PUBLICATION

Receivables Based Lenders Beware

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Lenders frequently enter into loans secured by accounts receivables and/or chattel paper. A security agreement is signed, and the lender files a UCC financing statement, "putting the world on notice" of its security interest in the collateral. Per the loan documents, the borrower supplies borrowing base certificates, personal financial statements, access for field inspections, and independent third party audits to "verify" the borrowing base. Based on these assurances, the borrower receives access to a percentage of the agreed "borrowing base" on a revolving line. Even if the borrower defaults, the lender has only loaned 75%, 80%, or 85% of the value of the collateral, so the lender is protected - right? Not so fast.

The answer to this question is quite complicated, and a complete dissertation on the various issues that come up in the context of receivables based lending is more apt for a law review article than a 500 word blog post; however, attention to detail and effective counsel can help you avoid some of the common pitfalls faced by lenders when these loans default.

First, you need to understand what type of collateral you are dealing with. Accounts receivable and chattel paper (among other types of collateral) are subject to very different priority rules under Article 9 UCC. Where a properly perfected UCC financing statement may be sufficient to put competing lenders on notice of a security interest in accounts receivable, a duly perfected UCC financing statement may not afford the same protection.

For example, purchasers (read: third party financiers) who take possession of (tangible) chattel paper or control of electronic chattel paper (as defined by Section 9-105) in good faith, in the ordinary course of business, without knowledge that the purchase violates the rights of the original lender, enjoy a senior priority lien in the collateral over parties perfected only by filing.

Of course, our first instinct is that everyone has knowledge. After all, isn't the entire point of the financing statement to "put the world on notice?" But this is not how the analysis plays out. In effect, the drafters of the UCC concluded that certain purchasers who perfect their interests in certain ways should not be burdened with first examining the public records. And in practice, third party financiers often acquire senior lien status through a "don't ask, don't tell" policy with regard to prior liens, which has become industry standard. In other words, your UCC financing statement may be completely worthless in a lien priority dispute with another lender, depending on the type of collateral at issue.

Many issues can be prevented by adopting policies to safeguard the collateral. For example, in the context of tangible chattel paper, a bank can avoid the priority shifting scenario by either taking actual, physical possession of the wet-ink contracts establishing a security interest in favor of the borrower or by stamping each and every copy of such contract with clear indicia of the lender's interest. But what if the contracts are signed electronically?

As technology continues to evolve, contracts are frequently being generated, executed, and stored electronically, and the legal framework surrounding these types of transactions is in its infancy and still very nebulous. However, like with tangible chattel paper, there are preventative safeguards and asset management and litigation techniques that can help maximize recovery and minimize loss exposure.

If you are an asset manager with receivable based loans in your portfolio, consider making a quick call to your legal counsel to discuss these and other issues that may affect the value of your portfolio.