Before you sign…

THE ATTRACTIONS OF FACTORING, SUPPLY-CHAIN FINANCING AND CASH CONSOLIDATION SHOULD NOT BLIND TREASURERS TO THE IMPORTANCE OF MAKING SURE THAT ALL THE DOCUMENTATION IS RIGHT FOR THE COMPANY.

As the availability of credit shrinks and capital adequacy issues reduce banks' appetite for corporate lending, so companies are looking closely at ways to promote working capital efficiencies and to develop, with banks, products that are available in times of market stress. Over the last 18 months, UK companies have increasingly employed three such products: factoring, supply-chain financing and cash consolidation agreements.

This article will outline how these products work and highlight some issues companies should be aware of when negotiating the product documentation with banks or other finance providers. The product documentation for transactions may vary greatly and the documentation will always need to be reviewed in the context of a company's own circumstances.

THE PRODUCTS.

- **Factoring.** This product is a means by which suppliers can streamline their income in relation to the goods and services they provide by legally assigning receivables to a bank at a discount for immediate cash, provided that such receivables conform to predetermined criteria. Non-recourse factoring is also a risk management tool.
- **Supply-chain financing.** This product is designed to help companies assist their suppliers and enable them to hold onto their money for longer, thereby improving working capital. The bank extends short-term financing to the company's supplier at a cost lower than what the supplier would have incurred if it had sought financing on its own, as the cost of providing this financing product is based on the creditworthiness of the company rather than that of the supplier. In return the supplier may agree to an extension of the term for the payment of invoices. Supply-chain financing takes the form of factoring facilitated by the supplier.
- **Cash consolidation pooling.** Here a business group uses a bank to co-ordinate the movement of balances in various bank accounts held by group companies in a number of jurisdictions to a central account, usually where the parent or finance entity is located. Transfers can then be made from this account to reduce or eliminate overdrafts by group companies.

CONTRACTUAL PROVISIONS.

- **Risk transfer.** One initial issue to consider in a factoring arrangement is whether it will be undertaken on a recourse or non-recourse basis. Pricing can vary significantly between the two.

With recourse factoring, the credit risk remains with the company. With non-recourse factoring, the factor bears an increased risk in relation to bad debts, although it rarely bears all the risk. Typically, the factor bears the risk to the extent that the bad debt is not sold in breach of a representation or warranty made in relation to that debt.

The scope of the representations and warranties is therefore crucial. While representations and warranties concerning title and the ability to assign are standard and acceptable, caution should be used when giving warranties about the customer's financial position: a company should only give representations and warranties about itself and its relationship with the customer.

General representations and warranties such as "the company has disclosed to the bank every fact or matter which the company knew or ought to have known would influence the bank's decision to purchase the debt", should be avoided as such a statement may effectively turn non-recourse factoring into recourse factoring.

Representations and warranties in disputes relating to a customer or a debt should also be carefully considered. It is vital that an acceptable definition of dispute is established to avoid the danger of a customer complaint to the company about an immaterial issue leading to a breach of warranty and thereby recourse to the company in relation to such debt.

A further issue that should be considered is whether the agreement should be committed or not. While this will also affect pricing, many companies are prepared to pay for the comfort that funds will be available to them in times of market stress.

■ **Guarantees and set-off.** Banks often request some form of guarantee from the borrower: after all, the price of financing is based on the credit assessment of the entity ultimately responsible for payment, and the lender may want to securitise the invoices they are providing financing for. That guarantee can come from the parent company, and in the case of a cross-entity guarantee can require every affiliate participating in the programme to guarantee the payments of every other participating affiliate.

It may be company policy that such guarantees are never provided, or provided only in very limited circumstances. Special care must be given when agreeing to cross-entity guarantees, as they may result in the provision of upstream guarantees, which may give rise to a different set of issues.

However, the inclusion of a set-off provision – in particular cross-entity and/or cross-transactional set-off – can amount to much the same thing, even though technically it is not a guarantee. While there are clear commercial reasons why in some circumstances a bank may want cross-entity and transactional set-off, in general companies should consider limiting such provisions as much as possible.

It is advisable to clarify at an early stage of the negotiations which group company will contract and whether the bank will require a guarantee, and, if so, from which entities.

■ **Service level guidelines.** In setting out services to be performed in agreements it is important that the service description specifies what the bank is to provide and what the company expects to receive with clear divisions of responsibility. The bank should also be required to perform the services in accordance with a set of service levels that can be effectively measured. Service levels are particularly important in ensuring system availability and dealing with issue resolution. Persistent failure to perform these services should trigger a right by the company to terminate the agreements.

OTHER ISSUES.

■ **Confidentiality and disclosure.** The use of factoring, supply-chain financing and cash consolidation agreements often require companies to disclose to the bank confidential information, such as supplier details or pricing/financial information. To restrict the use and disclosure of confidential information, companies should consider entering into a confidentiality agreement to deal with disclosures during negotiations and including a confidentiality clause in the agreements.

The information to be disclosed may also contain personal data that identifies an individual such as a sole trader, or an employee of a supplier or the company. If the company or the supplier process that personal data in the EU, they will be subject to the requirements of the EU's Data Protection Directive.

The directive's obligations include informing the individuals whose data is processed the purposes for which the data will be processed and prohibiting the transfer of the data to countries outside the European Economic Area (EEA: the EU plus Iceland, Liechtenstein and Norway) which are not considered to have adequate data protection laws, such as the US[1]. Banks will often deal with these issues by requiring the company to be responsible for compliance with applicable data protection laws. The company should therefore consider what personal data may be disclosed and obtain consent from individuals where required.

■ **Payment Services Directive.** The Payment Services Directive came into force in the EU on 1 November 2009. It applies where the payment service providers of the payer and the payee are located in the EEA and the payment services are in euros or other EU currencies.

The directive imposes on banks (and non-bank providers authorised as payment institutions) a large number of information requirements concerning the type of service, charges, security controls and period of notice for termination, which must be included in the terms and conditions of the agreements. The directive also imposes a number of rights and obligations on both payment providers and customers, the most important of which relate to liability for disputed payment transactions, value dating and execution times. Importantly, the information requirements and some of the rights and obligations can be disapplied if agreed between the bank/payment institution and the company[2]; a company should carefully consider before surrendering these valuable rights.

■ **Accounting treatment.** There is a possibility, especially in supply-chain financing, that extending the term of payment on invoices as a result of financing provided by the bank may result in the invoices being treated as bank debt of the company rather than trade debt.

If an assignee of invoices (the bank) is given more or greater substantive rights against the company over invoices than the rights originally given to the supplier – for example, by way of a guarantee or a cross-entity guarantee in favour of the bank (which the original supplier did not benefit from) – then consideration should be given as to whether this affects the accounting treatment of the relevant invoices. Another possible trigger could be extending the term of payment to a period greater than the generally accepted standard term of payment for trade debts in the relevant market.

UNAMBIGUOUS. It is advisable to ensure the bank provides a clear statement of all the legal and commercial requirements and implications of the transactions when making its proposal. And the company should be careful to determine at an early stage if those requirements raise any legal, accounting, commercial or other concerns. Companies should also consider whether experienced legal advisers would be of assistance to them in this process.

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Footnotes

1. *The few non-EEA countries currently deemed by the European Commission to have adequate data protection laws include Argentina, Canada and Switzerland. The Faroe Islands, Guernsey, Jersey and Isle of Man are treated as within the EEA for this purpose.*
2. *But a micro-enterprise (one with fewer than 10 employees and whose annual turnover and/or annual balance sheet does not exceed €2m) may not disapply its rights.*