Why trade gets paid

Geoffrey Wynne explains the principle of true sale and giving true trade priority in restructurings

In light of recent restructurings and regulatory developments, the title of this article is perhaps more optimistic than the result may be in practice. However, all is not lost and some guidance as to how to approach the issues in receivables financings may help to improve the position of the debt holder.

True sale of the receivable

The financing of receivables can be achieved by a loan secured on the receivable. Formalities need to be observed, including registrations of the security. This may not always be achievable and, in any event, the finance provider often prefers to own the debt outright. To achieve a true sale, one key element is to document the transaction correctly in order to show that the intention is to create a sale rather than to make a secured loan and, most importantly, to ensure the debt is transferred to the financer. Failure to deal with this issue can result in the transaction being re-characterised as a loan with or without security, depending on how the documents are constructed and interpreted.

The Deutsche Bank view

Trade finance underpins around 80% of world trade volumes and at Deutsche Bank we have been supporting world trade with this ever since our 1871 foundation.

As Chair of the ICC Banking Commission, I am proud to lead rule writing, research and advocacy for trade finance – in particular emphasising the value of trade finance as a tool that provides importers and exporters with the financing and risk mitigation that allows them to transact with distant and often unfamiliar companies.

One of the ways we do this is the ICC Trade Register, which aims to support banks in making this happen with the provision of an objective, transparent view of the credit-related risks and characteristics of trade finance using a rich, data driven approach. The Register has done much to demonstrate trade finance's favourable risk profile and continues to make the case for recognition as an investible asset class for institutional investors.

And as this article sets out, trade gets paid when it is structured correctly and the due diligence processes are followed to ensure safety and soundness are adhered to all the way along the value chain.

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Factoring, in particular, has shown that the whole debt need not be transferred and there can be recourse to the seller of the receivable if the receivable is not paid. That level of recourse is subject to negotiation. English law requires an assignment of the receivable as the mechanism to transfer title. This can be achieved with or without notice to the debtor. The buyer of the receivable normally collects it. Sometimes the buyer of the receivable agrees that the seller can collect the receivable on its behalf. It was an agency arrangement giving the seller the right to collect and account to the buyer.

Trade debt and true trade

There is no agreed definition, but a working definition would suggest that to be a trade receivable, the receivable should arise out of the sale of goods or services. Arguably, it should be payable within a reasonable period (perhaps 180 days) and not over a number of years. However, structuring the payment of receivables over years is used in forfaiting. And it also works where the assets in respect of which the receivables arise have a long useful life. True trade might be a subset of this definition which ties the receivable very specifically to the payment for known goods and services, often imported into the country of the buyer of the goods, rather than being part of a working capital arrangement where the receivable is less well defined.

> The premise that all trade debts arise under letters of credit is incorrect

Does it matter?

This is the crux of the argument. There seems to be no insolvency law that gives trade debt any priority. During the 1980s, as part of country restructurings in Latin America in particular, short-term debt was paid ahead of other debts and in full. Hence the argument was borne. And in restructurings of various Kazakh banks (2009)[1], there was priority granted to trade debt or, in some cases, a more closely defined trade debt which came to be called true trade. This was related to receivables generated from the sale of goods and services into the designated country and no more. These receivables received better treatment in the subsequent restructuring of that bank's debts. This was sorted by contract (not relying on insolvency law) but approved by the bankruptcy court.

Arguments were made, and continue to be made, that this principle was good as it encouraged the use of finance using trade receivables. The regulators took note of the possibility of viewing short-term payables under letters of credit as self-liquidating (because they closely followed the goods) and hence should get better capital relief.

Holding receivables, however evidenced, would then be good news for bank financers. Although credit risk mitigation under Capital Requirements Regulation (CRR) only benefits those banks that are on the advanced internal ratings based approaches. There are many structures that can be used to evidence receivables for their purchase.

The structures

The receivable could be just something that arises under an invoice that is assigned to the debt purchaser. There could be a notice on the invoice to pay the financer with payment to a designated account. Where there is a supply chain financing that is 'buyer-led' then the buyer undertakes to pay approved invoices to whoever owns the receivable. Sometimes the obligation of the buyer is replaced by an Irrevocable Payment Undertaking (IPU). Sometimes another group company (often the parent) replaces or supplements the commercial invoice with such an IPU. However, this may cause more problems than it solves.

Where does structuring lead?

There have been many structures using electronic platforms and/or IPUs. Spanish

Images: Getty

> The regulators can help and the guidance for self-liquidating letters of credit has already helped a little

energy giant Abengoa's transaction is a case in point.[2] Here, the parent IPU proved to be problematic as the parent had financial difficulties rather than some of its subsidiaries. Holders of the IPU rushed to check their claims against subsidiaries whose receivables they had. Restructurings and claims are still ongoing. Some argued that even where the IPU had become the main source of payment, they should be able to pursue their claim against the issuer of the invoice, and perhaps even obtain better terms in a restructuring as it was short-term trade debt. This has not always been successful. Indeed, even where claims against the subsidiary have been allowed, these claims are treated as unsecured claims with no priority over the general unsecured creditors.

In some cases, the holder of the IPU took the view that it would extend the payment terms of the receivable arguably well beyond its normal term. This was advantageous to the Abengoa company (as the buyer of goods) and its parent. The extended terms were granted by a financer (as the buyer of the receivable) rather than the seller of the goods. This caused Moodys to suggest that where this occurred and a bank financer extended the payment term, that receivable stopped being a trade receivable and became bank debt.[3] If this continues to be the case then not only is there little, if any, chance of the debt being treated as trade debt and being repaid early but the issuer of the IPU increases its bank debt and cannot reflect the receivable (it is payable as it has the obligation to pay) as a debt owing to suppliers. This would affect its bank debt covenants, for example.

Trade payables

Given the problems above, can a case still be made to pay trade payables ahead of other unsecured claims such as bank debt? Certainly, in some restructurings the buyer of goods has provided for the payment of (short term) payables in any restructuring, arguing that these should be paid to secure the supply of future goods. This is a sound idea. It is contractual and not covered by any insolvency law. While in theory this 'priority' should not depend on the holder of the receivable in question, there are restructurings where there has been a close look at how the receivable arose and who held it. In one case, receivables arising from a synthetic letter of credit arrangement (where working capital was created rather than deferred terms for a purchased asset) the debtor refused to pay those receivables in priority.

The way forward for receivables in a true trade context

It seems unlikely that there would be a wholesale change to insolvency laws to legislate for priority for trade debts over other unsecured claims. Clearly, creating some sort of security for true trade debt would be a solution. That could be possible where the receivable arises for the purchase of raw materials that then go into some sort of process which results in finished goods being sold. The receivable generated by that process could be assigned to the holder of the receivable for the raw material. This is a little complex and could be achieved at the moment with careful drafting, though it is not a general solution.

If there is a general feeling that trade debt should have a priority, those engaged in restructurings should take this as a principle of restructuring and implement it. That was the case in the Kazakhstan bank restructurings referred to above. It has also been adopted in other restructurings of a debtor with a large debt position, where some of its debts were bank debts but others were short-term debts owed, initially at least, to suppliers.

The regulators can help and the guidance for self-liquidating letters of credit has already helped a little.[4] However, the premise that all trade debts arise under letters of credit is incorrect. This is especially true when coupling it with the idea that a bank will always be holding title to the goods being financed.

Receivables are, to a limited extent, considered in credit risk mitigation. The treatment could be improved further with some clear definitions to allow short-term trade debt where the buyer of the goods has irrevocably agreed to pay. All these terms would need to be defined and care needs to be taken to avoid abuses by the parties. Office holders in restructurings as well as arranging banks would also need to agree the principles. These principles would define what the acceptable debt would be, both as to how it is generated and who holds it. This is not impossible, as previous restructurings have shown. However, answers have varied widely and there is still no certainty that trade debt would always be paid.

Having the principles agreed could improve supply chain financings, get more trade debt insured and generally ensure better treatment is obtained for trade debt in a regulatory context.

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Sources:
[1] See 'Restructuring banks, don't start from here' (November 2010) at www.economist.com/node/17583123
[2] See http://bit.ly/2ml1mCj at www.abengoa.com
[3] See Moody's announcement on 16 December 2015 at http://bit.ly/2n4T8VR
[4] See www.bis.org/publ/bcbs205.pdf