Transactional Lending:

Debt Hangover Relief for Overleveraged Entrepreneurs Satisfies Lenders

By Joseph F. Ingrassia

Entrepreneurial businesses are stymied by a hangover of debt. Federal regulations, bank lending criteria and mostly unsecured debt from the economic crisis are significant challenges. Companies are finding relief with secure, transactional lending structures to satisfy their growth trajectory goals and aid the forbearing bank to get principal paid back.

Entrepreneurs take risks and are skilled problem solvers. They simply make things happen. For years, there have been many companies unable to obtain financing from traditional sources. Today, the cards are still stacked against them. Many cannot qualify for financing because they have a substantial debt hangover of unsecured and under-secured debt with their lenders, likely in work-out.

The problems stemming from the economic crisis remain significant challenges for entrepreneurs who need financing to strengthen their business. Today's business climate has been bifurcated by the federal government into two segments: banks and favored industries that are too big to fail and must survive at all costs; and small companies who are required to fend for themselves in the spirit of true capitalism.

The "capitalist", as I will refer to them, are the entrepreneurial class in our economy who take calculated risks and, on a daily basis, must use their own wit and moxie to solve problems that arise day in and day out. Unfortunately, wit and moxie don't always pay the bills. Recent federal regulations, like Dodd-Frank, have made it more difficult for the capitalist to survive and grow. Dodd-Frank, requires banks to increase their reserve capital based on the riskiness of loans made. For most smaller companies that operate as capitalists in our economy, this means they will have a very difficult time getting financing from a bank regardless of size, unless the company has a very strong balance sheet and the principal shareholders have significant personal assets.

A Hangover of Debt: Risk for All

Add to the difficulties described above, most smaller companies (defined as companies with sales below $100,000,000 per year), that survived the financial crisis and the period of slow growth that has ensued since, have a hangover of debt that is mostly unsecured, but through work out agreements, forbearance agreements, and the personal guarantees of the principals remains on their balance sheet and acts as an impediment to growth. The banks and other lenders have not written down the debt consistent with the assets owned by the borrower. These companies are stymied because of the debt hangover. Their banks and lenders are justified in trying to collect as much of the balance due on their loans as possible.

However, along the way, if most companies cannot grow, they will typically go out of business. This fact possesses tremendous risks for the bank or lender and the entrepreneur. The risk to the bank is that the onerous conditions of forbearance will restrict working capital and limit the ability of the borrower to grow and make a profit through incremental sales growth. The borrower would then go out of business, leaving the lender with litigation and collection costs, most of which they will not be able to collect because the principals have had to add all of their liquidity to the business or pay down the bank as a condition of the forbearance agreement. The risk to the entrepreneur is even greater; if he/she fails to meet the demand of their customer, they will lose the customer. In today's world of consolidated retailers and industrial companies, losing a major customer could be the end for these highly leveraged businesses.

Transactional Lending: Hangover Relief for the Overleveraged

Our experience reviewing thousands of funding requests from companies that are highly leveraged with insufficient assets to collateralize their debt has been to decline the funding request. Any rational lender or factor would have to classify the funding request as hopeless or as an excellent candidate for a bankruptcy filing.

This exact situation has created an opportunity for a new transactional lending structure to meet the needs of both the entrepreneur and the lender's credit committee. The current market challenges include the need to accomplish three objectives:

1. Help the overleveraged company grow
2. Help the overleveraged company pay off its lender
3. Grow our portfolio without adding unintended risk.

Most forbearing lenders will not agree to a subordination agreement so a new lender or factor can get a first lien on the assets of the borrower, as this would defeat the purpose of the forbearance. We knew that the lender's goal is to be paid in full, whether or not the business survives. We knew that our solution would have to be novel enough to get the lender's credit committee to go along with the proposed financing structure.

Limited Subordination Agreement (LSA)

To meet all of these conditions, we developed the concept of a Limited Subordination Agreement. Under a "Limited Subordination Agreement" (hereinafter the LSA), the forbearing lender does not subordinate all of their security to the transactional lender. The forbearing lender only subordinates the accounts that are identified by the transactional lender as accounts it intends to finance or factor.

How it Works

For example, for a watch company who has large orders from Wal-Mart, Target, Groupon and Overstock.com, the transactional lender would step into the capital structure and negotiate an LSA with the lender. In that agreement, the purchase orders and the proceeds thereof from specific account debtors would be assigned to a firm like ours in exchange for financing the goods through our trade finance program. After our initial call with the lender, we worked out the details of whom the profits related to the sales are to be paid to, what happens in the event they collect accounts receivable belonging to us and we collect accounts receivable belonging to them. The list of accounts to be subordinated is listed on an exhibit to the LSA to provide flexibility to both the forbearing lender and the transactional lender. At the forbearing lender's option, all the purchase orders from the Exhibit A account debtors can be subordinated to the transactional lender until the transactional lender elects not to provide financing to the borrower or the LSA can be written in such a way that the lender has to consent in writing to each purchase order that falls under the LSA. The lender retains as collateral all other accounts and assets of the borrower.

From the borrower's perspective, the LSA allows his/her company to grow because the transactional lender is financing those orders that require the most working capital to fulfill. By operating with the transactional funder, entrepreneurs can use the limited working capital available through the forbearing bank to finance operations and other customers.

Growing Out of Financial Difficulties: A Closer Look

We have adapted two of our funding programs to facilitate the use of the LSA.

Delivering Goods to Customers—To accomplish this goal, the use of purchase order and trade finance is used for clients. Under the program, once the LSA is executed and due diligence is completed, a supplier credit facility is established for the customer by either issuing a letter of credit, a letter of guarantee or making a cash payment. The goods are shipped to a warehouse under our control and are shipped to the account debtor that is specified under the terms of the LSA. The invoice is either factored on a collection or discount basis depending on other underwriting criteria. Once the accounts receivable is collected into our lock-box, we recover our advance and fees and advise the forbearing bank that we will wire them the profit from the transaction. In the event that under the LSA each additional purchase order has to be approved by the forbearing lender, we would advise them of the next order and repeat the process.

Delivering a Service—For companies that deliver a service or have sufficient supplier credit to deliver the goods required under their customer's purchase order, we use our spot factoring program. In this case, we still require the assignment of the specific purchase order and the proceeds thereof. The forbearing lender has the same two options that were discussed earlier under the purchase order financing and trade finance program. This LSA specifies all purchase orders from specific account debtors or specific purchase orders from specific account debtors.

For lenders and factors who have reached their credit limit with a given account debtor, the LSA program works very well. In these instances, we step in and, for specific accounts, we will provide capital or factor the related accounts receivable above the credit limit established by the bank or factor. Our participation allows the lender or factor to retain the borrower relationship and maintain the credit quality of their portfolio.

Entrepreneurs and small businesses need innovative thinking to provide new structures to help them grow out of their financial difficulties. The LSA program provides a secure method to assist the company in its growth trajectory to outgrow its financial difficulties and to aid the forbearing bank in getting its principal paid back. The ultimate goal and hope is for it to lend again to the company, once their collateral and loan balances are in formula again. TSL

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