asset based lending) so as to avoid confusion

Purchase Price Rules Continued

- The buyer of the receivables must bear substantially all upside/downside risk.
  - Does the purchase price mechanism provide for some type of profit sharing? [BAD FACT]
  - Does the buyer receive a set return after which upside goes back to the seller? [BAD FACT]
  - Is the seller responsible for delay risk (interest for slower than anticipated collections, late payment penalties, etc.) [BAD FACT]
  - Does the purchase price mechanism contain a reserve that is released only if the sold receivable meets an expected performance level. [BAD FACT]
    - Example, 80% advance rate with 15% holdback if the receivable is collected. [BAD FACT]

What is different about cross-border transactions?

- EU has 27 countries, each with its own laws
- UK is more than one country
- Common law (US, UK, Commonwealth) is more pragmatic and concept based
- Civil law (Continental Europe, Mexico, Japan) is codified and more formal
- Possible unpredictable enforcement process (US bankruptcy is unique)
- Familiar US concepts (e.g. true sale) not recognized in many countries
- Different cultural priorities (social stability; debtor’s rights, etc.)

Typical Foreign Law Issues

- Seller is not a US company
  - Diligence Issues?
    - Hidden liens
  - Capital Controls?
  - Corporate Issues
    - We tend to gloss over these in the US but they may be critical in other countries
    - Latin America/Russia/China

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Typical Foreign Law Issues continued

– Enforcement Practicalities
    - Will you sue them in the US?
    - Do they have assets in the US?
    - If not, how will you enforce?
    - Will your NY judgment be enforced in Country X? If not, do you need to sue in country X?
    - Can you sue in country X? Do you have the right documents?
    - If not, should you be thinking about arbitration?

– Licensing
    - Perfection?
    - Enforcement?

Typical Foreign Law Issues

- Obligor is not a US company
  - Anti-assignment restrictions on receivables
  - Notice requirements
    - Effectiveness
    - Perfection
    - Setoff
  - Registration requirements
  - Enforcement restrictions / licensing
    - License may be require to collect even if no license is required to purchase
- **Your rights will probably need to be enforced locally so you must think locally!**

Practical Issues

- It is tempting to believe that what can be done in the US can be accomplished elsewhere (square peg / round hole)
- Cost-benefit analysis is important. Not all cases may warrant full compliance with foreign laws.
  - Credit Insurance?
  - Low concentrations?
  - Good obligor credit profile?
  - Typical European "Good Country" List For US Banks: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Ireland, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom

Practical Issues --- True Sale

- Permitted levels of credit recourse vary greatly by jurisdiction
  - A true sale in England, Italy, Hong Kong or Singapore may not be a true sale in New York!!!
  - In some jurisdictions there is no concept of a “true sale” – Switzerland
- IFRS and GAAP treatment is often different!
- Avoid misunderstandings – same words may have different meanings.

Two nations divided by a common language

“English”	“American”
Debts	Receivables
Insolvent	Bankrupt
Registering a Charge	Filing a Financing Statement
Participation	Assignment
Sub-participation	Participation
Completion	Closing
Trousers	Pants
Pants	Underwear
Public School	Private School
State School	Public School
Braces	Suspenders