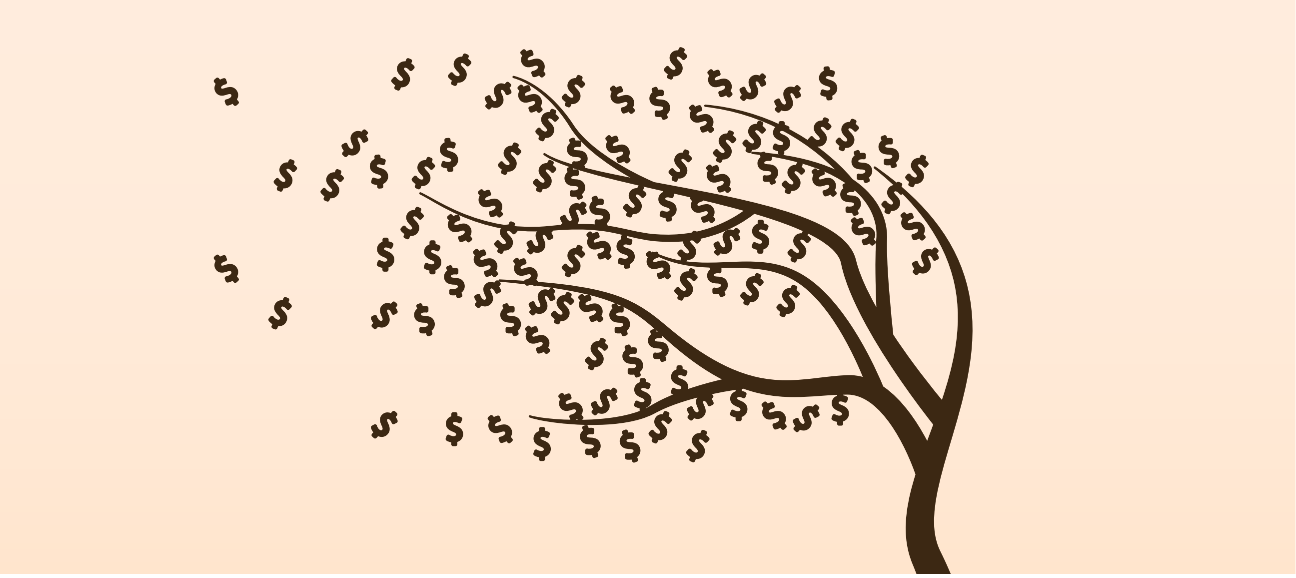

Not So Happy Deals: M&A in the Current Commercial Finance Landscape

In the follow-up to an article that appeared in the October 2018 issue, Steven N. Kurtz outlines how the COVID-19 pandemic has created a very different environment for mergers and acquisitions in the factoring industry and what opportunities are available.

This is a loosely-based sequel to an article that appeared in the October 2018 issue titled, "Mergers and Acquisitions in the Commercial Finance Industry." While part one focused on "happy deals," the economic downturn caused by the COVID-19 pandemic has halted trading by factors and asset-based lenders.

Factors and ABLs that are not bank-owned need funding sources. Most independent factors and ABLs are funded through rediscount lines or refactoring agreements. These lending agreements require a borrower to have eligible collateral, which focuses on the ultimate health of the borrower's factoring or lending portfolio.

When the borrower on the lending agreement has portfolio issues, the lender in the lending agreement is in an over-advance position, meaning there is no eligible collateral to support the loan advances. This puts the lender in a precarious position and puts clients and borrowers of the factor/ABL company in a bad position because the source of their funding is impaired through no fault of their own. In addition, the lenders to factors and ABL companies may have issues with their own portfolios, or their sources of capital may be problematic. During the Great Recession, capital sources for factors and

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ABL companies retreated from the market. This economic reality, unfortunately, is starting to take place again.

These potential failures of factors and ABL companies create opportunities for those fortunate enough to weather the storm while maintaining good relations with their capital sources. When lending agreements go south, the only way to exit the transaction is to lend to good factor clients and borrowers while finding buyers of the loans. Unlike the happy deals, where the equity in a portfolio sale demands and is entitled to a good premium, the default in the lending agreement means the portfolio buyer purchases and takes over the good deals. Sometimes before a failing factor or ABL company shuts down, it will allow clients and borrowers to leave early. Then the incoming factor or ABL lender buys out the deal because the client/borrower can't be funded due to liquidity problems. Sometimes the entire portfolio can be sold at once, but this kind of transaction is hard to engineer when the cause of the problem comes on suddenly and unexpectedly, as it has in this pandemic. The lender often orchestrates a situation where good factor clients and borrowers find new homes with multiple groups.

For those purchasing the entire portfolio, or several deals at once in a cooperative deal with the lender, due diligence must be done. In addition, buyers need to understand the reason for the default. Did the default occur because one or two deals caused an over-advance in the lending agreement? Was the default caused because the factor or ABL company was concentrated in one industry? At press time of this article, a very large factor in business for 25 years failed because of a heavy concentration in the garment industry and with retail account debtors. Several factors have stepped in to take the good deals. It is important to talk to the lender and ask hard questions. The answer may be lender fatigue because fuses get shorter in economic downturns.

The common way to acquire factor clients or borrowers from a lender is the purchase of several deals at once. This situation is remarkably similar to that of a factor or ABL company buying out a deal in good times and, in many situations, can be done along the lines of the IFA-approved buyout agreement. The incoming factor or lender will be expected to take the deals "as is, where is" and confirm that it has done all its due diligence. Of course, the incoming factor or ABL company will include lien searches on the targeted factor clients or borrowers as part of its due diligence. If the lien searches reflect liens behind the factor or ABL company, then the best option may be taking over factoring or borrowing transactions with the lender's consent. If this is the case, you will want to obtain releases and affirmations from the factor client or borrower.

THE FRIENDLY TAKEOVER

Sometimes, before the factor or ABL company fails or defaults, liquidity problems arise, such as when it is unable to timely fund deals due to insufficient availability in the lending agreement. That means factor clients and borrowers need to find a home and the new factor or ABL company has a new business opportunity. This friendly takeover is usually consensual by all parties. The old factor/ABL company has liquidity problems, the factor client/borrower needs a source of financing, the new factor/ABL company is willing to do the deal and immediately step in, and any fees and costs associated with leaving early are waived. This sort of friendly takeover can be done via a buyout agreement.

Although the friendly takeover seems like an easy deal, there can be problems caused by an unethical senior lender or sub-debt or insider creditors who wrongfully hold on to funds that belong to the factor or ABL company that takes over the deal. Here is how the problem arises: The runoff in the portfolio caused by the friendly takeover leaves the factor/ABL company with a smaller portfolio that has problem deals as a higher percentage of the "loans" on the books. This higher concentration of bad deals can further precipitate the factor/ABL company's demise with its lender.

HOLDING PAYMENTS

I have yet to see a rediscount lending/refactoring loan managed such that when the deal goes into default, the rediscount lender/refactor can easily come out whole. The likely reason for the foregoing problem is that the rediscount lender/refactor is usually not directly tied to the deals that the borrower factor/ABL company is doing. The portfolio runoff caused by the friendly takeover usually indicates an imminent failure, meaning that the friendly takeover buyer needs to be anticipated so that one can plan ahead and strategize as to how to address the situation of someone wrongfully holding onto payments made to the old factor/ABL company's bank account.

Account debtors do not always get their notice of assignments right and may pay the old factor/ABL company. This frequent problem is addressed in both the long and short versions of the IFA buyout agreement and similar agreements. In a perfect world, the old factor/ABL company simply accounts for and forwards the payment over to the new factor/ABL company. But, when the factor/ABL company has failed, it is not always that simple. The bank accounts are controlled by the rediscount lender/refactor, which is now facing a loss. While there is no legal, ethical or moral reason for the rediscount lender/refactor to hold

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on to a mistaken payment, in many instances, greed takes over because the rediscount lender/refactor is facing a large loss. There should not be a business reason to hold on to the money for more than a couple of days to check the records. This is because the rediscount lender/refactor either has a borrowing base that lists eligible accounts loaned against or records reflecting the account debtors subject to the refactoring agreement. Further, the good account debtors subject to the friendly takeover deals should not be the account debtors in the deals that caused the default in the financing arrangement. Wrongfully holding on to the mistaken payments is a step above actual theft. There is no excuse for this, but it happens — sometimes with the help of counsel.

The wrongful withholding of money by creditors of a failed factor/ABL company was not, until very recently, something that was planned for, much less expected. I'm also hoping perpetrators of this "crime against the industry" are guilted into changing their conduct. But the way to prevent this problem is to plan and expect this in the initial friendly takeover. You should take extra care to contact the account debtors a little more frequently than usual to cut off the potential mistaken payment. Find out who you need to contact at the rediscount lender/refactor just in case it does happen. You can have the outgoing factor/ABL company sign a joint letter to the account debtors outlining how the payments are to be made. A portion of the payment price could be escrowed to use as a cushion to account for and remedy this problem. It is unlikely a rediscount lender/refactor will approve this tactic, but it could let that person know it's an issue. In addition, you could write a preemptive letter to the rediscount lender/refactor after closing the friendly takeover that politely mentions you took over the factor client/borrower and that the rediscount lender/refractor should account for and remit payments for accounts that are now yours. If a mistaken payment is still made, immediately make a call to the right person and see where that goes. While laws in each state are different, it is still wrong to receive money by mistake that you know does not belong to you. The perpetrators who have engaged in this conduct know they are wrong but are facing a loss. Further, bad actors also know that sometimes it is not worth suing over the amount being withheld and expect the incoming factor/ABL company not to act. Hopefully this problem will stop.

If the Great Recession was any indicator, there will be more failures in the industry but hopefully not many. Industry failures will present opportunities for those who are better situated or lucky. Most of the opportunities will be for one or more deals but not entire portfolios. Extra due diligence will be required because companies will acquire these deals without any representations or warranties as to deal quality. One also needs to be mindful of the existing lender or refactor to be ready for a potential problem. I don't like to discuss failures in the industry, but unfortunately, this is a business reality these days. •

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malware hiding on our systems."

But what should a company do to protect itself against this type of cyber fraud? Troy believes security tokens are the key, both literally and figuratively.

"We can probably stop this through tokens, where in order to get into certain screens, you have a separate token that gives you a code to enter to get in," Troy says, noting that his company has considered two-factor authentication systems as well. "I think tokens might be the only thing that could possibly prevent this. We thought of two-factor authentication, which is popular with banks, but when hackers changed the bank accounts in our system, they changed the contact emails as well. You really can't let up on security now."

Troy's emphasis on continued security vigilance comes from the belief that this type of fraud is only going to happen more frequently, especially in the factoring industry. In conversations with his IT company, Troy discovered that attacks on his system are happening around the clock and not letting up anytime soon.

"Phishing scams are getting more and more sophisticated," Troy says. "These hackers are probably trying to get back in right now since they now know we clear the computers out and what they did worked." •