Financing of Trade Operations Secured by Receivables

Financing of trade is a very old but still risky business. Many lenders view loans for trade operations, particularly if secured by inventory purchased using loan proceeds, as a type of unsecured loan — if the borrower can't sell its inventory, the bank may not be able to either. More risks are involved where the bank finances not only the purchase, storage and transportation of the goods, but also their production.

Besides the current solvency of the borrower, lenders may be too focused on the lien over inventory as their sole security. This is an approach that works as long as the incoming inventory is voluminous and may easily replace as security the goods being sold. If the collateral is the largest factor to support the solvency the creditor may have chores. Thus, where the production may be limited by external factors, the lender is keen to consider an elaborate security structure. In addition to the pledge over commodities or fixed assets produced, this would include pledge over receivables and bank accounts. It is the latter types of security, namely the pledge over receivables, that this article addresses mainly from the creditor's standpoint.

There are structural and documental aspects to this legal challenge from the creditor's prospective.

The starting point is the contractual structure to be used. Pledge is the simplest option, but its enforceability over receivables and bank accounts is questionable. Under the general rule, pledgors are granted a one month cure period before the secured party may proceed with the enforcement. That is, in case of a default, the creditor has to notify the debtor, register information on commencement of enforcement in the state register of liens over movable assets, and then wait for at least 30 days before it may instruct the offtakers under the pledged contract to change direction of payment: no suspense account, attachment or trust structure can be enforced.

Meanwhile, the lender is busy watching its collateral evaporates. By the time the cure period is over, the debt might be paid off without any of the funds used towards repayment of the loan. Pledgors using unfair practices can move settlements to another bank accelerate the payments or make novation of the obligation in order to remove the lien. This might be particularly useful for the debtor if the original bank account was encumbered by the lien or if the lender is a Ukrainian bank with the write of contractual write-off.

The above problem is addressed primarily by the wording of the agreement (see more details below). In addition, lenders would often insist on supplementing the pledge with assignment of the pledgor's receivables. Because few lenders and even fewer pledgors would agree to the true sale agreement, or factoring as a security mechanism, due to their tax and commercial implications, the agreement would normally provide for conditional assignment, effective upon notification by the creditor in case of default.

Whatever the form of the security document is, the receivables should be of the right quality. Receivables pledged would ideally be derived from the long term contracts, with relatively constant or bullet performance. The lien over short term receivables is worth little. Under the contract, the pledgor should have the right to assign the receivables, the more approvals it needs from the lender, the better and it is best if the payment currency of the contract is the same as under the loan agreement. In all events the parties must be ready to work on replenishment of the receivables — a task involving signing of new documentation and stringent reporting requirements for the borrower and monitoring of the security by the lender through its agents.

Loan agreements routinely provide for an obligation of the borrowers to notify the lender of the volume of receivables subject to pledge and/or overall level of receivables free from any liens. The borrowers may be not diligent in properly complying with this requirement. Moreover, due to technical requirements for creation of pledge, it may be a call for lawyers rather than financiers to confirm whether receivables counted towards

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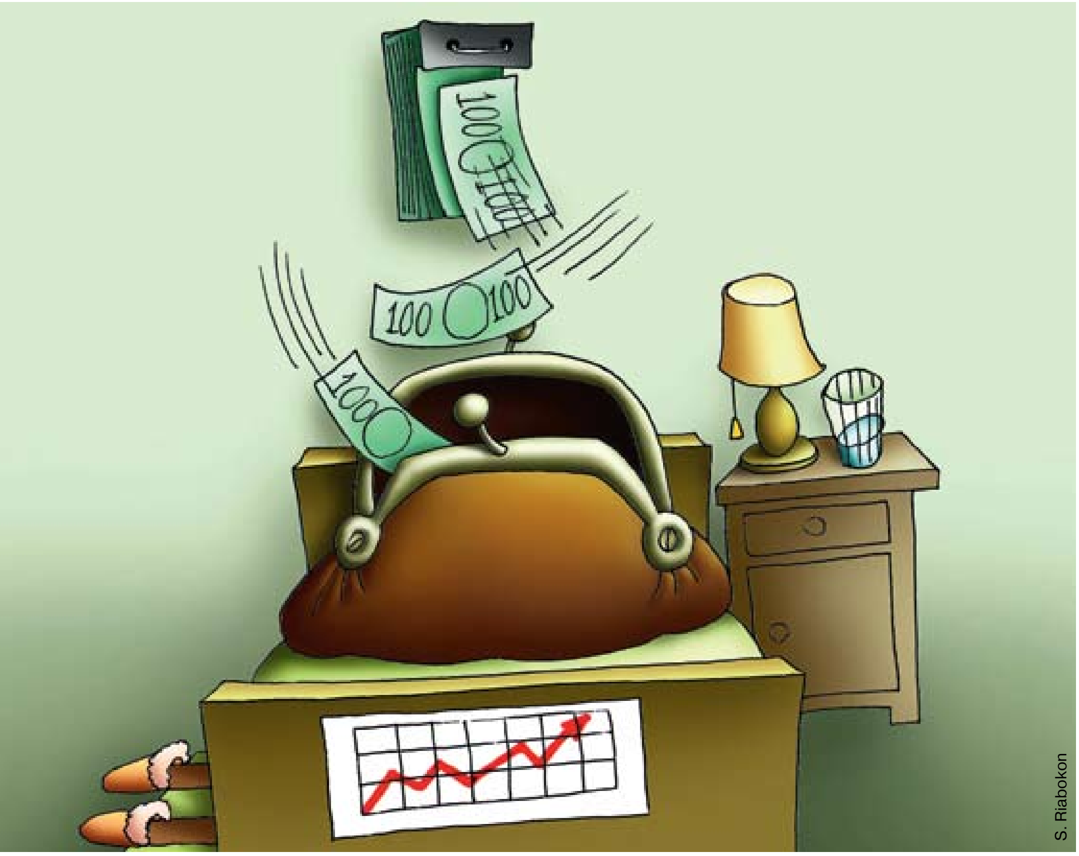
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collateral ratios are, from legal point of view, truly subject to pledge in favour of a particular lender.

Wording of the security agreement is the tool to make consensus work or fail. Because of the floating nature of the collateral, the security contract should cover not only receivables existing as of the date of pledge signing, but also the ones that will arise in the future. For this purpose, a mere reference to the volume of the receivables or the information on the debtor is not sufficient. At the very least, the pledge and/or assignment agreement should list each of the contracts covered, and contain reference that any future receivables arising out or in connection with respective contracts will also become subject to the pledge.

Some of the pledged contracts between the debtor (borrower) and its counterparts (offtaker) may prohibit assignment of the rights under the contract without consent of the debtor. The same consent is needed for pledge of receivables. Where it may not be received promptly or at all, the only option for using the collateral would be factoring, which is exempt from the consent requirement as a matter of law.

The offtaker must be notified of the pledge even where the pledgor may freely pledge and assign the receivables. But a mere notification would not suffice for making the security easily enforceable. The safest approach for the lender would be to have the offtakers consent, in writing, to be bound by the terms of the agreement, offtaker must concede to act in accordance with the instructions of the lender in case of the borrower's default. In order to implement this aspect of the lien, the pledge agreements would oblige the borrower to procure that the offtakers sign a formal letter, ordinarily in a form approved by and integrated in the security agreement, and have it delivered to the lender. The scope of the obligations of the offtaker provided by the contract is negotiated for the law and gives general direction without sufficient details. Ideally, they consist of acknowledgement of the pledge/assignment; the consent to pay money, in the normal course of business, to a specific bank account of the borrower, which would often be subject to lien, or, in case of default, to pay as instructed by the lender; undertaking not to change the terms of the offtake agreement without consent of the lender and provisions on the conversion of the currency.

Amendments may need to be made also to the contract with offtaker. The lender should be able to exercise some level of control over the cash flow from receivables. Therefore, the debtor can be offered to include express provisions on the bank accounts through which the settlements under offtake contracts should be made, and the prohibition to change them at will.

The lender is advised to reserve step-in rights and veto certain contractual changes as well as performance — as long as it does not turn into a micro-management, thus blocking the business judgement by the debtor. After all, sound business should be seen behind every collateral.

Breach of the covenants by the debtor would be an event of default triggering rights of foreclosure under the financing and security documents. To the extent the lender is a Ukrainian bank, it may rely on the use of the contractual write-off. Pledge of the rights to the account and assignment of rights structured in this way make this option attractive not only to the banks but also to other creditors.

Depending on residency of the lender and the offtaker, currency of the offtake contract may or may not create a problem.

The foreign lender, having no bank accounts in Ukraine, and with the claim secured by receivables denominated in Ukrainian currency, needs to convert the proceeds into foreign currency. The solution would ordinarily be an agency arrangement. Alternatively, the receivables can be assigned down to a factoring company or a bank. In case of pledge agreement, this can only take place upon the assignment of the principal claim (secured obligation) in whole or in part. Conditional assignment gives an advantage, as the rights can be sold separately from the assignment of the loan agreement — the only issue is the contractual arrangement on the offset of the principal debt.

Receivables denominated in foreign currency trigger a set of other problems. Assignment of receivables in cross-border contract, if ever realized, poses risks for the pledgor for violation of the 90 day rule. That is, the obligation to receive payment for goods delivered/services provided within the term provided by the law. Thus, if the lender receives the payment instead of the Ukrainian supplier, the pledgor may be subjected to tax fines, in particular, if it cannot prove that it received a consideration (for example, an offset of its payables (deliverables) to the lender (other creditor) under the principal contract. Demonstration of benefit may be particularly difficult if settlement of receivables is based on the pledge agreement and the lender is a foreign entity: tax authorities are reluctant to accept the pledge agreement and default notices of the pledgee as a proof. Thus, the clauses on consideration for the title to collateral (assigned/sold) as well as related standard documentation confirming settlement of debt, should be carefully drafted.

The borrower and potential buyer of the collateral may be particularly concerned about the interplay of the loan, security and perfecting documents — so that the receivables do not remain under the pledge after the assignment has taken place. As discussed above, the lender would, in many cases, factor down the receivables, especially if non-monetary deliverables are expected.

An ease of foreclosure depends primarily on whether the offtaker cooperates with the lender. It may be worth seeking an injunction freezing the accounts of the debtor and its receivables as well as initiating litigation in the offtaker's jurisdiction to compel an unaffiliated offtaker to follow the foreclosure

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