ASSET-BASED LENDING

PETER CLARKE

The Complete Guide to Originating, Evaluating and Managing Asset-Based Loans, Leasing and Factoring

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This book is for sale at http://leanpub.com/asset-basedlending

This version was published on 2017-11-19

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1.1 INTRODUCTION

The first important step to setting up an asset-based lending program is to get rid of all obstacles to asset-based lending for yourself or the borrower. You must have a positive attitude and seek to make the loan without fear or trepidation. But, always balance this approach with caution and a deliberate due-diligence approach to properly structuring the deal for the best interest of the bank. As a secured creditor, a bank, or other financial institution or company, should use due diligence to protect its collateral interest in the best means possible. At the same time, however, such lenders must offer their borrowers a program that not only meets their needs, but allows them to function properly under the asset-based lending arrangement established.

While there may be more paperwork involved in such financing, it should be tailored to the proper program or financial arrangement made available to the customer. At the same time, similar paperwork requested from the customer should not hinder its business operation or create any disadvantages to the borrower. This is why a suitable arrangement for both parties is a necessity. Remember that asset-based lending is somewhat more time-consuming than other lending because you are normally lending on a revolving basis against a percentage of eligible collateral, which requires constant policing and monitoring of collateral reports, schedules, and documentation and accounting items.

Because of the character of the risk involved and the specialized nature of this type of financing, technical loan staff assistance may be needed when contemplating new loan relationships with asset-based loan customers. For example, technical staff assistance should furnish guidance as to the initiation of a particular receivable lending program. This includes documentation preparation and any other necessary procedures in order to arrange for the proper financing assistance on behalf of both the customer and the bank.

Because of the volume of paperwork, many loan officers will not be able to properly service these credits. Also, many officers are only generalists or have another specialized lending background and may not have the ability to arrange this type of financing. Therefore, they may need the support of specialized staff within their bank or institution.

Small banks often do not have the luxury of support staffs. Their loan officers probably will need to learn more about these lending procedures than anyone because they may not have the experience or expertise in working with more involved and properly monitored commercial credits. In such banks, these loans should probably be serviced by those seasoned officers who have had the most experience in specialized lending.

In medium- to large-sized banks, loan officers frequently have the support of technical staff, which may be composed of personnel from loan review, loan administration, or credit administration. In these banks, the names of the line/staff departments that normally support the line commercial banking departments may be different in name or vary slightly in function, but they all generally do about the same thing and have similar responsibilities. Some of these banks have departments made up of internal legal staff or specialists who can provide additional assistance by looking over or reviewing loan documents and agreements or even drawing up such documents. This additional assistance may be especially helpful when dealing with intricate lending involving high-risk credits.

When possible, a specialized line/staff department should be formed to handle the servicing pertaining to such credits because of the constant volume of electronic and paperwork flow, and the accuracy needed to reconcile accounts, handle disbursements, and control collections. The loan administration department or other similar line/staff departments should handle the credit, documentation, and other agreement work. Of course, this is not to say that you should not call upon or use outside legal counsel besides internal staff when necessary to draw up or review documents. Your loan administration department personnel or other in-house attorneys or specialists can also often act as liaisons between the commercial loan departments and outside counsel when necessary. In general, support staff organization and functions will depend on your bank's own internal policies and philosophies and should be tailored to your needs.

You should remember, however, that if your own in-house attorneys draw the loan documents, there may be a legal question as to whether the cost can be passed on to the customer. If you feel you cannot pass on in-house legal costs to the borrower and your commitment or agreement requires the borrower to pay for it, which is often the case, you might as well have outside counsel draw the documents. In the larger banks, a specialized line department, which includes loan officers, often handles such high-risk credits. As you can imagine, the larger the bank the more specialized the entire handling of credits becomes. In more recent years, many banks have formed internal departments, or acquired or formed subsidiaries, through their holding companies to handle specialized lending. In some cases these subsidiaries also may allow them to have some additional legal and tax advantages along with other market advantages when doing business out of state.

The goal of the bank should be toward eventually qualifying the borrower for unsecured (open) credit, if asset-based lending is properly conducted. Of course, if the borrower is a Subchapter "S" corporation or a limited partnership organized to eliminate double taxation to the owners, they will generally bleed out all the earnings; thus, equity may never be built up by way of retained earnings to qualify for unsecured credit. Therefore, while the asset-based collateral borrower represents a higher credit risk because of its financial capacity or condition versus the unsecured borrower, you should constantly strive for and work with your customer to achieve an unsecured borrowing status. If this goal is achieved, it will mean less credit risk to you and less paperwork for both you and your borrowing customer. Asset-based collateral must be properly assigned and your interest must attach.

1.2 ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE (UCC)

Article 9, which is basically the only law that fully governs asset-based lending, was originally enacted to standardize and simplify secured transactions in personal property. The Article abolished the distinction between various security instruments and the terms associated with them. The purpose of the legislation was to modernize the law governing commercial transactions so that greater emphasis could be placed on agreement in business and in the uniformity of conducting that business throughout the nation. The rights, duties, and remedies available to the parties under the Article are not dependent on who has title. The Article provides for a systematic form of filing that allows for more certainty of and

Accessibility to information for public record purposes. (See Chapter 6, “Perfecting the Security Interest,” Section 6.02.) In essence, the law directly affects all persons who lend money or extend credit on the security of property other than real estate.

(1) Definition of Assignment

Assignment is the transfer by one party (the assignor) to another (the assignee) of the assignor's rights and interest in tangible or intangible personal property.

(2) Definition of Attachment

All loans secured by collateral in order to attach must be properly perfected, which means that three basic requirements must be met before collateral attaches and perfection in and to the collateral can be accomplished. Otherwise, a security interest will not be enforceable against the debtor or other parties with respect to the collateral. These requirements are:

- Value must first be given to the borrower in the form of loaned funds. Otherwise, the lender must offer a binding loan commitment to the borrower; and
- The debtor owns the collateral or has a right in it; and
- Either the collateral is in the lender's possession (including an agent on its behalf) as a secured party pursuant to agreement, or the debtor has executed a security agreement evidencing the assignment. (See Chapter 5 "Completing Notes, Security Agreements and Other Documents," Section 5.05.) A security agreement or assignment should also contain a description of the collateral.

A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs when the three events specified above have taken place unless, by explicit agreement, the time of attaching is postponed.

Normally, attachment becomes effective at the moment a banker, or other third-party lender, documents its loan commitment by having the borrower execute a written commitment or note and a separate security agreement. There must be an agreement between the parties; value must have been given by the lender; and there must exist property, tangible or intangible, that is pledged or assigned as collateral. If the secured party does not take possession of or title to the collateral, the agreement must be in writing.

(3) Definition of Secured Party

The definition of a secured party is any person or entity (including financial institutions such as banks) that extends secured credit on personal property, other than real property. Furthermore, for purposes of uniformity and clarity, this person or entity is considered a secured party for the interest of third parties that can determine this through public notice. Prior to the enactment of the Code, such persons were also known as lessors, conditional contract sellers, assignees, entrusters, and even chattel mortgagees (not for real estate, but for equipment).

(4) Definition of Debtor

The debtor is the person, entity, or party that receives the credit on the security of personal property. This is the party that was referred to, in addition to the debtor, as the lessee, conditional contract purchaser, assigner, trustee, and even mortgagor prior to the enactment of the Code, depending on what type of contract was executed. (Note: Do not become confused with the term debtor, which may mean either borrower, payer, or obligor, while an “account debtor” is a borrower’s customer from which accounts receivable or even other obligations are derived such as chattel paper and general intangibles. Even the term accounts, in and of itself, could refer to payables, debt, or obligations and is often confused with accounts receivable debtors). Also, the term obligor is now used in lieu of the word debtor according to the 2001 UCC Revision.

(5) Definition of Security Agreements

All prior Code contracts involving personal property are now referred to as security agreements. Such contracts should spell out all requirements of the agreement including representations, events of default, nonpayment rights, and remedies, and should be authenticated by obligors and debtors.

(6) Definition of Financing Statement

At times this term is confused with financial statement, however, while a financial statement is an accounting of one's statement of affairs, a financing statement is the document filed for purposes of public notice that reveals the creditor's security interest in the borrower's, assignor's, or pledgor's personal property. The purpose of this filing is to put the public on notice of the creditor's security interest. Although if the borrower has possession of the property, it may not necessarily own it free and clear, especially for the benefit of those other creditors or sellers contemplating extending credit to the debtor.

While the financing statement is normally a standard form that allows for a general description of the collateral, the separate security agreement document may be recorded for this purpose in lieu of using the separate financing statement. There are certain definite requirements, in addition to possible others, that must be met by the financing statement. In particular it should:

- Reflect the names of both the obligor or debtor and secured party (creditor) sufficiently enough to properly identify them.

- Be properly executed by both debtor and creditor with certain exceptions although it is no longer required to have the obligor or debtor sign the financing statement as long as they have authorized an authenticated security agreement.
- Appropriately identify the secured party's address in order to obtain further information, if necessary, regarding the creditor's security interest.
- Provide an adequate mailing address of the obligor or debtor.
- Provide a description by type or item of the collateral at least in a short super priority way.

(7) Definitions of Collateral Type

You should remember that there are factual differences under the Code that call for differences in types of collateral. Even though all inclusive classes of collateral distinctions may no longer be required regarding filing descriptions and identification purposes that have a bearing on filing jurisdictions the author prefers them. This could have a bearing on certain rights and remedies the creditor has pertaining to any particular collateral type and proceeds in the author's opinion in case this matter had to be settled in a court of law.

(a) Definition of Goods

In connection with asset-based collateral, there are two classification types defined as Goods: inventory and equipment. Goods are generally defined under the Code as "all things which are movable at the time the security interest attaches." This would include all tangible and physical personal property, which one might feel and touch.

(b) Definition of Intangible Personal Property

Intangible personal property, while it does exist, is not of a physical property nature. It does, however, represent a tangible interest in property and has supposed value by rights in and of itself. For our purposes in asset-based lending, one can quickly visualize at least four types of intangible personal property assets: accounts, notes, chattel paper, and documents. Since documents are such a specialized area of collateral, we refer the reader to A Banker's Guide to Secured Lending and Documentation (formerly Probus Publishing) for more information on lending against this particular type of collateral.

(c) Definition of Accounts Receivable

Accounts receivable is defined as the right to receive any sums due or to become due on open accounts and contracts resulting from the sale of merchandise or the performance of services rendered.

An account means a debt due or to become due arising out of the sale, storage, transportation, care, repair, processing, manufacture, or other improvement of tangible personal property; arising out of a contract there from; or arising out of the rendition of personal services that in the regular course of business will result in an open book account and are not evidenced by an instrument or chattel paper, whether or not they have been earned by performance.

These receivables will usually take the form of 30- to 60-day open trade accounts. Prior to the revision of Article 9 of the UCC, a contract right was defined as any right to payment under a contract not yet earned by performance. A revision amended this definition by eliminating the term contract right as unnecessary and modifying the definition of account to include the previous definition of contract right. According to the 2001 Revision of the UCC the term accounts receivable has been broadened to include other collateral types.

(d) Definition of Instruments

Instruments are defined as negotiable writings (including securities) that evidence a right of payment of money such as a note, are not themselves a security agreement or lease, and are transferable in the ordinary course of business by delivery if endorsed or assigned.

(e) Definition of Notes

Notes are considered in the broader definition of instruments that are defined as writing(s), whether negotiable or not, that evidence a right of payment of money.

(f) Definition of Chattel Paper

Chattel paper is defined as any group of writings that when combined include a monetary obligation and security interest in or lease of specific goods. Such collateral may consist of instruments, security agreements, conditional or installment sales contracts, and leases.

(g) Definition of Documents

The term documents refers to documents of title, such as warehouse receipts or other orders for the delivery of goods (bills of lading, etc.) that give the person in possession of them the right to receive, hold, and dispose of the documents and the goods covered there under.

(h) Definition of Inventory

Inventory is defined as any goods held by a person for future sale or lease or to be furnished under contract(s) of service. Such inventory may be in various stages of finished goods, work in process, or raw materials that may also be used or consumed in a business.

(i) Definition of Machinery and Equipment (M&E)

M&E is defined as goods bought primarily for business use that should not be included in the definition of inventory. Equipment is also the term used as a catch-all for all other tangible personal property as defined by the Code such as machinery, excluding fixtures and leasehold interests which may be a part of real estate. Therefore, this definition should not include building improvements and any construction in progress or supplies. Also, intangibles should be excluded like patents, tooling costs, and software.

1.3 ELIGIBLE RECEIVABLES

When lending on accounts receivable, it is a prudent practice to lend against only eligible receivables. This means there are certain receivables against which the lender should not give any credit or that of themselves do not meet the eligibility requirements for borrowing purposes, whether because of poor quality or otherwise. Such receivables may also not be eligible because they are a violation, not mandated by law to be taken in the normal process allowed within the Uniform Commercial Code, or need special assignments beyond the Code. When the bank takes a lien on accounts receivable, it should normally take it in blanket form, creating a collateral interest in all the borrower's receivables.

By taking a blanket lien, the lender may claim all proceeds of such receivables in order to be applied to or discharged against the borrower's debt if necessary, while only lending against those receivables it feels are eligible. Of course, this would not be the case if the debtor only offers a lien on specific receivables and the creditor is willing to lend on this basis.

1.4 INELIGIBLE RECEIVABLES

The following are those types of accounts deemed ineligible regarding only open accounts receivable lending:

- Any account that is created or arises out of a bill of exchange, contra account, offset, counterclaim, dispute, back charge, intercompany account (directly or indirectly related), extended, dated, or guaranteed sale, officer or employee account, account paying on a monthly basis, invoices representing unacceptable risks, invoices from debtors that prohibit assignments, and accounts not properly supported by evidence of sale as required. Also, not included in the category of acceptable and eligible open accounts are other obligations evidenced by or involving acceptances, chattel paper, trust receipts, conditional sales contracts, notes, and judgments.
- Any amount owed that was created from the sale or assignment of any rents, issues, profits, products, proceeds, or increase of tangible personal property. Also, if at the time of the sale or assignment, an obligation was created by an assignee who or which was the owner of an encumbrance or a lien.
- Any obligation arising out of a contract for work on or improvement to real property including government, municipality, or other public job, or any other sums due or to become due in this connection unless certain documentary procedures are met. (See Chapter 8, "Executory Contracts," Sections 8.05 and 8.06.)
- General, prime, or subcontract proceeds based on future performance of work or the amount unpaid on such accounts that represent billings for work not yet performed or goods not yet delivered. Such contracts may also be subject to subrogation by a bonding company. Therefore, you normally should preclude giving any collateral value for work to be

performed in the future (not completed and billed or unbilled) and retainages there from while also considering bonded jobs as ineligible for collateral purposes. When disputes, back charges, or offset claims are evidenced in documentation, these contingencies should be eliminated as eligible contract receivable collateral, too. Therefore, the only portion of any contract that might be considered eligible collateral involves amounts owed for completed work that either has been billed or has not yet been billed, and or has met milestone thresholds and requirements. There again may be instances when such billings are ineligible, depending on the circumstances and other requirements being met. (See Chapter 8, "Executory Contracts," Sections 8.03 and 8.04).

- Foreign receivables should, as a general rule, be considered ineligible collateral. However, in some instances, such receivables may be considered eligible collateral—preferably those accounts involving secondary government support from the Foreign Credit Insurance Association (FCIA) or by way of insurance and guarantees from other similar government agencies or programs such as involving Ex-Im Bank financing and SBA Export financing, which are often handled through an institution's International Department. If FCIA insurance or other such government subsistence is not obtained, factors such as country risk, currency restrictions and potential devaluations, political unrest, and foreign exchange must be weighed and closely evaluated before determining eligibility of foreign receivables.

1.5 ELIGIBLE EXECUTORY CONTRACTS

As stated above, executory contracts are not generally considered to be acceptable asset-based collateral because of the many performance aspects and underlying terms and conditions that may have to be met. However, at times, such collateral may be acceptable when it is a normal practice for borrowers to deal in such obligations or when account debtors are willing to be cooperative and accept third-party assignments. Also, while trade contracts would generally be ineligible, if a borrower has properly performed and the particular phase of work has been approved for payment, and is acceptable for billing by the account debtor payor who may be an owner, upper tier general, or prime contractor, the bank may consider lending against such collateral. Better yet, if the borrower has fully performed and finished with a job and has not yet billed the final payment, and the payor has signed off and approved the final payment including any retainage, the bank might be more willing to advance funds against any such final bills or invoices.

If the executory contracts involve inventory owned by the borrower, it could give the bank a little more to fall back on, as it could arrange for completion of whatever the contract required, such as processing regarding the inventory in case the borrower defaulted on the job.

1.6 INELIGIBLE EXECUTORY CONTRACTS

Ineligible Executory Contracts would involve those contracts whereby the bank was requested to provide front or start-up money to begin the contract. This might be considered the equity that the borrower needs to put into the job at the beginning themselves. The bank should never put itself in or find itself in a position where the borrower is ahead of it. If this were the case, by lending the initial start-up money, the contractor would be using the bank similar to the way it may do front-end loading, which would result in unnecessary risk for the bank by assuming more exposure for the future performance of the job, which should be the contractor's responsibility. If a manufacturing contract involves inventory owned by the borrower that must be processed to meet specifications, the up-front advance risk may be somewhat tempered since the borrower already owns the inventory in its raw or partially completed state. As stated above, municipal and government contracts require special assignment and handling versus other executory contracts; therefore, such contracts should be considered ineligible unless certain requirements have been met. For more information on perfecting and lending against municipal and government contracts, see Chapter 8, "Executory Contracts," Sections 8.05 and 8.06.

1.7 ELIGIBLE NOTES

Another type of asset-based collateral that may not be so prevalent is notes receivable. Notes that are considered instruments may be generated from the normal part of certain businesses such as jewelers, diamond dealers, furriers, art dealers, and other sellers of high-priced consumer items and durable goods, including sellers of real estate whereby the underlying real estate may secure the obligation. At times, banks are willing to discount, or lend against, notes created by their customers. Advances on notes may range anywhere from 50-100% of the balance of the note, including the net owed after any discounted amount, depending on the seasoning of the notes, and payments and maturities of the obligations. One advantage of taking notes, assuming there is no infirmity whereby the maker could claim a defense for nonpayment, is that they are often negotiable and can be sold, thus allowing the bank to be a holder in due course if the note(s) have been taken in good faith for new value, and properly endorsed and assigned.

1.8 INELIGIBLE NOTES

Ineligible notes include those that may be taken because the customer could not pay on an open account basis or had some other problems in payment including notes taken in lieu of a recorded judgment. Also included in the ineligible category would be many of the same types as those specified in eligible accounts above, such as notes from related parties including stockholders and employees, contra notes, intercompany notes, or notes taken from indirectly related parties. Any note taken with an infirmity may not necessarily disqualify it as collateral, although this may nullify the bank from being a full holder in due course; thus, the note would not necessarily be negotiable. However, the bank would still have general assignment rights under the obligation. Consumers are protected under the Federal Trade Commission, which results in certain restrictions, nullifying certain holder-in-due-course rights. Therefore, it would probably be optionally on the bank's part to consider notes not having full holder-in-due-course rights as ineligible.

1.9 ELIGIBLE CHATTEL PAPER

Eligible chattel paper often arises from the sales of durable goods by dealers of vehicles and boats and from the sales of appliances and furniture by product distributors and other items sold involving time payments. These sales are often financed by use of conditional sales contracts. The term conditional implies the sale is subject to certain conditions that must be met by the buyer who is now the obligor. The primary condition is that the obligor will not become the owner of the goods or equipment until they are fully paid according to the underlying contractual obligation. Also, when a lessor leases its equipment to a lessee, it normally creates a contract that may be considered chattel paper. Advances on chattel paper collateral may range from 50-100% of the contract, including any net amount owed if the paper were purchased by way of a discount, after giving consideration to the seasoning of the notes, terms and payment history, length and maturity of obligations, recourse to the party(s) selling the contracts, and any funded reserve that can be used to offset losses or applied against delinquencies. Such contracts are frequently bought with recourse similar to notes, which might also affect how much the bank will be willing to advance.

Recourse to the dealer or financier of the contracts may be in the form of full, limited, or nonrecourse guarantees of one kind or another. If the dealer or financier who is selling the contract to the bank signs it with full recourse, the bank can legally go back against the seller for any unpaid balance. Limited recourse may be in the form of limiting the seller or dealer's recourse to some percentage of the total outstanding paper or even setting aside small sums on each contract as a funded reserve. A more prevalent type of limited recourse is the repurchase agreement requiring the seller to buy back the balance of contracts that becomes past due over a certain period. However, the buyer of the paper is usually responsible for goods repossessions or returning them to the seller. Thus, this is not a guarantee of payment by the seller.

For lease transactions, title normally does not pass to the lessee, but the equipment that is considered the lessor's inventory will usually be returned to the lessor at the end of the contract. In such cases, the bank may not lend a high percentage of the contract, but instead lend a percentage of the actual cost of the equipment, unless it gets a funded reserve or some other means of payment assurance by perhaps having the lessee remit the stream of lease payments to it.

1.10 INELIGIBLE CHATTEL PAPER

Ineligible chattel paper may involve some of the same factors that make accounts and notes ineligible. If underlying lease contracts involve disguised or non true leases and the contracts are actually conditional sales contracts subject to the Code, the bank may have to decide how much it wants to rely on the revisionary rights back to the equipment before it sets advance formulas on leases that involve a different type of chattel paper versus the typical contract involving the sale of durable consumer goods.

1.11 ELIGIBLE DOCUMENTS

Documents considered eligible for lending purposes usually involve title documents that allow ownership to pass from one party to the next as it relates to the underlying goods. Generally, these documents involve fungible goods that can be identified in mass. Most frequently, they are stored in a warehouse under the control of a bailee. Storage is normally maintained in Public and Private warehouses. Warehouse receipts are issued by the bailee, who does not legally own the goods but maintains control over them; thus, the term bailee can be used for these caretakers. Banks can lend against these goods and maintain control over them by using the services of bailees. However, this control is relinquished once these goods are released by the bailee.

Therefore, because of the warehouse control involvement, these goods most frequently involve the storage of commodities such as cotton, grain, soybeans, and wheat. Warehouse receipts may be negotiable or nonnegotiable. Documents of title include order bills of lading, which are considered nonnegotiable. On the other hand, warehouse and dock receipts alone or general orders for the delivery of goods may fall into either the negotiable or nonnegotiable categories. Advances on documents may range anywhere from 50-90% of the cost or even selling price of the commodity or merchandise. The bank may also be willing to lend more if repurchase agreements are in place from suppliers.

1.12 INELIGIBLE DOCUMENTS

Ineligible documents include those that may have prior liens or evidence that does not show clear title ownership in the borrower's name even though the bank may have warehouse receipts in its possession. Also, what might have to be subtracted from the value of such collateral as being ineligible are any unpaid warehouse charges that should be eliminated from any established borrowing base. Such charges give the warehouse a priority lien like any other secret lien that is not subject to the Code. Other factors that can affect the eligibility as it pertains to maintaining a proper borrowing base include fluctuations in prices and deteriorations in products. Remember, you are dealing in commodities that are changing in value constantly and at times may be subject to rapid deterioration and spoilage, thus creating more risk in values. There are a great number of nuances within the whole area of taking documents as collateral. For more information on this whole subject of lending against documents, see A Banker's Guide to Secured Lending and Documentation (formerly Probus Publishing).