Fundamentals of Factoring
USA (National/Federal)

Related Content

A Practice Note covering factoring transactions, including their structure, the services provided by factors, types of factoring facilities, and factoring fees. This Note also discusses the advantages of factoring over traditional bank financing and key issues to consider in structuring and negotiating factoring agreements.

Many businesses, both large and small, factor their **accounts receivable** (accounts). Factoring is sometimes wrongly perceived as a source of financing of last resort, favored by financially distressed companies that cannot obtain traditional bank financing. In fact, the majority of American factoring volume arises from contracts between large, old-line factors, many of which are bank owned or affiliated, and creditworthy client companies, many of which are in the apparel, textile, furniture, and footwear industries. Beyond these traditional factoring markets, factors today purchase accounts receivable from clients in almost every industry, including electronics and other consumer goods, government contracts, medical services, construction, transportation, and other service industries.

Despite the prevalence of factoring in the US, many attorneys, accountants, finance professionals, and judges have surprisingly little knowledge of this old form of commercial finance. This article provides an overview of factoring, focusing on:

- How factoring works (see What is Factoring?).
- Non-recourse versus recourse factoring (see Non-Recourse vs. Recourse Factoring).
- The services offered by factors (see Related Services Provided by Factors and Additional Services Offered by Factors).
- Advantages for businesses of factoring over traditional bank financing (see Advantages of Factoring).
- The various types of factoring facilities (see Types of Factoring Facilities).
- Notification versus non-notification factoring, and the factor's verification of accounts receivable owed by the factoring client's account debtors (see Notification and Verification).
- Clients' criteria when choosing a factor (see Choosing a Factor).
- The factor's initial **due diligence** on prospective clients (see Factor's Due Diligence).
- The legal and business issues typically covered by factoring agreements (see Factoring Agreements).
- The main documents and closing deliverables involved in factoring transactions (see Transaction Documents and Closing Deliverables).
- Key issues to consider in structuring and negotiating factoring agreements (see Structuring and Negotiating Factoring Agreements).
- The sequences of events, after execution of a factoring agreement, in a traditional factoring relationship (see The Factoring Process).

For a glossary of factoring terms, see Box, Factoring Terminology.

What is Factoring?

Factoring is an ongoing financial arrangement involving three parties:

- The factor, which purchases the client's accounts receivable and performs other services related to the accounts.
- The client, which desires to convert its accounts receivable into working capital.
- The account debtor, whose purchases of goods and services from the client generate the client's accounts receivable.

In consideration of a commission (also known as a factoring commission or discount fee), the client sells the factor its current (not overly aged) accounts receivable owed to the client by third-party customers (account debtors), arising from goods sold or services rendered by the client to the account debtor. Depending on the form of factoring chosen, the factor may finance its client by making cash advances to the client before its purchase of the subject accounts.

Accounts receivable purchased by factors generally collect in about 45 days. Many factors limit accounts eligible for purchase to those aged 60 days or less. The factor or its client typically notifies the account debtors that their accounts have been purchased by, and are payable only to, the factor (see Notification and Verification).

Non-Recourse vs. Recourse Factoring

Traditionally, factors purchase accounts receivable from their clients without recourse. This means that if a purchased account is not collected by the factor, due solely to the financial inability of the account debtor to pay, the factor must still pay its client the agreed purchase price. Because of the factor's assumption of this credit risk, the sale of these accounts to the factor is treated as a "true sale" under **Generally Accepted Accounting Principles (GAAP)**. In other words, on the asset side of the client's balance sheet, the accounts sold to the factor are replaced by cash.

However, even when the factor buys accounts without recourse, it still retains "quality recourse," and can reverse the purchase (referred to as a "chargeback") of accounts receivable that:

- Are disputed by the account debtor.
- Breach **representations and warranties** made by the client to the factor at the time of sale (for examples of common representations and warranties, see Factoring Agreements).

Although factoring originally developed as a non-recourse sale transaction, in common American commercial parlance today, factoring includes any transaction structured in form as a purchase of accounts receivable, even if no credit risk passes to the factor. In full recourse factoring, purchased accounts that are not collected by the factor within a relatively short time, often 60 to 90 days, *for any reason* (including bankruptcy or other financial inability of the account debtor to pay), are charged back to the client by the factor. That is, the client must refund the payment made by the factor.

In most states, full recourse factoring transactions are re-characterized as secured loans, with the factor's payment treated as a loan secured by the accounts receivable. However, in Texas and Louisiana, the intent of the parties governs. In these two states, if the parties intend a factoring arrangement to be treated as a true sale of accounts receivable, even if the factor has full recourse against its client, the transaction will be recognized as a true sale.

Many foreign countries take the same approach as Texas and Louisiana. In England, for example, full recourse factoring is treated as a true sale of accounts receivable, if that is the intent of the parties. UNIDROIT (a French abbreviation of International Institute for the Unification of Private Law) does the same. The UNIDROIT Convention on International Factoring (1988) (adopted by relatively few countries, not including the U.S.), in Article 1(2)(b), defines a factor as performing"at least two of the following functions":

- "Finance for the supplier [the client], including loans and advance payments."
- "Maintenance of accounts (ledgering) related to the receivables."
- "Collection of receivables."
- "Protection [of the client] against default in payment by debtors."

Modern factoring agreements often combine non-recourse and recourse factoring. In partial non-recourse factoring, for example, the factor's credit risk on the purchased accounts is limited by time. If the account debtor becomes insolvent or bankrupt before the expiration of the credit risk period (for example, 60 or 90 days from the invoice date), the factor bears the loss on the account, so long as it was not disputed by the account debtor. If, however, the account debtor becomes insolvent or bankrupt after the credit risk period has expired, the factor charges back the account to the client.

Factoring differs from traditional receivables financing in that factoring involves a purchase and sale of the accounts receivable in a true sale, rather than a loan secured by borrower's accounts receivable. Therefore, factors are primarily concerned with the quality of the assets being purchased (the accounts receivable themselves), rather than the client's ability to satisfy financial covenants and ratios. That is, the factor focuses on the creditworthiness of the client's customers rather than the client. For a discussion of receivables financing, see Practice Note, Borrowing Base: Overview: Receivables and the Borrowing Base.

Related Services Provided by Factors

Factors provide a number of services to their clients related to the factoring transaction. These include:

- **Credit protection.** In non-recourse (and partial non-recourse) factoring, factors provide credit protection to their clients. If
  - the factor purchases an account without recourse;
  - the account is not disputed by the account debtor and is not otherwise ineligible; and
  - the account is not collected due solely to the financial inability of the account debtor to pay;
  - then the factor must pay the full purchase price to the client.
- **Bookkeeping and collection services.** Factors often provide bookkeeping (ledgering) and collection services to their clients for the purchased receivables. However, in factoring transactions where the customer is not notified, the factor hires the client as its agent to service the purchased accounts (see Notification and Verification).
- **Financing.** Factors often provide financing to their clients in a transaction known as advance factoring. Rather than paying for the accounts receivable on what would ordinarily be the purchase date, the factor advances funds to the client on a date prior to the purchase date. Typically, the amount of the advance is between 70% and 90% of the purchase price of the accounts receivable. This advance can be treated either as an interest-bearing loan or a partial prepayment of the purchase price. Most large factors treat advances as loans.

Additional Services Offered by Factors

Beyond factoring facilities, many factors also offer a range of other services to their clients, such as:

- Accounts receivable financing (revolving loans), inventory loans, and other forms of **asset-based lending**, such as **term loans** (for an overview of asset-based lending transactions, see Practice Note, Asset-based Lending: Overview).
- Purchase order financing.
- Letters of credit (for information on letters of credit, see Practice Notes, Letters of Credit in Financing Transactions: Overview and Commercial Letters of Credit).
- Government contract financing.
- Import-export financing and other forms of trade finance.

Advantages of Factoring

Businesses can garner several benefits by factoring accounts receivable, as compared to traditional bank financing. These include:

- Reduction of credit losses, in non-recourse and partial non-recourse factoring, by the factor's assumption of the credit risk on approved accounts receivable.
- Reduction of credit and collection expense and increased efficiencies in billing and collecting accounts receivable by outsourcing some or all of these functions to the factor. This allows the client's management to focus on production, marketing, purchasing, and other functions, which can be especially attractive to small and mid-size businesses.
- Improved and more timely financial reporting, from the factor to the client, on matters such as:
  - the aging of open accounts receivable;
  - account debtor payment (collection) history;
  - credit risk;
  - disputes with account debtors;

- deductions claimed by account debtors on their accounts, such as for lost, returned, or damaged goods; and
- discounts claimed by account debtors.

- Ability to obtain financing in the form of advances by the factor against purchased accounts (see Advance Factoring). Alternative financing, such as asset-based lending, might not be available to the client, particularly if the client:
  - is newly formed;
  - is growing rapidly;
  - is thinly capitalized;
  - has a narrow customer base, so that a large volume of accounts receivable are from a small number of customers (excessive concentration);
  - has slow-paying customers (bad turnover);
  - has high credit losses; or
  - is financially troubled.
- Few or no financial covenants, with higher or even unlimited funding on accounts accepted for purchase, especially in non-recourse factoring facilities.
- Faster approvals.
- More limited guarantees. For example, the factor may accept a validity and non-diversion guarantee from the client's principals that does not extend to credit risk assumed by the factor. By contrast, a lender might require a full guarantee (for information on the different types of guarantees used in bank loan financings, see Practice Note, Guaranties: Overview).
- Enhanced ability to raise sales and smooth out seasonal fluctuations in demand, for example, by obtaining seasonal "over-advances" from the factor. An "over-advance" is an advance to the client in anticipation of accounts receivable that will arise at a later date and be sold to the factor at that time.
- A closer working relationship with the factor's employees than might exist with a bank administering a line of credit.
- Access by the client to the factor's specialized industry knowledge, which might lead to new customers and additional business for the client.

Types of Factoring Facilities

There are three principal types of factoring facilities:

- Maturity factoring.
- Collection factoring.
- Advance factoring.

Maturity Factoring

From the 1920s through the late 1970s, when most factoring clients were wholesale businesses, meaning that their account debtors were manufacturers or distributors rather than retailers, factors often provided maturity factoring (also known as wholesale factoring) to these clients. In maturity factoring, pure credit protection is provided. Each month the factor purchases all credit-approved accounts receivable generated during the month, paying the client on the average maturity date of the accounts purchased, plus an agreed number of days for collection.

If an approved account does not timely collect, due solely to the financial inability of the account debtor to pay, the factor still pays the client the purchase price. In pure maturity factoring, the factor does not provide financing to the client. However, the client benefits by obtaining a predictable income stream because the factor pays the purchase price on an agreed date (the average maturity date), and by transferring the related credit risk to the factor.

For an example of a maturity factoring agreement, see Standard Document, Maturity Factoring Agreement.

Since the 1970s, as the United States has changed from a manufacturing economy to a service economy, the factoring business in the United States has been transitioning from maturity factoring to collection factoring, where the clients' customers are typically retailers.

Collection Factoring

Most factoring today is collection factoring (also known as retail factoring), where the client's customer is a retailer. In collection factoring, the factor pays its client the purchase price for accounts receivable after they are collected by the factor, typically on a weekly basis.

If an approved account receivable remains unpaid after it has matured, and it has not been disputed by the customer, the factor must pay the client for the receivable when a determination has been made that it cannot be collected due solely to the financial inability of the customer to pay. Depending on the terms of the factoring agreement, this determination may be made when:

- The account receivable remains unpaid for a specified period of time after its maturity date. Extended payment delays are deemed to be attributable to the account debtor's financial inability to pay.
- The client provides the factor with reasonable proof of the account debtor's financial inability to pay.

For an example of a collection factoring agreement, see Standard Document, Collection Factoring Agreement.

Advance Factoring

Advance factoring is different from maturity factoring and collection factoring in that the purchase price for the accounts receivable is advanced to the client as a loan on a date earlier than the purchase price would ordinarily be paid. The loan is not made against the accounts receivable themselves, but against the purchase price that the factor will pay for them. The advance rate is typically between 70% and 90% of the factor's purchase price.

Advance factoring is usually offered as a separate facility in either a maturity factoring agreement or a collection factoring agreement. Ordinarily, the client receives the purchase price for the receivables when the agreement calls for it, either on the average maturity date (in the case of maturity factoring) or on the weekly date following collection (in the case of collection factoring). But when the client's cash flow is low, it can request an advance from the factor, based on accounts receivable that it expects the factor to purchase at a later date. The advance is then typically repaid, with interest, from the proceeds of the next purchase price payment.

For an example of an advance factoring agreement, see Standard Document, Advance Factoring Agreement.

Discount Factoring

Discount factoring is essentially a variation on advance factoring, where the factor's advance is treated, not as a loan, but as a prepayment of the factor's contractual obligation to pay the purchase price for the accounts receivable. Because the purchase price is prepaid, the amount of the purchase price is discounted (reduced), based on an agreed discount factor. The discounted purchase price is also reduced by the amount of the factoring commission payable by the client on the purchased receivables.

In some cases, if the factor charges a relatively higher factoring commission, the prepayment might not be discounted.

For an example of an discount factoring provision in a maturity factoring agreement, see Standard Document, Maturity Factoring Agreement: Section 4(e) and Drafting Note, Discount Factoring.

Spot Factoring and Block Discounting

Spot factoring is a one-time purchase of a single invoice by a factor. A variation known as block discounting is a one-time purchase of multiple invoices in a single block. Spot factoring and block discounting are different from traditional factoring, in that factoring is an ongoing arrangement for the purchase of receivables between factor and client. Spot factoring and block discounting are generally more expensive than traditional factoring, reflecting the higher risk and greater expense associated with one-time transactions.

Notification and Verification

Most factoring agreements require account debtors to be notified that their accounts receivable have been sold to the factor. In particular, they require that:

- Invoices be marked as sold to the factor.

- Account debtors be instructed to make all payments on their invoices directly to the factor.

Article 9 of the **Uniform Commercial Code (UCC)** addresses, among other things, issues related to notification and defenses of the account debtor. For example:

- Under UCC Section 9-404(a)(1), the factor is subject to all terms of the contract between the account debtor and the factor's client and, therefore, to claims in recoupment or defenses arising under that contract.
- Under UCC Section 9-404(a)(2), once the account debtor receives notice of the factor's purchase of its account receivable, any claim or defense which arises thereafter cannot be **set off** against the purchased receivable.
- Under UCC Section 9-404(b), any account debtor claim or defense arising before the account debtor receives notice of the factor's purchase serves only to reduce the amount of the account debtor 's payment obligation to the factor, and cannot be used by the account debtor to establish any affirmative liability on the part of the factor in respect of the purchased receivable. For a more detailed discussion of *Section 9-404 of the UCC*, see American Factoring Law*, Ch. 7.II.A*.
- Under UCC Section 9-406, once an account debtor is notified that its account receivable has been sold by the client to a factor, the account debtor's obligation to the factor is not discharged if the account debtor instead pays the client. This reduces the risk of fraud that would occur if a client, in breach of its factoring agreement, continued to collect sold accounts and retained the collected proceeds, rather than turning them over to the factor.

About 20% of American factoring today is done on a non-notification basis. In some forms of non-notification factoring, the factor purchases accounts receivable as they are created, and the factoring agreement provides that the client serves as the factor's collection agent (subject to collection parameters set by the factor, and to the factor's right, in its discretion, to terminate the client's role as servicer and to collect the accounts itself). The client then turns the proceeds of collected receivables over to the factor, or, if the factoring agreement requires, deposits these proceeds in a lockbox controlled by the factor.

In other forms of non-notification factoring, the factor purchases accounts receivable only once they age past an agreed date or go into payment default. Factors generally charge more for non-notification factoring because of the risk of the client diverting collection proceeds.

Factors may also require accounts receivable to be verified before they purchase them (although this is not typical for large, old-line factors dealing with established clients). Verification requires the account debtor to confirm that:

- The amount payable is correctly shown on the client's invoice or purchase order.
- It does not assert any defense, offset, or counterclaim against its obligation to pay the account receivable.

Verification is conducted both in writing and by telephone. If the customer verifies an account receivable to the factor, the factor has an independent cause of action (based on **promissory estoppel**) against the customer if it fails to pay.

Choosing a Factor

Clients consider several criteria when choosing a factor. These include:

- Reputation, financial strength, and stability of the factor.
- Pricing (amount of factoring fees and advance rates).
- Products and services. For example, if credit protection is required, clients must consider whether the prospective factor offers non-recourse or partial non-recourse factoring facilities. Clients may also consider whether the factor will buy accounts receivable on a non-notification basis, if the client so desires.
- Industry experience.
- The nature and amount of **collateral** required, beyond accounts receivable, if the factor is advancing funds.
- Online access to information about purchased accounts receivable.
- Speed of response, reliability of the factor and the client's ability to reach the factor's key decision-makers quickly.
- Personal service.

Factor's Due Diligence

Like lenders in loan transactions, factors usually perform due diligence on prospective clients before entering into definitive factoring agreements. Often, the factor charges a fee for this review. The scope of a factor's due diligence, which is either carried out by the factor itself or by a third party on the factor's behalf, typically includes:

- Verifying the financial status of the prospective client. For example, the factor reviews:
  - UCC, tax, judgment, pending litigation, and other searches against the prospective client;
  - the client's most recent **financial statements** and tax returns;
  - bank statements;
  - collection reports; and
  - receivables aging reports.
- Running credit reports on the client, such as those prepared by Dun & Bradstreet, Experian, NACM and other credit reporting agencies.
- Investigating the principals and senior management team of the prospective client and performing background and credit checks on those persons.
- Verifying the **good standing** of the prospective client and confirming its authority to sell accounts receivable to the factor.
- Reviewing the financial strength of the prospective client's customers, particularly if accounts are being purchased without recourse.
- Investigating any contractual or other impediments to a prospective sale of accounts receivable to the factor (such as those arising from existing **liens** or factoring relationships, anti-assignment clauses, and recoupment risks).

Factoring Agreements

Factoring agreements are two-party agreements between the factor, as purchaser of accounts receivable, and its client, as seller. Factoring agreements are also called Sale and Servicing Agreements and Factoring Accounts Receivable Purchase Agreements. Factoring agreements cover a wide variety of legal and business issues, including:

- The sale and purchase of the client's accounts receivable.
- Whether accounts receivable are purchased on a non-recourse, partial non-recourse, partial recourse/split risk (where credit risk on accounts receivable is shared between the client and the factor, on agreed terms), or full recourse basis.
- Whether accounts receivable are purchased on a maturity or collection factoring basis.
- Whether accounts receivable are purchased on a notification or non-notification basis (see Notification and Verification).
- The term of the factoring agreement, and its termination.
- The purchase price for accounts receivable. The purchase price is generally the face value of the receivables, less contractual discounts and other deductions allowed or allowable, whether or not taken by customers, less the factor's commission (see Factor's Fees and Expenses).
- Whether the agreement provides for advance factoring or discount factoring. Advance factoring is mostly done by large, old-line factors, with advances typically bearing interest at a floating rate calculated as a spread over a bank's prime rate. Discount factoring is usually done by smaller factors, with the factoring agreement specifying the discount applicable to the purchase price prepayment. See Character of the Factor's Initial Advance.
- Reserves held by the factor, and when reserves will be released back to the client.
- Chargeback rights of the factor for disputed, partially paid, and ineligible accounts.
- The client's grant of a security interest to the factor, covering:
  - the proceeds of the purchased accounts receivable (that is, the purchase price paid for them by the factor);
  - non-purchased accounts receivable;

  - credit balances owed by the factor to the client; and
  - any other collateral taken by the factor.
- Whether the client must offer all of its accounts receivable to the factor for purchase (although this is not typical, at least for smaller factors). If not, how factored receivables will be chosen. And the extent of the factor's discretion to reject receivables that are offered to it.
- Representations and warranties by the client about the nature and validity of both the purchased accounts receivable and the non-purchased receivables pledged as collateral. These can include representations and warranties that the receivables:
  - are validly owned by the client;
  - are not subject to liens, offsets, defenses, or counterclaims;
  - are within applicable concentration limits;
  - have not been previously rejected for purchase by the factor; and
  - have not been re-aged.
- Representations and warranties by the client about itself, including:
  - its exact legal name, state of organization or formation, and legal standing in that jurisdiction;
  - that its execution and performance of the factoring agreement have been duly authorized, do not breach other contracts, and do not require third-party consents; and
  - that it is solvent and will remain solvent.
- Covenants by the client, including commitments:
  - not to change its state of organization or formation without giving the factor prior notice;
  - not to change lockbox instructions and procedures or sweep instructions without the factor's permission; and
  - to include a legend on invoices for all accounts receivable sold to the factor, notifying the customer of the sale and instructing the customer to pay the factor directly.
- Concentration limits for customers.
- The factor's set-off rights. The factor can set off indebtedness of the client to the factor (for advances received, interest, legal fees, factoring commissions, ledger debt, and other charges) against monies that the factor owes the client (the credit balance in the client's account with the factor), arising from sums owing for the purchase price of the factored accounts receivable (net of initial advances).
- The extent of any guarantees by the client's owners or managers, or by third parties, of client obligations to the factor. Guarantees may include:
  - a full guarantee of collection, meaning the guarantor assumes all risk that accounts receivable will not collect, including credit risk;
  - a guarantee that protects the factor against the sale of ineligible accounts receivable by the client; and
  - a guarantee against diversion by the client of the collected proceeds of factored accounts receivable, if they are not turned over by the client to the factor as required.
- In limited circumstances, covenants relating to the client's financial condition.
- Billing and collection procedures, including who bills and who collects the accounts receivable, and, where appropriate:
  - the treatment of non-factored accounts receivable; and
  - the client's agreement to act as agent for the factor, servicing the accounts receivable sold to the factor.
- Defaults and remedies.
- Boilerplate provisions governing matters such as corporate authorization, amendments, choice of law, disputes, waiver of jury trial, and notices.

For examples of factoring agreements, see Standard Documents, Maturity Factoring Agreement, Collection Factoring Agreement, and Advance Factoring Agreement.

Transaction Documents and Closing Deliverables

Transaction documents and closing deliverables commonly used in factoring transactions include, in addition to the factoring agreement:

- Security agreements (if the factoring agreement itself does not serve as a security agreement) from the client and from any guarantors who give guarantees secured by collateral (for more information, see Practice Note, Security Agreement: Overview and Standard Document, Security Agreement).
- **UCC-1 financing statements**, identifying the client as the debtor and the factor as the secured party (for more information, see Practice Note, UCC: Preparing and Filing Financing Statements).
- Subordination agreements and letters of indemnity, as needed, in circumstances where:
  - an existing lienholder is not paid off with the proceeds of the initial advance made by an incoming factor;
  - an incoming factor comes in "on top" of an existing factor's position;
  - an incoming factor purchases the position of an outgoing factor and the client has other secured creditors; or
  - tax liens exist, in which case the client must also have in place (and stay current on) an installment payment agreement with the Internal Revenue Service.

  In transactions where the incoming factor comes in on top of an existing factor's position, the existing factor (old factor) terminates its purchases of accounts that arise after an agreed termination date, pursuant to a letter of indemnity agreement among the old factor, the incoming factor (new factor) and the client. The factoring agreement (and the credit risk assumed by the old factor) remains in place for all accounts purchased by the old factor prior to the termination date. After the termination date, the old factor collects out its position on the retained accounts. The new factor purchases accounts from the client that arise after the termination date and, in factoring parlance, comes in "on top" of the old factor's position.

  Alternatively, under a buy-out agreement, a new factor can pay off the old factor, for an amount equal to its funds-in-use on purchased accounts not yet collected, and the client releases the old factor from any further credit risk.

  For more information on takeover transactions and their various structures, see American Factoring Law, Ch. 10.
- Guarantees. These can be:
  - full guarantees, where the factor does not assume the credit risk;
  - limited validity guarantees that protect the factor against the sale of ineligible accounts receivable by the client; and
  - non-diversion guarantees that protect the factor against the client's refusal to turn over the proceeds of factored accounts to the factor.

  For a discussion of guarantees, see Practice Note, Guaranties: Overview.
- **Closing certificates** and **corporate resolutions** or consents.
- A legal opinion from the client's counsel regarding the validity and enforceability of the transaction documents, security interest, lien perfection and priority, and other closing-related matters.
- A bill of sale or purchase assignment for the initial sale of accounts receivable to the factor. If the factoring agreement does not provide for the automatic assignment to the factor of all accounts receivable arising after closing, a bill of sale or purchase assignment is executed, not only on the day of the initial closing, to evidence the initial sale of accounts, but also periodically thereafter, to effectuate and further evidence sales of accounts purchased in subsequent batches, after the initial closing.
- **Good standing certificates** for the client and any guarantors.
- Tax, judgment, and UCC lien searches with respect to the client and, where appropriate, large account debtors (for more information, see Practice Note, UCC: Conducting and Reviewing UCC Searches).

Structuring and Negotiating Factoring Agreements

Before advising a client about a prospective factoring arrangement, counsel should consider the client's goals and consider the following key issues:

- The type of factoring that best suits the client's needs.
- Whether the transaction involves a true sale of accounts to the factor.
- Commissions, fees, and expenses payable to the factor.
- The character of the factor's initial advance, if applicable.

Choosing the Type of Factoring Facility

The following matters are important to a client's decision about the type of factoring facility that best addresses its needs:

- If the client needs credit protection, non-recourse maturity factoring (if the account debtors are at the wholesale level, such as manufacturers and distributors) or non-recourse collection factoring (if the client sells to retailers) may be most appropriate, or a partial non-recourse facility, depending on the level of credit protection required. If the client does not require credit protection, but needs bookkeeping, ledgering and collection services, a recourse factoring facility may be more suitable.
- If the client requires financing from the factor, the client should request an advance factoring facility, which can be provided on either a maturity or a collection basis.
- If the client wishes to make a one-time sale of accounts receivable to enhance its cash position, spot factoring may be most appropriate.
- If the client does not require bookkeeping, ledgering, and collection services from the factor, non-notification factoring may be most suitable because the account debtors are not told that their accounts receivable have been sold to a factor.

True Sales and Off-Balance Sheet Financing

Generally, under American law, client accounts receivable that are sold to the factor without recourse are treated as having been sold to the factor in a true sale, and the receivables are replaced on the client's balance sheet with the cash proceeds. This can be useful, if, for example, the client is bound by covenants in other commercial agreements that prohibit the client from borrowing against its accounts receivable, but do not prohibit it from selling those receivables.

Except in Louisiana and Texas, the prevailing rule in American law is that full recourse factoring is not treated as a true sale of accounts receivable to the factor, but is characterized instead as a loan secured by the accounts receivable (see What is Factoring?). For a detailed discussion of true sale issues and each party's accounting in a true sale of accounts receivable, see *American Factoring Law, Chs. 4 and 14*.

Factor's Fees and Expenses

Clients must consider whether their gross margins are sufficient to cover the cost of factoring. Factoring fees depend on several variables, including the:

- The number of accounts receivable to be factored.
- Invoice size.
- Age of the purchased accounts (the older the accounts, the higher the risk and the pricing).
- Number and diversity of the account debtors.
- Creditworthiness of the account debtors.

The factor's fees and expenses include:

- **Commissions.** Factors charge commissions for the credit risk they assume and for providing bookkeeping, ledgering, collection, and other administrative services to their clients. Clients should consider that:
  - large factors often charge low commissions on their purchases of accounts receivable, generally in the range of 0.5% to 2.5%, with a commission of 1% being typical; and
  - smaller factors generally charge higher commissions, and, in some cases, the commission varies over time, subject to an overall cap (for example, the factor's commission could be 1.5% per month, subject to an overall cap of 15%).

- **Commitment fees.** Factors often charge commitment fees at inception of the factoring facility.
- **Interest.** Factors charge interest on advances (often calculated on the average daily balance of the advance) if the advances are treated as loans. The interest rate is typically based on a bank prime rate plus an additional margin. Smaller factors, which generally charge higher commissions, sometimes do not charge interest on advances.
- **Discount.** Where advances are treated, not as a loan, but as a discounted prepayment of the purchase price, the discount represents an amount equivalent to the interest that would have been charged on an advance (see Character of the Factor's Initial Advance).
- **Additional fees.** Additional fees may be charged in particular factoring arrangements. For example, some factors charge minimum monthly commissions and minimum annual commissions. Factors may also charge early termination fees if the client wants to terminate the factoring agreement earlier than its stated expiration date.

Character of the Factor's Initial Advance

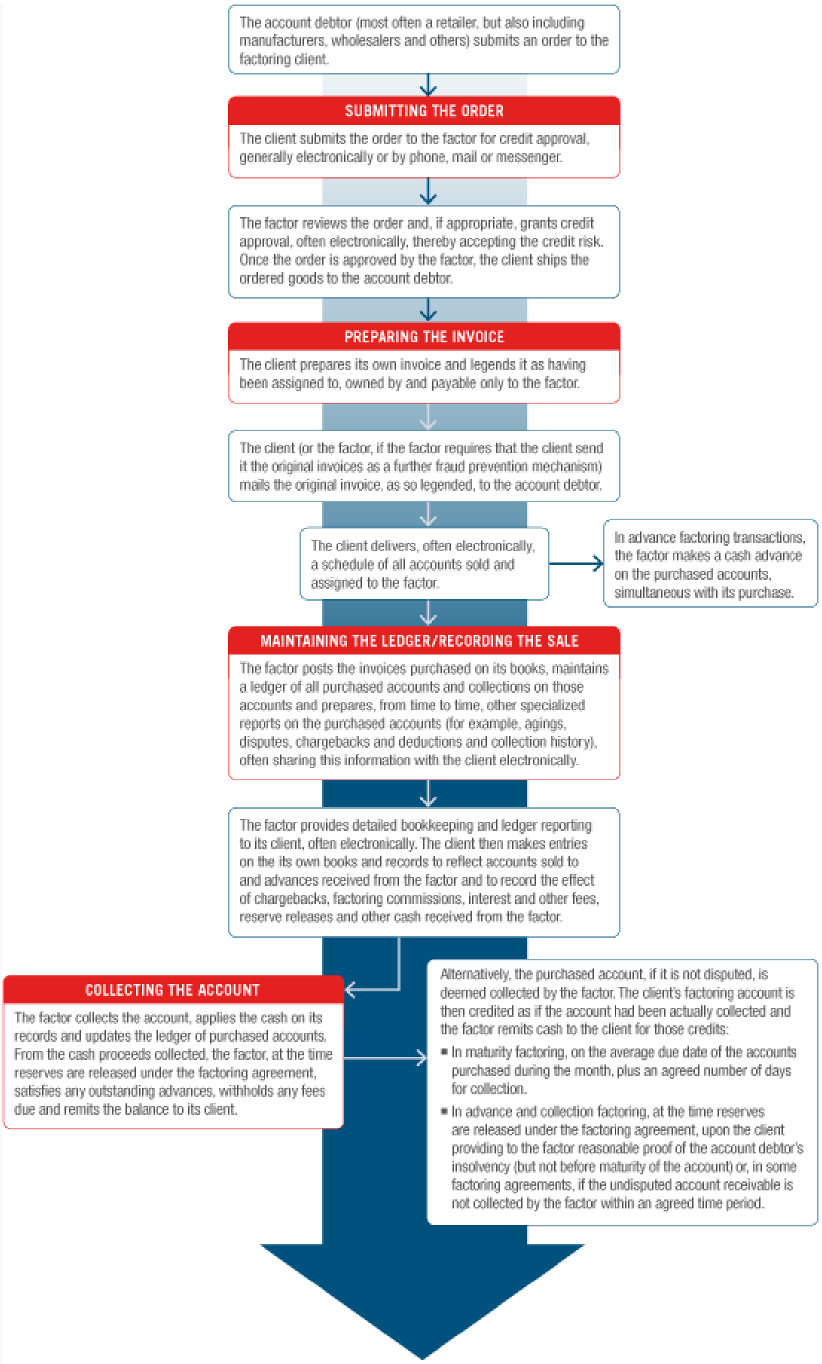
As discussed above, most large factors treat advances as interest bearing loans to the client. Some factors, however, treat the initial advance as a non-interest bearing prepayment of the factor's purchase price of the subject accounts, but charge a higher factoring commission. Because the purchase price is not payable by the factor until the accounts mature, some factors discount the amount of the initial advance to reflect the client's early receipt of funds.

If the advance by the factor is treated as a:

- Loan, the outstanding amount of the loan is repaid by set off against the factor's obligation to pay the purchase price of the accounts. In this case, the factoring agreement addresses all lending aspects of the factoring arrangement and separate **promissory notes** are not executed.
- Partial prepayment, the amount of the advance is set off against the full purchase price, but receipt of the advance does not give rise to indebtedness owed to the factor. Rather, the advance just reduces the balance of the purchase price owed by the factor to the client.

The Factoring Process

The following flowchart illustrates the general sequence of events, after execution of a factoring agreement, in a traditional, non-recourse, notification factoring relationship:



Factoring Terminology

Account Debtor

The customer of the client, who is the obligor on an account receivable sold to the factor.

Advance

In advance factoring, the portion of the purchase price of the factored accounts receivable, often 70% to 90%, which is advanced by the factor to the client on the date of purchase. Such an advance is sometimes referred to as “cashing the sale.”

Balance Payment

When the factor makes an advance to the client, it is typically limited to 70% to 90% of the purchase price for the accounts receivable. The "balance payment" is the remaining 10% to 30% of the purchase price, net of factoring commission and other fees owing to the factor.

Batch

Also known as a "schedule." A group of accounts receivable purchased by the factor during a specified time period (for example, weekly, bi-weekly, or monthly).

Chargebacks

Disputed and ineligible accounts receivable purchased by the factor but later returned (charged back) by the factor to the client under the terms of the factoring agreement, reversing the factor's purchase of those accounts receivable. Chargebacks also include other amounts charged back to the client, such as amounts attributable to discounts, allowances, and credits taken by the account debtor.

Client

The seller of accounts receivable, to the factor.

Client Risk

Also known as "department risk" and "mill risk." Those accounts receivable purchased by the factor from the client on a full recourse basis, with no assumption of credit risk by the factor.

Commissions

Also sometimes referred to as "discount fees." The factor's charges to its client (calculated as a percentage of the purchase price of the factored accounts receivable) for assuming credit risk and for performing billing, collection, and other services provided to the client.

Dilution

The portion of purchased accounts receivable that do not collect, expressed as a percentage of the face value of the purchased accounts.

Disputed Account

An account receivable that does not collect for reasons other than credit risk assumed by the factor (that is, for reasons other than the account debtor's financial inability to pay).

Factor

The purchaser of accounts receivable, from the client.

Funding Limit

Also known as the "facility limit." The dollar amount beyond which no new accounts will be factored. This is sometimes expressed as the maximum volume of purchased accounts receivable not yet collected by the factor or as the maximum permitted balance of the factor's open advances.

Funds-in-use

Also known as "funds employed." The sum of the factor's open advances that are not yet collected, plus all other fees and expenses due from the client to the factor.

Ledger Debt

The indebtedness of the factor's client to a third party (which is itself a client of the factor) for goods sold or services rendered. Factoring agreements typically include ledger debt within the meaning of indebtedness owed to the factor, for purposes of set-off.

Maturity

The date when purchased accounts receivable are due and payable under the sales contract between the client and its account debtor. In a maturity factoring agreement, the factor pays its client on the average monthly maturity of the purchased accounts.

Non-purchased Accounts

Client-owned accounts receivable that are not sold to the factor, but are often pledged by the client to the factor as security for fees, expenses, and other obligations owed by the client to the factor under the factoring agreement. Collections by the factor on these non-purchased accounts are sometimes referred to as "non-factored funds."

Old-line Factor

A factor that purchases client accounts receivable without recourse, assuming the credit risk for these accounts. An old-line factor generally also:

- Notifies the account debtors of the assignment.
- Collects the purchased accounts (sometimes in the factor's own name).
- Maintains a detailed bookkeeping ledger for the purchased accounts.

Reserve

An unsegregated amount on the factor's books, generally a credit balance (due to the client), representing the net of:

- Credits for:
  - the amount of the purchase price owed by the factor to the client on the purchased accounts receivable; and
  - any other credits, including collections received by the factor on non-purchased accounts.
- Debits arising from, for example:
  - advances made to the client on the date of purchase;
  - releases of reserve amounts, from time to time, by the factor to the client;
  - commissions, interest, and other fees and charges owed to the factor by the client; and
  - chargebacks, by the factor to the client.

Roughly speaking, the reserve equals the inverse of the advance rate. If the advance rate is 80%, the reserve, before the various charges, is 20%.

For a more complete glossary of factoring terms, see *American Factoring Law, 2011 Supplement*.

PRODUCTS

PLC US Finance, PLC US Law Department