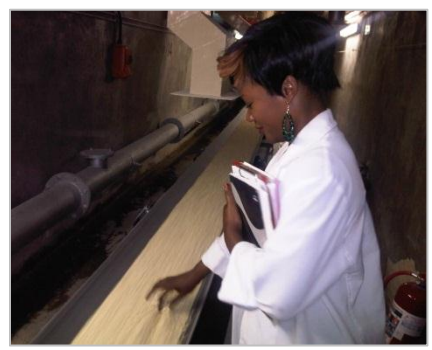
ACCOUNTS RECEIVABLE FINANCING

Adoption of the UCC principles in establishing Accounts Receivable Financing

GENERAL APPROACH



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Overview

In accounts receivable financing the bank advances funds against the value of the receivables that have been assigned by a borrower as collateral for a loan.

Accounts receivable financing can be used in the generic form of asset protection lending where, due to the nature of the business (low value added, high volume), a company is undercapitalized and has a permanent financing need. When such a business - for example, a commodities company - does not qualify for an unsecured loan, the bank may take security interest - usually in both its inventory and accounts receivable – and advance funds (up to a specified borrowing base) against the value of the inventory and receivables currently in the collateral pool. In such cases, accounts receivable financing is provided in conjunction with inventory financing and is intended to be a permanent financing vehicle.

In other cases, accounts receivable financing may be provided as an interim measure extending from a few months to two to three years when a company experiences any of a number of conditions.

1. Borrowing requirements exceed bank willingness to extend short-term unsecured credit, due to sharp growth or limited or impaired capitalization.

2. Inadequate cash flow prohibits cleanup of unsecured short term lines at the end of a season or fiscal cycle.

3. Liquidity is insufficient due to slow or lengthening receivables.

4. Competition forces the granting of longer terms to customers.

In these cases, accounts receivable financing is usually not intended to be permanent financing vehicle but to assist a company that is experiencing temporary conditions of increased stress. This form of secured financing assists a company with growth potential to generate the liquidity necessary to realize that potential. The average financing relationship lasts for about two or three years until the secured facility has achieved its purposes of maximizing liquidity while the borrower generates the capital base necessary to support its activities in an unsecured line context. This form of accounts receivable financing is handled primarily by the Asset Based Lending Division of the Asset Based Financial Services Group, although other departments may also handle this type of financing, particularly when they want to maintain direct control over the lending relationship.

In this section we will discuss the considerations and procedures for administering and controlling loans secured by the assignment of accounts receivable. The procedures described here are those followed by the bank's Asset Based Lending Division but are similar to those followed by other divisions when securing receivables.

Description

In accounts receivable financing, the bank advances funds against the value of receivables that have been assigned by the borrower as collateral for a loan. Receivables are usually assigned continuously, forming a collateral pool, with the bank lending up to a certain percentage of the value of the collateral currently in the pool. In cases where the receivables are large single items, readily identifiable to the obligor, the bank may make separate loans against the assignment of the specific receivables, rather than lend against a pool of receivables.

The percentage the bank advances against the value of the collateral in the pool (or against specific receivables) is determined through an analysis of the financial strength of the borrower and the quality of the receivables. This analysis considers particularly the creditworthiness of the borrower's customers; the borrower's bad debt experience with them; and the selling terms and discounts offered. The percentage advanced against eligible assigned receivables is generally around 80%, with upward or downward adjustments according to the perceived quality of the receivables. The total amount the bank is willing to advance against the eligible receivables in the collateral pool is called the borrowing base.

The loan is usually made on a revolving credit basis with no cleanup required. Funds are advanced against eligible receivables as they are assigned, and borrowings are evidenced by demand notes or bankers acceptance following the terms and conditions of the security agreement.

As the borrower collects the receivables, he endorses the checks received and remits them to the bank for deposits in a cash collateral account. This is a restricted depository account and is not subject to withdrawal by the borrower. Settlements are made on a weekly or semi-monthly basis, when the balance of the account is applied to pay down the outstanding loan, with any excess remitted to the borrower or maintained in a reserve account. (This use of a cash collateral account provides high yield for the bank, which can collect interest on the outstanding loan and use the depository balances to make new loans. The effective return to the bank is increased when settlements are less frequent.)

The borrower's customers are generally not notified of the assignment of the receivables, and the assignment is with recourse, that is, the borrower, not the bank, assumes the risk of collecting the assigned receivables and is obligated to repay the full amount advanced against the receivables whether or not any of the accounts have defaulted. The bank thus has recourse to the borrower for any unpaid accounts. The company continues to evaluate the creditworthiness of its customers when granting terms, and bookkeeping and collection functions remain with the company as usual except that all payments are transferred to the bank for deposit in the cash collateral account and the company's books are subject to periodic audit by the bank.

In some cases, the bank will require that the borrower's customers be notified of the assignment of their receivables and that payments are remitted directly to the bank. Notification and direct remittance are implemented when the bank feels that, due to weakness of the borrower's internal accounting procedures, greater control is required to ensure that the assignment of receivables and the crediting of the proceeds are properly handled.

Sometimes a borrower may negotiate with the bank for the assignment of receivables on non-recourse basis; that is, if any of the assigned receivables defaults, the bank assumes the loss and has no recourse to the borrower for the amount advanced against uncollectible receivable. The bank will agree to the non-recourse assignment of receivables only if it has judged the creditworthiness of the obligors to be unquestioned. Assignment of receivables on a non-recourse basis is very infrequent. A more common arrangement is factoring, which is the outright purchase of a company's receivables by a factor, who assumes all credit and collection functions. Factoring is usually on a non-recourse basis, with the factor assuming the risk of loss on any uncollectible receivables.

Procedures for Administering and Controlling Loans Secured by Accounts Receivable

The bank's policies and procedures for handling accounts receivables loans, which are summarized below, have been developed to meet the three conditions of asset protection lending: seniority, protection and control.

Seniority: Secured lending is justified, first of all, on the basis that the bank's claim is senior to the claims of other creditors. In accounts receivable financing, seniority is achieved by the establishment of a valid security interest in a firm's receivables (following UCC requirements).

Protection: To ensure that the bank will be protected against loss, the net realizable value of the assigned receivables must be sufficient to satisfy the amount of the loan. Protection is achieved, first of all, by establishing the lending formula or rate of advance – the amount the bank is willing to lend against assigned receivables – based on analysis of the quality of the receivables and a determination of their net realizable value. Since, except when the bank is lending against specific receivables, the assets in the collateral pool are continuously turning over, the value of the receivables in the pool must be monitored on a daily basis to ensure that the amount borrowed does not exceed the borrowing base, as calculated based on the value of **eligible** receivables currently in the pool.

Control: Control refers to the process of monitoring and policing the loan to ensure that the bank's security interest in the receivables is not jeopardized and that the net realizable value of the collateral is maintained on an ongoing basis. Prior to the UCC, in order to maintain a valid security interest in the receivables, a secured lender was required to obtain from the borrower all collections of receivables in the form received and to make sure that no collections or returned merchandise were commingled with the debtor's funds or property. Under the UCC, however, the debtor may be given complete freedom to make collections, to deposit these collections with its own funds, and to dispose of returned merchandise without voiding a lender's security interest in the receivables and their proceeds. Nevertheless, the bank continues the practice of policing the transaction, monitoring the amounts collected, and checking the conditions of the accounts. Borrowing base reports, of course, are commonly used as an element of control providing frequent checks on the value of the collateral pool. The extent of the policing procedures is determined on the basis of credit considerations; they need no longer be performed because they are legally essential.

The steps outlined below for administering accounts receivable loans are not exhaustive but will indicate the strictness and sequence of control exercised by Bank in servicing its accounts receivable loans:

1. A search for financing statement of record is conducted to determine any prior fillings.

2. A security agreement is signed.

3. A UCC financing statement is field.

4. The bank examines the borrower's books and records. The objective of the examination is to evaluate the quality of the receivables, to determine whether the accounts to be assigned represent actual sales and are free of any encumbrance or right of set-off, and to determine the percentage of the borrower's receivables that are likely to be ineligible as collateral. The results of the examination are reported on the Applicant Preliminary Examination Report form.

5. The borrower's ledger sheets, where required, are stamped as follows to show the assignment of the receivables: "For value received, this account has been assigned to the Bank.

6. The borrower assigns terms specific accounts to the bank. Under the terms of the security agreement the borrower has given the bank a security interest in all of its accounts receivable, both those currently in its possession, as well as those it will acquire over the future term of the loan. To effect the assignment of specific accounts, the borrower signs the chase form, Report of Assigned Accounts. This document specifically assigns to the bank as collateral the listed accounts receivable. After the initial assignment, all new accounts, invoices, or add-ons are assigned in a periodic basis-weekly, semi- monthly or monthly-by submitting a Report of Assigned Accounts.

7. Upon receipts of each Report of Assigned Accounts, the loan department enters into its computer records information on the assigned receivables, including identifying data, amount, eligibility as collateral, and due date.

8. The bank advances funds up to the amount of the borrowing base, as defined in security agreement and as calculated based on the value of the receivables currently in the collateral

pool. (Ineligible and past due receivables are excluded in the calculation of the borrowing base. The computer system allows for daily monitoring of the status of each assigned account.)

9. The borrower receives the collection representing payment on assigned receivables in trust for the bank and delivers to the bank the actual checks, notes and other instruments of payment, which have been endorsed "to any bank or banker." At the same time, the borrower submits a Collection Report. The finance department processes the collections, entering into the computer records the payment received on the accounts receivable. The collections are applied to the daily loan balance.

10. The borrower submits to the bank a Credit Adjustment Report for any allowances or credits given to the account debtors. The borrower must similarly account for all returned or repossessed merchandise. These adjustments reduce the value of the collateral pool, and the borrowing base, for lending purposes.

11. The borrower prepares and submits an accounts receivables aging report as of the end of each calendar month of the accounting period. The report provides the means of reconciling the Bank's records with those of the borrower. It is used to verify that all collections representing payments on assigned accounts received by the borrower have been forwarded to the bank.

12. The bank cautions the borrower to indicate the assignment of accounts receivable in financial statements furnished to other parties.

13. The borrower quarterly provides financial statements to the bank.