What is Your Lender Doing with Your Receivables?

as published in *Houston Business Journal* - May 25-31, 2007

WINSTEAD
Attorneys and Counselors

© 2007 Nelson R. Block

A business's accounts receivable are one of its most valuable assets, not only to the business but to its lender. In an ongoing business, the continual turn of accounts receivable on a frequent basis make them a reliable source of revenue and, therefore, of collateral support for financing the business.

The steps necessary to secure the lender in its position in the receivables are sometimes confusing to the business owner. Here are the steps by which a lender obtains its secured position in its customer's accounts.

In the case of businesses which sell inventory, the receivable is created when the inventory is sold on credit. The Uniform Commercial Code ("UCC") governs security interests in inventory, accounts receivable and other kinds of personal property. It provides that a lender establishes or "perfects" its position against other creditors by filing a financing statement (form UCC-1) stating the type of collateral with the proper filing officer – the Texas Secretary of State's Office for entities formed under Texas law. The first creditor to file a financing statement has first priority. In such cases, the process of gaining collateral in the "accounts" (the UCC term for accounts receivable) begins even before the inventory is sold. Between a lender who has a secured position in inventory *and its proceeds* filed before a lender who has security in accounts, the inventory-and-proceeds-secured lender takes priority over the accounts-secured lender.

But the ordering created by the filing of financing statements only provides protection when the collateral is accounts. When the customer who owes on the account – the "account debtor" – pays by sending the borrower a check, the filed financing statement does not perfect the lender's security interest in the funds represented by the check once it has been placed in the company's bank account. At that point, the nature of the collateral changes and, unless the proceeds are "identifiable cash proceeds" which can be traced by the lender, the lender must have a security interest in the bank account. If the lender is the bank where the account is maintained, then the creation of a security interest will be sufficient to perfect. Usually the bank lender's documents will also contain a right of set off, which is not a security interest but gives the lender the right to take the funds in the account upon a default in the loan.

If the lender is not the bank where the account is maintained, then in addition to the lender's security interest, it will need an account control agreement. This is a three-party document signed by the lender, the borrower, and the bank where the account is maintained. The most significant feature of the account control agreement is the bank's agreement to honor payment instructions only from the lender, not from the borrower, after the lender has given written notice to do so.

In order to capture checks sent in for payment, the lender will often create a lockbox account, usually at the bank where the borrower does business. The lockbox agreement provides that all envelopes addressed to the borrower that are received at a post office box under the bank's control – the lockbox – will be opened and checks deposited in a special account which is either set up with the lender or covered by an account control agreement. Letters and other items received in the lockbox are sent to the borrower.

In addition, account debtors are notified to pay their accounts by mailing their remittances to the lockbox. This arrangement is "full notification," as distinguished from an agreement with the borrower to only notify its customers after an event of default. Lenders refer to this full notification feature, coupled with the lockbox and deposit account, as "dominion of funds" because the lender now has a security interest, as well as some measure of control, over the entire process by which the borrower's cash flow is received.

Once received, the lender may wait for one to three days before crediting the loan balance in order for the checks to go through the clearinghouse process. Borrowers sometimes contract for these clearing periods, or "float days," for a time that is longer than may actually be required for checks to clear, permitting the lender to continue to charge interest on the loan balance. Once the cleared funds are credited to the loan, the lender will be in a position to advance fresh funds upon the purchase of inventory or the creation of new accounts receivable.

Nelson R. Block is a shareholder at Winstead PC specializing in credit and real estate transactions.

Contact: *Nelson R. Block, Shareholder*
Houston Office, Winstead PC
713.650.2746 direct, nblock@winstead.com