

## **Factoring With Finesse:** *The Finer Points of Negotiating Contracts*

*Factoring relationships are principally governed by the factoring contract that ideally reflects the rights and remedies of the parties, along with procedures, systems and reporting requirements. The following article highlights key elements required in factoring contracts which help to avoid unnecessary costs and difficulties down the road.*

By Harvey S. Gross

**F**actoring remains an essential part of the business cycle. However, in my 39 years of working with factoring providers, clients, customers, professionals, and other financial institutions, it is apparent that many, if not most people, do not know all the “ins and outs” of factoring. This article will point out some elements in successfully negotiating a factoring contract.

The factoring relationship is principally governed by the factoring contract, which ideally reflects all of the rights and remedies of the parties, as well as procedures, systems and reporting requirements which the relationship will include. A poorly written factoring contract—or worse, a poorly understood one—can create unnecessary costs and difficulties down the road. I have seen too many cases in my career in which a factoring “client”—the supplier who contracts with the factor to borrow money, sell accounts receivable, etc.—didn’t really understand how the factoring relationship worked, and how availability under the contract would be calculated. I have also seen too many lenders get into factoring, without putting into place the controls and reporting systems that are really crucial to being successful in the factoring business, and especially using contracts that did not properly protect the factor’s interests.

Among the key terms in the factoring contract are the start and termination dates, and notice requirements that may apply to termination. Since minimum anniversary charges may apply, timely notice of termination is important. For many clients, factoring is used as a temporary financing method in the growth and development of its business, and unexpected surprises as the client is trying to exit the factoring relationship are most unwelcome.

Monthly charges may also apply, as well as charges for an unused minimum volume of transactions. Regarding the latter, the client would be wise to have these defined on an annual, not monthly, basis so as to allow for normal monthly fluctuations in business activity.

Most factors charge due diligence fees to prospective clients which are designed to cover the factor’s costs of getting up to speed about the client’s business as well as get comfortable with the collateral. The client’s reporting systems are evaluated so that the factor can determine the reliability of the information it will receive from the client on a regular basis.

The client’s basic cost is the commission on invoices that are factored. The amount of this commission can vary widely, with the lowest commissions charged to larger clients who turn over a higher volume of transactions, and who have lower historical levels of dilution—sales returns and allowances, disputes, and bad debts. Other charges may be included, such as service charges for maintaining and monitoring the account, field audits, interest costs and unused line of credit fees for borrowing. All of these and other costs go into the pricing aspects of the factoring contract.

Equally, if not more important, is the structure of the factoring contract. How will the availability of funds to the client be determined, and what will be the timing of that availability? How will the collateral be valued for purposes of payments from the factor, and how will the factor’s other credit exposure to the client’s customers affect the factoring relationship? Will there be personal guarantees or other credit enhancements in effect, and how will these be structured? How many days does the factor have to advance payment after payment is required?

While most factoring contracts will designate an advance rate for purchase or loan facilities, there will usually be “weasel words” that permit the factor to make its own determination in regard to any particular invoice or customer of the client. The standard specified may be “in the sole and absolute discretion” of the factor. It is unlikely that a prospective client will be able to get such language changed, however the client should perform its own due diligence on how a particular factor has treated its clients in this regard. Furthermore, a client might seek to provide in the contract the right of termination without excessive penalty if the factor is withholding approval or reducing the advance rate on the client’s invoices beyond a certain threshold.

### **Evidence has shown that customers provide better payment performance and take fewer unreasonable deductions when they know that the factor is watching...**

Since the factor is free to withhold approval for a given invoice or customer of the client, the client might well decide to proceed anyway with the transaction as “client risk”. However, even if the factor is not providing funding or credit insurance in respect of such invoices, the factor may still be providing services such as posting sales, recording payments, collection efforts, etc. Indeed, it may benefit the client to have to factor still provide these services, as there is strong evidence that the client’s customer will pay more reliably and take fewer unauthorized deductions when the factor is involved. Nonetheless, the client should be entitled to a preferential, i.e., cheaper cost, with respect to non-approved invoices, and the client should ensure that this contract term is included.

What about the factor’s credit exposure to a particular customer of the client due to the factor having other clients with the same customer? Many factoring contracts provide a right of offset for the factor whereby the factor

can withhold payment to the client if the factor has not received payment from that customer in respect of other clients' invoices. This effectively cross-collateralizes the client with other clients whom he may not even know, however it is a common practice. While it is a term that must be negotiated and depends on relative bargaining position, the client should strive to eliminate or limit the factor's right of offset when the customer takes a deduction. On clients purchasing from other clients, the Accounts Payable could be due to the factor and mingled with credit balances and/or loan exposures. The argument that should be made on behalf of the client follows: the client should receive open credit terms under normal circumstances, and should not be penalized just because it is a client of this particular factor.

As noted above, even where a factor is not providing advance of funds through a loan or purchase of an invoice, there is still benefit to the client by having the factor involved as the interface with the client's customer concerning collections and resolution of disputes. Evidence has shown that customers provide better payment performance and take fewer unreasonable deductions when they know that the factor is watching, since (due to the right of offset discussed above) the customer's behavior could be magnified in its effect on credit facilities from other suppliers. Notwithstanding this benefit, a client should also be concerned with at what point in time the factor is entitled to charge the client's account for an unresolved dispute with (and deduction by) a customer. A typical arrangement is to allow a certain number of days after invoice date before charge back occurs. Obviously a larger number of permitted days is beneficial to the client.

Similarly, the nature of the factor's efforts with regard to disputes and charge backs by the client's customer should be spelled out. The client will want the factor to "walk a line" between treating the client's customers properly but still dealing firmly with obligations due the client. The client may want to have some input into how the customer gets treated by the factor, recognizing that the factor's money or risk may be involved.

In "client risk" situations where the client has decided to take on the credit risk itself because the factor has refused to "check" that customer's invoices (i.e., refused to approve them), as noted above, the factor may still be handling the bookkeeping and collection efforts. The factoring contract should provide for at what point in time the factor will post a deduction or charge back to the client's accounts after the customer's nonpayment or evidence of insolvency, as well as filing of claims or lawsuits against the customer.

The contract should provide for the amount of time within which the factor must advise its credit decisions regarding the client's invoices and customers, for how long a credit approval remains in effect, and for what limit of amount. In factoring arrangements involving lines of credit that don't require a determination by the factor on each and every customer or invoice, the permitted range of payment terms to be offered by the client to its customers should be specified, as well as any flexibility regarding extensions, late shipments, over-shipments, etc.

Most factors restrict client invoices to domestic customers, however in this age of globalization, exports are increasingly an important part of the client's business. A client will want to provide for inclusion of defined export invoices in the factoring contract if necessary. Similarly, importation of goods usually requires posting of documentary or standby letters of credit, which a client that is not a bank borrower cannot obtain from a bank. The factoring contract should provide for a facility for letters of credit if these will be necessary, and lay out maximum amounts, fees, transferability, assignability, extendibility, whether partial shipments and drawings are permitted, and all of the other critical details that pertain to L/Cs. Most important, the factor will likely want a lien on the inventory that results from such importation, and a method for tracking how the inventory turns into accounts receivable.

Most prospective factoring clients ask, sooner or later, whether they have to include all of their sales under the factoring contract. They no doubt

believe that at least some of their sales involve a reduced risk of nonpayment or dispute, and therefore would prefer to avoid factoring costs in regard to this subset of the client's business. In factoring arrangements that involve accounting and collection services, of course, all sales must be included, however it is possible to negotiate a carve-out for those invoices where factoring credit services are not needed. The factor will look at the overall relationship in its pricing and structure, and take into account any customers that are not part of the arrangement. Even where there are carve-outs, the factor will still look at the client's overall financial strength and creditworthiness, and such credit risks that are retained by the client could figure into the factor's evaluation.

How should clients select a factor with which to work? Unless the client is sophisticated and experienced, it is strongly advised that clients utilize a qualified intermediary to obtain several proposals from competing factors, and consider having a professional liaison interface with the factor to help set up systems and reporting, as well as solve issues that arise. In particular, a qualified professional is there to confirm that the client is realizing the theoretical benefits of factoring: credit services and cash flow support, and elimination or prevention of duplicative overhead such as accounting, credit management and collections personnel. Furthermore, the expected benefits of reduced bad debt expenses and quickly turning accounts receivable must be counted against the costs of factoring.

From an accounting standpoint, the client's balance sheet should look better than with bank lending, since there is no real debt leverage, just a "Due from Factor" account instead of accounts receivable. The best factoring companies will have much of their reporting on-line so that clients can closely track their availability and cash flow, and this should all be reflected in the factoring contract. The client will want to see clearly when credit approvals, holds and declines are being issued. An aging of accounts receivable should be calculated and reported continuously. Any notice of disputes by the client's customers should be timely reported, as well as charge backs. Finally, the factoring contract should include specimens of the forms and reports that are to be provided by the factor and the client to each other.

Among the leading law firms servicing factors and factoring clients is Silverberg Stonehill & Goldsmith, P.C. in New York City. Robert Stonehill of that firm says that, in any contract negotiation, the relative bargaining power of the parties is a key factor in determining what terms are ultimately agreed upon. Nonetheless, here is a partial "hit list" which he has provided of items to be considered in a factoring contract, with the caveat that no checklist can substitute for having competent legal counsel at one's side when negotiating such a contract.

- Commission rate and minimum commission guarantee amount (calculate on yearly basis)
- Interest rate charged on advances
- Number of collection days allowed for the factor before receipts are credited
- Interest charged on collections even where there are no funds advanced, resulting in hidden surcharges
- Minimum charges per invoice, which can mushroom where a factoring client is shipping directly to multiple locations for its customer, i.e., store-door delivery
- Surcharges applied to certain accounts, i.e., companies in bankruptcy
- Collateral provided to secure the factor other than pledged accounts, and against what obligations the secured collateral applies, i.e., where client purchases products from another client of same factor, security may apply to that account payable
- Personal guarantees, and to what obligations these apply

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- Term of factoring contract, notification requirement for nonrenewal, mutuality of right of termination, applicability of termination fee if factor terminates without cause, and prorating of any minimum annual charges upon early termination
  - Responsibility of client to challenge factor's statements for errors and omissions within set time
  - Rebuttable presumption of customer disputes lodged during period leading up to customer's insolvency, in determining charge backs by factor or relieving factor of credit risk
  - Right of factor to withdraw credit approval once issued, and sharing of loss on sales canceled as a result

Done correctly, factoring can be a tremendously valuable tool for growing businesses. But care must be taken to do things right the first time, and that means observing the finer points of factoring. **abfj**

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