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Six Things Every Purchaser of US Commercial Accounts Receivable Should Know

Over the past several years, non-recourse receivables financing has been embraced by many major financial institutions and non-bank investors in the US market. With its (i) favorable regulatory treatment for regulated institutions, (ii) perceived positive risk/reward profile and (iii) adaptability to recent technological advancements such as distributed ledger technology (i.e., blockchain), non-recourse receivables financing likely will grow increasingly popular in the US market.

Here we outline some of the legal elements under US law that any prospective purchaser should be aware of before engaging in any purchase of accounts receivable.

Uniform Commercial Code Financing Statements Are Not "Precautionary."

When purchasing accounts receivable, the filing of a Uniform Commercial Code (UCC) financing statement by the purchaser is mandatory, not a precaution. Pursuant to UCC Section 1-201(37), the term "security interest" includes not only the interest of a lender secured by "accounts" and "payment intangibles" but also the interest of a buyer of those interests. In addition, UCC Section 9-109(a)(3) provides that Article 9 of the UCC specifically applies to "a sale of accounts, chattel paper, payment intangibles or promissory notes." Together these two provisions serve to require that an outright buyer of a receivable, just like a lender taking a lien against such receivable, must file a UCC financing statement in order to perfect its ownership interest in such receivable. The failure by a purchaser to file an appropriate UCC financing statement will generally result in such purchaser being "unperfected" and treated as an unsecured creditor in any bankruptcy of the originator of the receivable.[1] In bankruptcy, the originator or its trustee will have the rights of a judicial lien creditor and will take priority over the unperfected interest of the purchaser. In addition, this will mean that the unperfected purchaser would typically lose in any priority contest with any properly perfected secured creditor of the originator or, if the originator has fraudulently or accidently sold the same receivable to another purchaser that is properly perfected, with any such competing purchaser.

UCC Releases and Intercreditor Agreements Are Always a Good Idea and Often Essential.

Because the UCC requires that any party claiming a lien or an ownership interest in a receivable file a UCC financing statement to be perfected, it is common practice in the United States for any prospective purchaser of receivables to conduct searches of the appropriate UCC filing records to determine whether the receivables it wishes to purchase are subject to any prior lien or ownership interests of other parties. It is common for UCC searches

to turn up existing relevant financing statements. Financing statements often contain broad asset descriptions which will include all of the receivables of the originator. It will typically be impossible for the prospective purchaser to determine solely from the information provided in the financing statement whether the prior interest holder has any interest in the receivables to be purchased by the prospective purchaser. This is especially relevant because pursuant to UCC Section 9-322 and certain other relevant provisions of the UCC, if a prospective purchaser were to purchase a receivable subject to an existing lien or ownership interest, the prospective purchaser would acquire such receivable subject to such prior interests.

In order to deal with this "double-pledge" or "double-sale" risk, most receivables purchase agreements will require the originator to make various representations, warranties, covenants and indemnities designed to protect the purchaser from prior interests. If a receivable is sold to the purchaser in breach of these protections, a common remedy is for the originator to be required to repurchase any affected receivable from the purchaser. In most situations, these remedies are perfectly adequate to protect the purchaser's interests. However, this is not the case if the originator is insolvent and doesn't have the financial wherewithal to make the purchaser whole. It is therefore advisable for the purchaser to obtain an appropriate amendment to or partial release of any existing conflicting UCC financing statements with any conflicting interest holders. It is also advisable for such purchaser to obtain a written agreement with any such conflicting interest holders that clearly establishes the superior ownership interest of the prospective purchaser with respect to its purchased receivables.

The Bankruptcy Code Automatic Stay Will (Almost) Always Be a Factor in Any Originator Bankruptcy.

In the United States, most larger receivables purchase facilities operate on a "non-notified" and "servicing-retained" basis. In this type of facility, the originator continues to invoice, collect and manage the receivables on behalf of the purchaser. The account debtors of the receivables are rarely notified of the sale of their receivables unless there is a problem with the originator's performance or overall financial strength. In order to provide some protection to the purchaser, many facilities require that the originator establish a segregated bank account which will receive only collections from the receivables sold to the purchaser or, in the alternative, from account debtors whose receivables are likely to be sold to the purchaser. This collection account is then often pledged to the purchaser pursuant to a first-priority lien (often through the use of a deposit account control agreement) so that the purchaser can be assured that no other party has a prior lien over the collection account.

While this arrangement is always advisable and highly beneficial for a number of reasons, purchasers should remember that because this collection account is ultimately still the property of the originator, the "automatic stay" under the Bankruptcy Code will still apply to the collection account, at least initially. Under Section 362 of the Bankruptcy Code, the filing of a bankruptcy petition triggers an automatic stay, which enjoins most collection and enforcement actions by creditors against the debtor or property of the debtor. The broad scope of Section 362 of the Bankruptcy Code enjoins creditors from continuing any pending litigation against the debtor or taking control of property of the debtor or in the possession of the debtor without

prior approval of the bankruptcy court. Such stayed actions would include the enforcement of any liens over the debtor's bank accounts. To the extent that any such collection accounts contain only or mostly collections on purchased receivables, there is no reason to expect that a bankruptcy court would not ultimately agree to modify the stay to allow the purchaser to proceed against the collection account. However, prospective purchasers should still be mindful that any such request will invariably involve some meaningful delay as well as at least some interaction with the insolvency of the originator.

True Sale Is a Subjective Determination.

Under Section 541(a) of the US Bankruptcy Code, the commencement of a bankruptcy case by a debtor creates an estate consisting of all property owned by the debtor at that moment in time. This is important because if an originator sells a receivable via a "true sale," then the originator no longer has any interest in the receivable and such receivable does not become the property of the originator's bankruptcy estate. Given that purchasers of accounts receivable will typically be advancing well in excess of 95 percent of the net invoice amount of each receivable, being held to be a creditor could lead to a highly negative outcome.

While bankruptcy courts are the principal arbiters of when a true sale exists, the US Bankruptcy Code doesn't actually provide any guidance on what constitutes a true sale. Under US law, the nature of a debtor's interests in most property (including receivables) is interpreted under state law. The bankruptcy court's determination of whether a receivable has been validly sold to a purchaser will depend on its application of such state law. Unfortunately, case law in most US states, including New York, is limited, highly fact-specific and sometimes conflicting. Notwithstanding the lack of total consistency, it is generally accepted that the existing modern case law on true sale most heavily emphasizes two key elements: (i) the substantive intent of the parties and (ii) the lack of credit recourse to the seller of the receivable or any guarantor. Other often-cited factors, such as commingling of collections, are important elements in the analysis but are often examined for how they impact the court's determination of the first two items.

Because intent is a key element, it is important for a receivables purchase agreement to use the language that would befit a purchase and sale transaction. It is also always important to have a clear and unambiguous statement that the parties actually intend a true sale. However, the key word in intent analysis is the word "substantive." Unlike in some other countries, merely producing an optically appropriate receivables purchase agreement and going through the technical compliance steps such as filing a UCC financing statement are not sufficient on their own. A US bankruptcy court properly applying the existing case law would typically look beyond the statements in the purchase agreement to try to ascertain the underlying substantive intent of the parties based on the economics of the transaction. The most important factor in determining such substantive intent is the appropriateness of the purchase price for the receivable (which should be both determinable at the time of sale and also reflect reasonably equivalent value) but other factors, such as the seller's degree of control of the receivables after sale and, of course, the degree of credit recourse left with the originator, also play an important role.

Because of this substantive element, absent some fairly obvious examples, it often isn't possible to conclude definitely that any particular feature of a transaction would cause a court to find that a transfer does or does not constitute a true sale. Instead, it is more accurate to view modern true sale analysis as a scale on which the bankruptcy court will balance the totality of the facts and circumstances.

Foreign Law Matters (Sometimes A Lot).

In many receivables purchase transactions in the US market, both the purchaser, as well as a material portion of the originator's business, will often be located in the United States. The receivables purchase agreement will also purport to be governed by US law, typically New York law, and the parties will elect New York as the forum for any disputes among the parties. In this scenario it is easy to be tempted into believing that non-US law is unlikely to ever be relevant. This is often untrue. In a number of key scenarios, non-US law cannot only be relevant, it can be the primary law under which the rights of the purchaser will be evaluated.

For example, foreign law is highly relevant any time that the originator is an entity organized under the laws of a jurisdiction outside the United States. The primary reason is that any insolvency of that originator will likely be adjudicated in the jurisdiction of its organization, not in the United States. A second common example is a situation where the underlying contract giving rise to the receivable to be purchased is governed by the laws of a non-US jurisdiction, even if the receivables purchase agreement itself is governed by US law. In either such example, and depending on the specific non-US jurisdiction, there is no real guaranty that a non-US court or insolvency administrator will actually apply US law to the receivables financing transaction. This concern is especially real in situations where the rights of competing local creditors, insolvency administrators and other stakeholders are involved.

To the extent non-US law becomes relevant, a purchaser will often need to consider a number of regulatory, tax and other legal issues. The two items almost always necessary to be considered are (i) the enforceability of contractual anti-assignment provisions and (ii) account debtor/obligor notice requirements. The former item is especially important for US purchasers. In the United States, purchasers of accounts receivable are protected from restrictions in the underlying contract giving rise to the receivable on the ability of the originator to sell such receivable. UCC Section 9-406 specifically provides that any such contractual restrictions are not enforceable. As a result, the originator can freely sell its receivable without any fear of consequence from the account debtor/obligor. Unfortunately, the UCC Section 9-406 approach is followed in only a minority of places in the world. In many places, a purchaser acquiring such a receivable may find that it has no rights whatsoever to enforce the receivable against the account debtor or, in a few jurisdictions, no rights at all. Likewise, in many places around the world, a failure to notify an account debtor/obligor at the time of sale could result in the sale being unenforceable against such account debtor/obligor.

It Often Looks Better at the Store Than at Home.

Clients often ask us whether it is possible to purchase receivables from a company in Country X. Clients rarely, if ever, ask about the difficulty or expense of enforcing their rights in Country X if something goes wrong. The answer to the first question is favorable more often than not. The answer to the second question, unfortunately, is less often so.

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Endnotes

[1] The originator and seller of the receivable is referred to in this Legal Update as the "originator."

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