Drafting Extra Protection for Your Factoring Deals

Factors sometimes forget that at its core, factoring is about collecting from account debtors. Too many times, factors rely on recourse provisions, personal guaranties and reserves to protect them from losses. Unfortunately, it is not uncommon to have a deal where you are having trouble collecting from account debtors and you suddenly realize that you have serious exposure.

BY SCOT PIERCE

Factors sometimes forget that at its core, factoring is about collecting from account debtors. Too many times, factors rely on recourse provisions, personal guaranties and reserves to protect them from losses. Unfortunately, it is not uncommon to have a deal where you are having trouble collecting from account debtors and you suddenly realize that you have serious exposure. You then discover that you are underreserved. You call your client only to learn that he or she has no more invoices to advance and is in dire financial trouble. What do you do?

Your only options may be to write the debt off or file a lawsuit. If you can find a solvent defendant, filing a lawsuit may be the better option. You know that one of primary maxims of litigation is to go after the deep pocket so you sue everyone and see who is able to pay. Then the account debtor does what every account debtor who has not paid an invoice does–he or she argues offset. The account debtor claims that your client breached the contract, failed to deliver the goods in a timely manner, the work was faulty, and so forth. Although your due diligence should have caught these problems, many times the due diligence was not as clean as you had hoped. Maybe you did not quite ask the right questions, or the account debtor's response was not as clear as you originally thought or you asked the wrong person. Usually, whether these excuses can be overcome depends on the facts of the case. But what besides perfect due diligence could you do in the future to put yourself in a better position to litigate these kinds of situations?

One possibility is having your client obtain signed waiver of defense clauses from account debtors. A waiver of defense clause is essentially a clause where an account debtor specifically waives any defenses to payment for offsets and the like. This is different from a clause stating that the account debtor is not aware of any claims or offsets. You want the account debtor to specifically waive any defenses, not just agree that they do not currently know of any defenses.

These clauses seem to be a hot topic with courts in the last few years. If executed correctly, courts have generally been enforcing these clauses. Uniform Commercial Code section 9-403 sets out the standard for enforcement.

(b) . . . [A]n agreement between an account debtor and an assignor not to assert against an assignee any claim or defense that the account debtor may have against the assignor is enforceable by an assignee that takes an assignment:

(1) for value;

(2) in good faith;

(3) without notice of a claim of a property or possessory right to the property assigned; and

(4) without notice of a defense or claim in recoupment of the type that may be asserted against a person entitled to enforce a negotiable instrument under section 3-305(a).

(c) Subsection (b) does not apply to defenses of a type that may be asserted against a holder in due course of a negotiable instrument under Section 3-305(b)

Most states have adopted a version of the uniform commercial code that is very similar if not identical to the uniform rules above. Before drafting a waiver, however, always check the relevant state's specific version of this section.

The benefit of these clauses is that they offer numerous protections for factors. When enforceable, the waivers generally prevent account debtors from asserting any defenses other than infancy, duress, lack of legal capacity, illegality of the transactions that, under other law, nullifies the transaction, fraud in the inducement and discharge in insolvency proceedings. Simple contract defenses are not available. Because of this, courts have rejected a number of normally viable contract defenses as a matter of law. For example, courts have rejected the following defenses:

(a) failure to properly install equipment;[1]

(b) failure to properly attach all necessary schedules to the contract;[2]

(c) the parties never having a meeting of the minds on the contract;[3] and

(d) material alterations voiding the contract.[4]

Other defenses have also been rejected by courts.

Strong policy supports enforcing these waivers. While evaluating a case involving a waiver of defense clause where payments on a finance lease were assigned and securitized, the California Fourth District Court of Appeals stated "[S]ecuritization is the modern version of the historical

practice of financing by factoring in which a factor bought a creditor's accounts by paying a percentage of the face value and receiving an assignment of the accounts. Enforcing a waiver of defenses, save for those that would be good against a holder in due course of a negotiable instrument, promotes the transfer of accounts by allowing a purchaser to rely on the face of the documents. Thus, the lessee, like the maker of a negotiable instrument, bears the risk of putting into the stream of commerce documents that appear regular on their face but have underlying flaws."[5] It may be helpful to remind your judge of this policy if you end up attempting to enforce one of these waivers in court.

To take advantage of these waivers, ensure that your waiver meets the requirements of Article 9. First, the clause should be between your client and the account debtor not you and the account debtor or you and your client. One of the primary requirements in enforcing waiver of defense clauses under section 9-403 is that the agreement be between an account debtor and assignor. In 2002, the Ohio Court of Appeals considered a case where a factor was attempting to enforce a waiver of defense clause.[6] The Court specifically refused to enforce the clause because it was executed between the factor and the account debtor, not the client and account debtor as required by Ohio's version of section 9-403. But what happens if your client does not have a waiver of defense agreement with the account debtor, but you want to enforce this type of clause directly with the account debtor?

In that situation, courts have used state contract law principles rather than the Uniform Commercial Code to determine if the agreement is enforceable. The usual problem with enforcing an agreement directly between the factor and account debtor is that the account debtor claims that it received no benefit from signing the waiver so the waiver is unenforceable. In August of 2009, the Third Circuit Court of Appeals considered a case where an account debtor presented as a defense to a factor's attempt to enforce a waiver of defense clause.[7] The account debtor argued that the waiver lacked consideration because the account debtor received no benefit by signing it. The Court rejected this argument and held that the account debtor did receive a benefit from signing the waiver. The benefit that the Court found was that the account debtor signed the waiver to facilitate the factor's client receiving financing. This financing enabled the client to perform its obligation for the account debtor sooner which benefitted the account debtor. That was enough to render the waiver enforceable.

In 2002, however, the Ohio Court of Appeals declined to enforce a waiver of defense clause between a factor and an account debtor because it found no benefit to the account debtor.[8] The Court rejected the argument that the waiver of defense clause should be enforced under contract principles. The Court found that the agreement lacked consideration since the account debtor received no benefit from signing the waiver. Unfortunately, the opinion does not tell us if the parties set forth any theories of consideration. But the lesson is that although an agreement between the client and account debtor is the most effective way to execute an enforceable waiver of defense clause, a properly executed agreement directly between a factor and an account debtor may also be enforceable.

Finally, it is worth emphasizing that the factor itself must qualify under section 9-403 to receive the benefit of the waiver. The factor cannot know there is a performance problem before it accepts the invoice, then attempt to enforce the waiver. The Dallas Court of Appeals considered a situation like this in 2008.[9] The court rejected enforcement of a waiver of defense clause because the factor essentially participated too much in the transaction. The court found that the factor knew its client was having performance problems, knew of problems with the leases underlying the transaction, and knew that the client may have difficulty performing under the lease. Because of all of this, the court held that factor did not take the assignment in "good faith without notice of a defense" and, therefore, could not qualify for protection under article 9.

If drafted and executed properly, waiver of defense clauses can be valuable tools. Although these clauses may not solve every problem, they can add another layer of protection in your deals. They may be especially helpful in those situations when your client wants to tender you replacement invoices to make up for uncollectible invoices. Whether a court will enforce the clause, however, may not be the waiver's only value. Just the existence of a well drafted clause that appears to be enforceable may be enough to create the leverage you need to get paid. And the bottom line is that you are in the business of collecting from account debtors. •

[1] *Popular Leasing USA, Inc v. Mortgage Sense, Inc.*, 2008 WL 1952380 (Cal. Ct. App. 2008) (Nonpublished/Noncitable).

[2] *Wells Fargo Bank Minnesota, Nat'l Ass'n v. B.C.B.U.*, 49 Cal. Rptr. 3d 324 (Cal. Ct. App 2006).

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] Capital City Fin. Group, Inc. v. MAC Constr., Inc., 2002 WL 2016332 (Ohio Ct. App. 2002).

[7] *Hunts Point Coop. Mkt., Inc. v. Madison Fin., L.L.C.*, 2009 WL 2700169 (3rd Cir. 2009).

[8] *Capital City Fin. Group, Inc.*, 2002 WL 2016332.

[9] *IFC Credit Corp. v. Specialty Optical Sys., Inc.*, 252 S.W.3d 761 (Tex. App.-Dallas 2008, pet. denied)

Scot Pierce is a partner with the lawfirm of Bracket & Ellis, P.C. located in Fort Worth, Texas. He has represented a number of factors with commercial litigation and bankruptcy issues. He also regularly writes articles and presents speeches on creditor rights issues. He can be reached at 817-339-2474 or spierce@belaw.com.