

TRENDS IN LAW

The Mirage of Gross Receivables in Lender Finance

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Picture this: A lender extends a \$70mm “lender finance” revolving loan facility to a factoring company. Availability under the facility is governed by a borrowing base, calculated generally as 75% of eligible receivables. The eligibility criteria include the standard and customary exclusions and limitations. But that is not the issue here. The issue here concerns a much simpler, yet more fundamental, question: *What is the “receivable” that is used to build the borrowing base in the first instance?*

In most lender finance facilities to a factoring company, the “receivable” used to build the borrowing base is the amount advanced by the factor against receivables of its client, or the “net funds employed,” in factor-speak. The borrowing base is typically built on net funds employed to a factored client, rather than on the gross factored receivables of the factored client, because any portion of the factored receivables in excess of the net funds employed, or the “reserve,” in factor-speak, is ultimately payable back to the factored client. Said another way, even though the factoring agreement provides for a sale of the receivables from the client to the factor, the client retains the economic right to the reserve. For perspective, this is the same reason that the borrowing base for a lender finance facility to an inventory lender would not include the underlying inventory itself, but only the amounts advanced by the inventory lender against that inventory.

Yet, as a matter of practice, some lender finance facilities to factoring companies will build the borrowing base using gross factored receivables, rather than the net funds employed by the factor against those receivables.

Before we get into the potential ramifications of the “gross receivables” approach, let’s talk about why a lender might take this approach. While it could certainly be the result of a conceptual misunderstanding concerning the extent of the lender’s right to those receivables, it is often due more to practical than conceptual reasons.

Factors, by their nature, think in terms of gross receivables. Their software is built around gross receivables, they track gross receivable balances and those figures are easy to

report and reconcile. While factors can and do track net funds employed, doing so requires tighter systems and an overall more granular approach to operations. Some factors, particularly newer or smaller factors, may not have the capacity or systems to report with the frequency or detail required to build a borrowing base from the net funds employed. For these factors, a borrowing base built on gross factored receivables may be the most feasible option, or at least a concession they are able to extract when there are multiple lenders competing to win their business.

Whatever the reason may be for building a borrowing base to a factoring company with gross factored receivables rather than net funds employed, it does not change the potential ramifications for lenders who do so. Most notably, a borrowing base built using gross factored receivables will likely result in the lender’s effective advance being much higher, and its equity cushion being much smaller, than it expected.

By way of example, consider the following differences with respect to a \$100 receivable for which the factor advances to its customer 80% or \$80. If the borrowing base in the factor’s credit agreement with its lender is 75% of net funds employed, the factor’s availability with respect to such receivable is \$60 (i.e., 75% of \$80). Assuming the factor draws the full \$60, the lender’s equity cushion of \$20, or 25% of the \$80 net funds employed, is exactly what it expected.

By contrast, if the borrowing base in the factor’s credit agreement with its lender is 75% of gross factored receivables, the factor’s availability with respect to such receivable is \$75 (i.e., 75% of \$100). Assuming the factor draws the full \$75, the lender’s equity cushion is \$5, or 6.25% of \$80 gross factored



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receivable. Clearly, this is not what the lender expected.

Why is there such a huge difference? Because gross factored receivables include amounts that were never funded by the factor in the first place, the “reserve” in factor speak. The reserve is collateral security for, and can be applied against, the obligations of the client to the factor. However, once those obligations are repaid in full, the client has the right to receive any remaining reserve. As such, when gross factored receivables are included in the borrowing base, the borrowing base is artificially inflated by the amount of that reserve.

Obviously, building the borrowing base with gross factored receivables rather than net funds employed does not leave the lender with much margin for error in the event of a wind-down or liquidation of the factoring company borrower. It also does not leave the lender with much “dry powder” to help bridge even a temporary liquidity shortfall or plug an unexpected expense of the factoring company. Simply put, a lender who builds a borrowing base for a factoring company borrower with gross factored receivables rather than net funds employed will have less flexibility to navigate around any potential performance or collateral issues with its borrower.

Another potential risk of building the borrowing base with gross factored receivables rather than net funds employed is that it may make it more difficult to refinance the credit facility. Most lenders to a factoring company will require that the borrowing base be populated with net funds employed rather than gross factored receivables. However, as illustrated above, a borrowing base built on gross factored receivables will often result in an effective advance rate against net funds employed that is materially higher than the market will accept. As a result, when it comes time to refinance, there may not be enough availability under the replacement facility to repay, in full, the exiting lender. If not, the gap will need to be filled with equity or subordinated debt, potentially turning a routine refinancing into an unexpected capital event for the factoring company borrower.

Additional availability generated by a gross receivables borrowing base may address near-term liquidity needs. However, factoring companies and their lenders should evaluate how that structure performs across credit cycles and refinancing events. A structure that maximizes availability today can constrain flexibility tomorrow. Ultimately, clarity around what constitutes the true “receivable” being financed is essential to sound underwriting by lenders and to a borrower’s ability to plan for sustainable, long-term, growth.

We hope you enjoyed the column and, of course, are always interested in your feedback. As such, if you have any questions or comments, please let us know at james.cretella@blankrome.com or narbeh.grigorian@blankrome.com. 📧

and commercial finance, factoring, and specialty finance companies, as well as borrowers, in creating, negotiating, and documenting a variety of alternative and specialty finance products.

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