FEATURE STORY

Whose A/R Is It, Anyway?

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Financing receivables involves lending against the most liquid and readily collectible asset of a company, but it is not without challenges. Appropriate analysis and diligence are always required.

Takeaways

1. **Analysis and diligence regarding ownership of the collateral is critical before financing receivables.**
2. **Various factors can impact your lien priority in receivables; know the competing interests before financing receivables.**
3. **Identify your liquidation strategy and what obstacles may arise before financing receivables.**
4. **Threats to the ownership of the collateral may not be readily apparent.**
5. **Threats to the priority of a lender's security interest may not be readily apparent**

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Financing backed by accounts receivables, whether through a secured loan structure, a factoring arrangement, or a securitization structure, is a primary source of working capital for companies seeking a consistent stream of liquidity. From a lender's perspective, financing accounts receivables (or "receivables") involves lending on the most liquid and readily collectible assets of a company. For most borrower companies organized in a jurisdiction within the United States, a lender can obtain a perfected security interest in such company's receivables if the company executes a security agreement in favor of the lender that grants to the lender a security interest in such company's receivables and the lender files a UCC-1 financing statement in the appropriate jurisdiction covering the receivables. Sounds easy, right? Not always. Because sometimes:

- Receivables that the lender believes are a part of its collateral package are actually outside of its reach;
- The lender does not have a first-priority perfected lien in the company's receivables; and/or
- Obstacles exist that impact the lender's ability to realize on the value of the receivables.

This article highlights some common scenarios, and some not so common scenarios, adversely affecting receivables financing. However, this article does not and cannot describe every situation. Accordingly, before lending on receivables, it is critical for lenders to analyze the following: (1) who owns the receivables? (2) what could impact the priority of the lender's security interest in the receivables?, and (3) are there any impediments to collecting such receivables?

Scenario #1 Medicare/Medicaid Receivables

SCENARIO: Lender provides financing to a healthcare provider, such as a skilled nursing facility or cancer treatment center ("Provider"). Provider is paid for its services from a number of sources (including directly by patients), but the bulk of its revenue is paid by third-party payors, such as insurance companies, Medicare and Medicaid. Those payments are all made directly into one deposit account. Lender obtains a valid and perfected security interest in the Provider's receivables; but, when the lender requests that the Provider sign a three-party deposit account control agreement ("DACA") to perfect the lender's security interest in the deposit account, Provider refuses. Now what?

ISSUE: Despite the fact that the lender may have a valid and perfected security interest in all of the third-party payor receivables[1], including reimbursements from Medicare and Medicaid ("Government Receivables"), pursuant to the regulations promulgated by the Center for Medicare Services ("CMS"), there are restrictions on payments being made to persons other than the Provider. The Government Receivables must be paid directly to the Provider and must be negotiated by and under control of the Provider. These requirements affect several key rights that receivables lenders expect to have. First, after an event of default, a secured lender would expect as a remedy to be able to direct account debtors to pay the lender directly and to negotiate those payment obligations with such account debtors. With respect to Medicare

[1] *Wilson v. First Nat'l Bank*, Lubbock, Tex. (*In re* Missionary Baptist Found. of Am., Inc.), 796 F.2d 752 (5th Cir. 1986).

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and Medicaid receivables, this is not a permitted remedy. Additionally, specific guidance has been issued that limits the ability of a lender to have a perfected security interest over a deposit account into which payments owed to a Provider for Governmental Receivables are made. In other words, the Provider cannot enter into a DACA in favor of its lender to perfect a security interest in such deposit account because the Provider is required to retain control over such deposit account.[2] Furthermore, if the depository institution where such deposit account is maintained is also the lender to such Provider, then such lender must expressly waive its right of offset against such deposit account for loan obligations.

Additionally, specific guidance has been issued that limits the ability of a lender to have a perfected security interest over a deposit account into which payments owed to a Provider for Governmental Receivables are made. In other words, the Provider cannot enter into a DACA in favor of its lender to perfect a security interest in such deposit account because the Provider is required to retain control over such deposit account.[2]

SOLUTION: Although the Provider must retain control over the ability to collect and negotiate the Government Receivables, a market-accepted multi-step solution exists to enhance the lender's ability to ultimately realize upon the proceeds of the Government Receivables. First, the Provider will need to bifurcate the deposit account into which receivables are paid into at least two deposit accounts: one Government Receivables deposit account into which Governmental Receivables are paid ("Government Receivables Account") and a non-Government Receivables deposit account into which all other receivables are paid (the "Non-Government Receivables Account"). Second, the Government Receivables Account must be set up to sweep on a daily basis pursuant to a deposit account instruction agreement (sometimes referred to as a "DAISA" or collection account agreement "CAA") to the Non-Government Receivables Account which is subject to a customary DACA in favor of the lender. This arrangement is referred to as the "Double Lockbox Technique", although lockboxes are rarely involved. This allows the lender to obtain a perfected security interest in the deposit account where such proceeds of the receivables ultimately end up, without violating the applicable Medicare and Medicaid rules. Additionally, the loan documents should include a covenant that the Provider will not change these sweep instructions. While this workaround does not provide the lender with ultimate control over the Government Receivables initially and there are other nuances involved, it does provide the lender with some assurance that it will be able to realize upon the proceeds of these Government Receivables because they ultimately end up in a deposit account that is subject to the control of the lender.

Scenario #2 Government Contracts

SCENARIO #2: Lender provides financing to company that supplies goods and services to a United States government agency ("U.S. Agency"). The company grants a security interest in all its receivables to the lender and signs a security agreement and the lender files the appropriate UCC-1 financing statement. When the company defaults on the loan, the lender wants to exercise its secured creditor rights and notify the U.S. Agency to pay the lender instead of the company.

ISSUE: While Article 9 does govern the creation, attachment and perfection of the security interest in the company's receivables, the U.S. government does not recognize the assignment of the receivable to the lender unless and until the lender complies with specified procedures for filing notices with the government under the Assignment of Claims Act and related regulations.[3]

SOLUTION: If a lender wants to collect directly from the United States government, there is no workaround to avoid complying with the federal statutes governing assignment of claims. However, the lender does have several strategies it can employ when lending to a company with receivables due from the

[2] *Medicare Claims Processing Manual*, § 30.2.5—Payment to Bank (July 31, 2020).

[3] See 31 U.S.C 3727; 41 U.S.C. 6305; 48 C.F.R. Chapter 1 et seq. (2019).

government so that it not without recourse. Examples include complying with the statutes at closing, capping the amount of such receivables in the borrowing base to limit availability created by government contract receivables in the borrowing base, or establishing a liquidity or availability marker whereby, if liquidity or availability falls below a certain dollar level, then the company must take the necessary steps to comply with the Assignment of Claims Act.

Scenario #3 Accounts Receivable that are Proceeds of Another Creditor's Collateral

SCENARIO #3: Company is in the software business. It generates revenue by licensing its intellectual property to customers in the ordinary course of its business. Company has a loan secured by its intellectual property in favor of lender A. Company contacts lender B seeking a loan secured by company's receivables. Lender B will only lend on receivables that are subject to its first-priority perfected security interest.

ISSUE: Are the receivables unencumbered assets available to secure lender B or are they already subject to lender A's prior perfected security interest as "proceeds" of lender A's collateral? A perfected security interest in a specific item of personal property collateral automatically attaches to the identifiable proceeds of that original collateral if the security interest in the original collateral was property perfected.[4]
To the extent that the receivables arise out of licensing the intellectual property, then those receivables likely are proceeds of the intellectual property. If lender A has a valid and perfected security interest in the intellectual property, then the receivables that are proceeds of such collateral are (at least for a period of time) subject to the perfected security interest of lender A.

SOLUTION: If insufficient unencumbered receivables exist to support lender B's loan without including the receivables that are proceeds of lender A's collateral, the best solution may be to have the lenders enter into a split collateral intercreditor agreement. The lenders can agree, by contract, to split the collateral pool up between themselves through a split collateral intercreditor agreement. Split collateral structures are fairly common these days; however, extra care must be taken in drafting the separate collateral buckets in situations like this where proceeds of one lender's collateral will be the priority collateral of another lender. If lender B cannot obtain an intercreditor agreement establishing its priority lien in the receivables, then lender B should not extend credit in reliance on those assets and such receivables should be excluded from any borrowing base. Receivables can constitute proceeds of another creditor's collateral under a variety of different scenarios so it is important that lenders carefully consider competing claims at the outset and structure accordingly.

Scenario #4 Post-Petition Accounts Receivable

SCENARIO #4: Similar to scenario #3 above, the company is in the software business and it generates revenue by licensing its intellectual property to customers in the ordinary course of business. The company has a loan secured only by its receivables. The loan is not secured by intellectual property. Company files for bankruptcy.

ISSUE: Does lender have a lien on the receivables that the Company generates after it files for bankruptcy? While most secured loans are set up so that the security agreement grants a lien on after-acquired assets and proceeds, rather than limiting the lien to specific items in existence at a static moment in time — the rules change upon a bankruptcy filing. One of the primary purposes of the Bankruptcy Code is to provide the debtor with a chance for a fresh start. Accordingly, the Bankruptcy Code contains various provisions designed to further this goal. One primary example of this is section 552 of the Bankruptcy Code, which operates to cut off a pre-petition creditor's liens on property that the debtor acquires after the petition date. There are some exceptions to this rule. The primary exception is that a secured creditor will generally continue to have a lien on the post-petition after acquired assets that constitute proceeds of the lender's prepetition collateral.[5] Unfortunately, that exception will not protect the lender in the scenario described above where the lender was only granted a lien in the receivables and not in the intellectual property.

SOLUTION: In order to ensure that the lender's collateral package includes receivables generated on a post-petition basis from the continued licensing of intellectual property, the lender should also take a security interest in the underlying intellectual property as well. This recommendation holds true for other assets such as receivables generated by inventory.

Scenario #5 Rents vs. Receivables

SCENARIO: Company offers fully furnished apartments, complete with housekeeping and concierge services, on a temporary basis as corporate housing pursuant to a written contract. Company does not own the apartment buildings, but rather offers the housing and services in numerous buildings it leases that are located across the country. Company obtained financing from lender secured by the corporate housing revenue ("Temporary Housing Receivables"). Lender filed a financing statement covering all "accounts". Company files bankruptcy and the unsecured creditors committee claims that the lender is unperfected because it failed to perfect its security interest in the Temporary Housing Receivables under real property law.

ISSUE: How should the lender perfect a security interest in the Temporary Housing Receivables? Article 9 of the UCC expressly excludes from its scope "the creation or transfer of an interest in or lien on real property, including a lease or rents."[6] If the creation of

a security interest or lien involves a lease or rents of real property, then a secured party must create and perfect its lien under applicable state real property law by recording an assignment of rents. The question comes down to whether a company's receivables are "accounts" under the UCC or "rents" under real property law. Unfortunately, the answer is not straightforward and varies depending on the jurisdiction involved and the services to which the payments are related. For example, there are numerous and conflicting court decisions as to whether hotel and motel revenues constitute rents or receivables under Article 9 of the UCC.

SOLUTION: So, even if the Company does not consider itself a landlord, but rather a service provider generating receivables, it is not the company's interpretation of its situation that governs. Before making the loan, it is critical that the lender evaluate whether the Temporary Housing Receivables under the law of each state where the underlying real property is located would be characterized as rents or accounts, and perfect accordingly. Such an initial analysis is warranted whenever a company generates revenue associated with the usage of real property such as extended stays, temporary corporate housing, self-storage facilities, and data center storage sites.

The company has requested that the lender include in its borrowing base the receivables derived from the company's construction projects, which are supported by performance bonds because such receivables will provide the company with significant availability under the line of credit.

Scenario #6 Secret Liens

SCENARIO: Lender is evaluating an asset-based line of credit for a company in the agricultural belt, which has several businesses, including a construction business and a ranching operation that sells meat and meat products to customers. For the company's largest construction projects, the company is typically required to obtain a performance bond from a surety (the "Surety") that guarantees that the company will complete the project according to the contract signed by the company and the owner of the project. The company's ranching operation consists of the purchase and slaughter of cattle and then the sale of the meat and meat products to small grocery chains.

The company has requested that the lender include in its borrowing base the receivables derived from the company's construction projects, which are supported by performance bonds because such receivables will provide the company with significant availability under the line of credit. The company has also requested that the lender include in its borrowing base the receivables arising from the company's sale of meat and meat products to grocery stores. What should the lender include in the borrowing base?

ISSUE: If the surety is required to perform under the performance bond and complete the company's bonded construction project, then the surety will be subrogated to the rights of the company to the receivables from that construction project through its equitable right of subrogation and its contractual right to indemnity, which are typically back-stopped with an assignment of the receivables. The surety's rights to the receivables arising from the bonded construction project will be superior to the lender's security interest in such receivables, and this is the case regardless of whether the surety has a perfected security interest in the receivables. In fact, it is extremely rare for a surety to perfect its security interest in receivables under Article 9 of the UCC. So, a lien search will typically not reveal this issue (hence the issue is "secret" or "hidden").

With respect to the receivables arising from the company's sale of the meat and meat products, the company is likely a packer under the Packers and Stockyards Act of 1921 (the "PSA"). Accordingly, livestock that the company purchases and inventories of, or receivables or proceeds from meat, meat food products, or livestock products derived therefrom, must be held by the company in trust for the benefit of the unpaid sellers of the relevant livestock until full payment has been received by such unpaid sellers. To preserve its rights in the trust, the seller must provide certain written notice to the company and regulators. The trust assets will not become part of the bankruptcy estate if the company files a bankruptcy petition. Therefore, unpaid sellers will have priority over secured creditors in the assets of the

[6] U.C.C. § 9-109(11).

statutory trust, which include the receivables arising from the sale of meat and meat products. The trust arises by operation of law and no UCC-1 filing is ever made. Another secret lien.

SOLUTION: It is very risky for the lender to advance against receivables arising from bonded construction projects by lenders in light of the surety's superior rights to the receivables arising therefrom if the company fails to finish the project, including because it files bankruptcy. In this case, the lender should ensure that it is receiving periodic reporting from the company as to which of its construction projects are the subject of performance bonds. The receivables arising from such projects really should not be eligible to be in the borrowing base. Some lenders in the market are willing to include receivables arising from bonded construction projects, but they will usually cap the amount at an extremely low percentage of the overall borrowing base. The receivables arising from non-bonded construction projects can be included in the borrowing base, subject to customary eligibility criteria, and the lender and the company can evaluate whether other assets are available that can be included in the borrowing base to provide the company liquidity.

With respect to the receivables arising from the company's sale of the meat and meat products, these can potentially be included in the borrowing base, subject to customary eligibility criteria, if the lender receives adequate reporting from the company as to the unpaid amounts owing by the company to sellers of the livestock and copies of any notices that sellers send under the PSA. The lender should have the unfettered right to impose a reserve against the availability created by the borrowing base in an amount at least equal to the amounts owing to sellers of the livestock by the company.

Please also note that the lender should evaluate whether the company in this case is creating receivables through the sale of perishable agricultural commodities (think vegetables) or products derived therefrom because sellers of such assets have similar protections as livestock sellers under the Perishable Agricultural Commodities Act ("PACA"). Yet another secret lien.

Moreover, sureties' rights and PSA and PACA trusts are just the tip of the iceberg when it comes to secret liens. Other secret liens include, without limitation: tax liens (which can prime a secured lender in certain circumstances) and are often not filed in the borrower's jurisdiction of organization, landlord liens that arise by operation of law and can cover inventory of the borrower, mechanic's liens, the scope of which varies by state, environmental liens and liens in favor of the Pension Benefit Guaranty Corporation. Furthermore, the unsecured trade creditors of a borrower and the U.S. government may in certain circumstances be able to convert their general unsecured claims into what are effectively secured claims if they have valid recoupment or setoff rights.

As noted in the beginning, this article offers just a glimpse of the risks a receivables lender may encounter. The key for any receivables lender is to conduct adequate diligence before making the loan to confirm its collateral package, confirm its lien priority, confirm its liquidation strategy, and include appropriate asset eligibility, reserve provisions, and reporting covenants in the loan documentation governing the loan.

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