

# THE COMMERCIAL FACTOR

Newsletter for the Factoring Industry



Volume 1 Number 2  
Fall 1999

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## BANKS BEWARE: You May Owe Your Customer's Factor! or HEY FACTORS: Does Your Client's Bank Owe You Money?

by Mike Ullman, Esq.



Since my last article published in "The Commercial Factor" Vol. 1, Number 1 of the Summer 1999 Newsletter, I've had the opportunity to participate in and conduct a couple telephone speaker series with a number of you throughout the country. For those of you that missed one of those conferences, you did not get a chance to hear about the very real opportunity to get paid from a source you may not have considered – your client's bank (I hope my banking clients don't get too upset about this article but I have a real affinity to my factoring clients; so here goes...)<sup>1</sup>

The dilemma faced by many courts has been the need to reconcile §§9-104(k) and 9-306(2) of the Uniform Commercial Code ("UCC").<sup>2</sup> So, what's the problem: §9-104(k) says that "deposit, savings, passbook or like accounts" **are excluded** from Article 9 coverage. §9-306(2), on the other hand, provides that when there has been a sale, exchange, or other disposition of collateral, a security interest in that collateral continues in "any identifiable proceeds including collections received by the debtor." Does the factor lose its lien rights in proceeds of accounts that end up in your client's bank account? Can the factor's lien attach to these "funds" in the face of §9-104(k)'s language? Does it matter if the account is a segregated account where only those type of proceeds are deposited? Does the filing of a bankruptcy petition change the rules, and if so, how? The answers are: no, yes, maybe and most definitely yes. Here's why.

Most courts that have addressed these issues over the years hold that the §9-104(k) exclusion means only that a bank need not obtain and record a UCC financing statement in order to assert its right of offset. Since §9-201 of the UCC makes security agreements "effective, between the parties, against purchasers of the collateral and against credi-

tors," a factor's lien rights in the accounts and any "identifiable proceeds" of those accounts means that its lien rights extend to the funds (i.e. proceeds) so deposited. In the non-bankruptcy setting, the factor who is able to identify its proceeds is entitled to seize those assets and *takes priority* over a bank that seeks to set off any debt it may be owed. As a practical matter, as soon as the factor discovers its account debtor's payment has or may be diverted, written notice should be given to every potential bank, advising each such bank of your lien rights, and suggesting that in the event your account proceeds have reached your client's bank account you claim priority and no disbursement or setoff with respect thereto will be permitted. If you fail to get results, consider filing suit against your client and either immediately subpoena the bank(s) and seek production of all relevant records or serve a prejudgment writ of garnishment, or both.

What happens in the bankruptcy or insolvency context? A different set of rules. §9-306(4) of the UCC reads:

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:

(a) Identifiable noncash proceeds and in separate deposit accounts containing only proceeds;

(b) In identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;

(c) In identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account prior to the insolvency proceedings; and

(d) In all cash and deposit accounts of the debtor, in which proceeds have been commingled with other funds, but the perfected security interest under this

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## Upcoming Events

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Mike Ullman from Ullman & Ullman, P.A.

Tuesday, December 7th

1:00pm Pacific Time

**Topic: Bankruptcy**

1. Are you exposed to preference or fraudulent conveyance liability?
2. Will your contract's liquidated damages clause stand up in bankruptcy court?

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# The Commercial Factor

Newsletter for the Factoring Industry

The International Factoring Association

555 Chorro Street, Suite B  
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The International Factoring Association's (IFA) goal is to assist the Factoring community by providing information, training, purchasing power and a resource for the Factors. The IFA provides a way for Commercial Factors to get together and discuss a variety of issues and concerns to the industry. Membership is open to all banks and finance companies that perform financing through the purchase of invoices of other types of accounts receivable.

The Commercial Factor invites the submission of articles of interest to the Factoring industry. For more information on submitting articles or advertisements, please e-mail [info@factoring.org](mailto:info@factoring.org), or call 800-563-1895.

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# Concentrations in Purchasing and Financing Accounts Receivable

by Scott Mitchell, CFE

Factors and Asset Based Lenders are being asked to finance a number of opportunities today that require an advance or purchase of concentration account debtors. There are several risks in purchasing and advancing against account debtor concentrations. We should examine each of the risks, identify the characteristics of each risk, and develop strategies to manage the risks.

The obvious risk that all analysts think of is **credit risk**. The factor or lender is concerned with the account debtor's ability to pay debts when due. This is particularly important for full recourse factors and lenders that do not research the account debtor's credit profile in detail. There are many avenues to research here. D&B ratings or D&B reports are the first line of defense. If the account debtor is a public company, an internet search on EDGAR will provide 10-K's and 10-Q's. What financial information has the client or borrower obtained from the account debtor? If all else fails, call your friendly contact at your non-recourse factor and find out if they credit check this account debtor. Payment patterns of specific concentration account debtors can be analyzed through subsequent collections procedures. The specific account debtor turnovers should provide an early warning system for the inability to pay debts when due.

Once we understand the credit profile of the account debtor, we should come to some conclusions about an ability to purchase or lend to some degree. However, there are several other risks that must be faced before a full "concentration limit" and monitoring plan can be established.

The next risk that Factors and Asset Based lenders face, especially with concentration account debtors, is **return risk**. This risk has a very high profile with account debtors such as Wal-Mart, K Mart, Sears and other discount mass merchandisers. We could study the dilution rate of specific concentration account debtors and develop a tiered advance rate structure to mitigate return risk. We should also be aware of new product introductions that may drive dilution rates beyond historical levels as a result of a lack of acceptance at the retail level. Again, certain invoices could be eliminated or a tiered advance rate could mitigate this risk.

Our clients and borrowers face the ultimate **business risk**, if the concentration account debtor should take their business elsewhere. Is this a risk in all clients and borrowers? We should take a close look at our client's operations. Do they operate in a job shop manner with large orders in specific runs? Such a profile would suggest constantly changing concentrations, with the ability to replace the business when necessary. Is the client a distributor filling the needs of a few account debtors all of the time? This would suggest permanent concentrations, rather than the temporary conditions mentioned above. Even distributors with permanent concentration account debtors can face a fair share of business risk. Most distributors do not have high fixed costs, hence they are not operationally leveraged. When sales drop, a company with low operational leverage will drop variable expenses commensurately and survive.

The manufacturer with high fixed costs is operationally leveraged. A loss of a concentration account debtor is devastating to this business. Concentration limits and monitoring should be the most stringent for operationally leveraged companies. Any Factor or Asset Based Lender focused in this sector should be careful that high gross profit margins will exaggerate the return risk. If we lend

80% on a \$1,000 invoice that gets placed back into inventory at \$500, we are out the \$300 profit that did not materialize. This could easily place the Factor in an overadvance or an inventory advance.

A very important risk that is quite often overlooked is the **fraud risk**. The easiest place for a client or borrower to hide the pre-billed or "fresh air" invoices is in the concentration account debtors. This is particularly easy for clients that ship to the account debtors through company owned trucks. Strong phone verifications, confirming every invoice should mitigate this risk. However, there are account debtors that won't phone verify. If you have a concentration account debtor that accepts shipments from the client's trucks but will not phone verify, this should be considered in a limit or advance rate.

The biggest issue that most of us face in fraud risk, is the sheer volume of transactions. That is why it is such a concern in the concentration account debtors. Shipping tests that include an "outbound trace" will have the ability to verify that shipments have occurred and can place them to time of pick-up, time of delivery, and the individual at the account debtor who signed for them. "Outbound trace" deliveries can also be confirmed via the internet for most national carriers today. This means that large volumes of invoices can be outbound traced within minutes. This is a major step forward and can detect pre-billing and "fresh air" invoices to a very high degree of confidence. Some Factors and Asset Based Lenders will actually recommend utilizing a national based carrier, in order to provide a sufficient advance rate on invoices that can be proven through this method. On the other hand, keep in mind that proven deliveries do not mitigate return risk.

In order to design a strong mitigant to fraud risk, the Factor and Asset Based Lender should always ask if they can truly verify the existence of the account debtor, the purchase orders, the invoices, the shipments, and the timely issuance of credit memos.

Finally, we need to put together a matrix for all of the risks:

- Credit Risk
- Return Risk
- Business Risk
- Fraud Risk

Eligibility, limits, and advance rates should be considered for every large concentration account debtor in light of the above risks. There are no sure bets, but the need for lots of information on concentration account debtors can be developed into a framework that should tighten the decision box.

*Scott Mitchell is a Senior Vice President and National Audit Manager for Fremont Financial Corporation.*



# FACTORING NEWS

## Acquisitions

**Heller Financial Inc.**, the commercial factoring company, announced that it would sell its Commercial Services unit to **CIT Group** for \$560 million. The unit includes the domestic factoring business, which lends money to textile and apparel manufacturers, and asset-based revolving credit facilities and accounts receivable management services. As of August 31, 1999, the unit had total net assets of \$435 million, reflecting \$953 million of factored accounts and \$518 million of credit balances due factoring clients.

The New York Times, October 5, 1999

**Textron Financial Corporation** agreed on September 23, 1999 to purchase the **Litchfield Corporation** for about \$183 million in cash to increase its resort-financing business. Textron currently provides financing for aircraft, equipment and golf. Litchfield has more than \$550 million in managed finance receivables and provides financing to time-share property and rural land developers.

The New York Times, September 24, 1999

**Heritage Bank of Commerce** has signed a definitive agreement to acquire **Business Factors, Inc. (BFI)**. The transaction is expected to close before the end of 1999, pending regulatory approval. BFI specializes in factoring, accounts receivable financing, inventory loans, equipment term loans, and other business loans. As of June 30, 1999, they had gross loans of \$20.2 million and total assets of \$21.3 million. Heritage Capital Group, the division of Heritage Bank of Commerce which provides asset-based financing and factoring, will combine their operations with those of BFI.

Business Wire, September 17, 1999

**Wintrust Financial Corporation** signed an agreement to purchase 100% of the common stock of Milwaukee-based **Tricom, Inc.** Tricom provides value-added out-sourced administrative services and short-term accounts receivable financing. The proposed acquisition will provide Tricom with additional capital needed to expand its lending services in a national market. Tricom will operate as a subsidiary of Hinsdale Bank and Trust Company, a wholly-owned subsidiary of Wintrust.

PR Newswire, September 17, 1999

**Litchfield Financial Corporation** announced on August 24, 1999 that it had acquired 53% of the outstanding shares of **American Growth Finance**, the factoring company headquartered in Dallas, TX. AGF provides accounts receivable factoring services to small businesses serving mostly Fortune 1000 companies. Litchfield provides financing to creditworthy borrowers for assets not typically financed by banks. It hopes that factoring will help to further diversify its \$545 million serviced portfolio.

PR Newswire, August 24, 1999

## Mergers

**Cynergy, Inc.** announced on September 29, 1999 that it had merged with **Mercantile Factoring Credit Corp.** of Reno, NV, and Montreal, Quebec. Cynergy is the surviving corporation and has changed its name to "Mercantile Factoring and Credit Online Corp." The company is in the development stages of operating an on-line loan exchange which will provide an internet site where borrowers can seek business loans collateralized by the borrower's assets, including accounts receivables. Lenders will be able to bid the borrower's offerings in an auction format. The Company expects the web site will be operational on November 30, 1999.

Business Wire, September 29, 1999

## Agreements

**Allstate Financial Corporation** announced that it has entered into a loan agreement with **Value Partners, Ltd.** Value Partners advanced Allstate \$1 million, in an unsecured loan, for general corporate purposes, including working capital. Allstate provides funding to small and medium-sized companies through asset-based lending and the purchase and monitoring of their accounts receivable.

PR Newswire, September 8, 1999

## Bankruptcy Filings

Company: **Southwest Capital Inc., aka California Mortgage Capital**  
Location: Aliso Viejo, CA  
Type of Business: Lease consulting, invoice factoring & equipment leasing

Los Angeles Times, September 24, 1999

## Investigations

David P. Cullen and Andrew M. Shapanka, both of Massachusetts, pled guilty to one count of conspiracy to commit mail fraud in connection with a scheme to defraud investors. The pair told investors their funds would be used to purchase government receivables through a company called **Rose Equities Services, Inc.** and that their investments would yield a high return in a short period of time and be virtually risk free. The funds were never used to purchase the account receivables, but instead deposited and used for their own purposes.

PR Newswire, September 14, 1999

Four people were indicted by federal authorities of running a massive securities fraud operation out of an Irvine, CA-based investment firm, **Cross Financial Services Inc.** The indictment alleges that the four solicited more than \$22 million from about 700 investors over a 16-month period in 1993-1994. The company allegedly promised investors their money would be used to make short-term loans to businesses that had been awarded government contracts, although Cross Financial was not engaged in the business of factoring government receivables. The defendants allegedly used the investor funds "to pay themselves huge salaries and commissions and to purchase luxury items such as private airplanes and boats."

City News Service, September 3, 1999

A breach of contract lawsuit was filed in Texarkana, TX in the continuing saga of **Southwest Factors Inc.**, the Little Rock factoring company whose collapse triggered state and federal securities investigations. The lawsuit alleges that Southwest's dealings were based on forged invoices from Starkey Electric Co. and that **Regions Bank** knew of the forgeries and failed to alert investors. Named in the lawsuit are the former President of Southwest Factors, Mike McNew, his attorney, three defunct corporations owned by McNew, Regions Bank, two of its officers and a few others at Regions.

Arkansas Business, July 26, 1999

If you have any news items you would like to include in the next issue of The Commercial Factor, please e-mail them to [info@factoring.org](mailto:info@factoring.org).

# OK, Tell Me, What's So Great About Full Recourse Factoring?

by Patrick H. Stiehm, Esq.

Most small and/or nontraditional factors purchase accounts receivable with "full recourse." What that means, at least as a legal matter, is that the factor's client is promising the factor ("warranting") that each and every account sold to the factor by the client will be paid. In fact, the client warrants that each and every account will be paid within a certain time period. The client goes on to promise that if any of the accounts are not paid within the promised time frame, then the client will buy all such accounts back from the factor.

Many of us have come to be wed to this concept of "full recourse" factoring because it makes us comfortable. How can we lose? Why, it is almost like making a loan. That is the good news. The bad news is, that it is almost like making a loan.

There are two important areas where full recourse factoring is treated like a loan for legal purposes. The two areas are bankruptcy and usury. In each case the courts have traditionally looked at full recourse factoring and where the theoretical "ultimate risk of loss" resides, i.e., with the client. That has been sufficient for the courts to determine that in the bankruptcy and usury context, full recourse factoring is really lending.

What does that mean to the full recourse factor?

What it means in bankruptcy is that when your client files, the automatic stay goes into effect on your collecting your "collateral," i.e., the accounts you have purchased from your client. This is true whether it is a Chapter 7 or a Chapter 11. That, in turn, means that the prudent full recourse factor, is in court as soon as possible, asking for a lifting of the stay.

This lifting of the stay is usually a forgone conclusion in a Chapter 7. That is because it is usually obvious that the estate has no equity in the accounts receivable and the trustee, if there is one, will usually agree to abandon the accounts or agree to the lifting of the stay. In Chapter 11 the story may be quite different. In a Chapter 11 you can have your former client, now a hostile debtor in possession, seeking to use the "cash collateral," (again, the accounts you have purchased) to continue to operate the business.

It is beyond the scope of this article to discuss the handling of these bankruptcy problems. It is useful however, to contrast the plight of the full recourse factor in bankruptcy with the nonrecourse factor in bankruptcy. If an account receivable of a debtor in bankruptcy is sold to a nonrecourse factor, prior to a filing under the Bankruptcy Code, it is treated like any other pre-bankruptcy sale of an asset. In the courts view, the asset (the account receivable) was not owned by the bankruptcy debtor, at the time of the filing, which is the same as the time of the creation of the bankruptcy estate. It follows, therefore, that the estate has no interest in the accounts receivable and the automatic stay does not affect the factor's ability to collect the account.

In the usury area, the effect of being a full recourse factor, means that you have to avoid doing business in certain states, i.e., New York, Florida and Colorado to name a few. These and other states have civil and in some cases

criminal statutes that are draconian in their effect. It also means that your documentation has to be very carefully drawn to insure selection of the law of a usury friendly state as the law governing your transactions and where your contract will be litigated. This is invariably the full recourse factoring friendly state in which you are located. Some full recourse factors, go to the extreme of requiring their prospective clients to come into the state where the factor operates to sign the factoring agreement, so as to avoid unwittingly falling into the jurisdiction of a court in a state with harsh usury statutes. The nonrecourse factor does not have any of these problems.

This brings us to the question of what is a nonrecourse factor. A nonrecourse factor simply assumes the credit risk when it purchases an account. That is all. This means that if an account is not paid because the debtor is financially unable to pay it, then the risk of loss falls on the factor. In nonrecourse factoring the other risks of doing business remain with the client.

What that means, at least as a legal matter, is that the client of a nonrecourse factor is still promising the factor ("warranting"), among other things that each and every account sold to the factor

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## BE PREPARED... Revised Article 9 is Coming!



Revised Article 9 has already been passed in six states (effective date of 7/1/2001), and has been introduced to the legislatures in 15 others. At this pace it won't be long before the state(s) you do business in will pass RA9.

Anyone involved in secured transactions will be impacted by the enactment of RA9. Those that are unaware of the UCC filing requirements under the new act will face the risk of filing financing statements that don't properly perfect their security interests. This risk is particularly real given RA9 provisions for limiting the grounds of rejection of financing statements by filing offices.

The time to begin educating and preparing yourself for the implementation of RA9 is **now**.

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**RECOURSE continued from page 5**

by the client is: (1) the property of the client and that the client is the sole and absolute owner of the account; (2) that each account represents an accurate and undisputed statement of indebtedness from an account debtor to the client, for a sum certain, without offset or counterclaim and which is due and payable within no more than X number of days from the date of invoice; (3) that each account is an accurate statement of a bona fide sale, delivery, and acceptance of merchandise or performance of service by the client to an account debtor; (4) that all invoices will state plainly on their face that the accounts have been sold and assigned to the factor and are payable only and directly to the factor; and (5) that the debtor is solvent.

This means that the factor can still put an unpaid account back to the client if it is not collected by the factor for any of the reasons cited above or for any other reasons that the factor may insert in the factoring agreement, except, of course, the lack of financial capacity on the part of the debtor.

The decision as to whether or not you are going to be a full recourse factor or a nonrecourse factor is clearly a business decision and not a legal decision.

In making that decision the factor has to look at what percentage of accounts he or she has historically been unable to collect as a result of credit and which percentage has historically been for other reasons, i.e., defective product, bad workmanship, etc. You also have to ask yourself if the extra protection you have as a full recourse factor is worth the price you pay in bankruptcy and vis-a-vis usury laws.

You should also ask yourself how meaningful full recourse to your client is as a practical matter. How many of your clients can reach into their pockets and buy back a big invoice that is not collectable or a bunch of little invoices that have gone bad? You should ask yourself if the best protection isn't really in your systems of credit checking and verification and all the other safe guards you have, rather than from recovering from your client.

In addition, is that extra protection worth what you pay in terms of competitive disadvantage by being a full recourse factor? Potential clients (prospects) don't know the technical differences between full recourse factoring and nonrecourse factoring. All that they hear when considering the two is that with one the risk of nonpayment stays with them and with the other the factor assumes the risk. If you were a potential client looking at two factors and all else was equal, which would you go with?

Whatever you decide, it should be with full knowledge and a full realization as to what the real difference is between the two.

<sup>1</sup> There are very good and substantial arguments that this analysis by the courts is incomplete, i.e., lenders don't routinely put the debtors of their borrowers on notice, they don't reserve the right to compromise accounts, even if the borrower isn't in default, they don't require their borrowers to take the accounts off their books, just to site a few examples of the sort of thing one could argue courts should look at. However, given the history of the acceptance of this position by the courts and the length of time it has been accepted, the effort to accomplish such a change in the law would, I suspect, be both time consuming and expensive, with no assurance of success. If you stand to lose enough however, maybe you and your attorney should consider it.

<sup>2</sup> I have deliberately avoided using the term "traditional factor" here. In my opinion that term implies much more than just being a full recourse factor. Since the purpose of this article is simply to contrast the difference between full recourse and nonrecourse factoring, I did not want to confuse matters by implicitly getting into other areas beyond the scope of this article.

*Pat Stiehm is with the Stiehm Law Office in Alexandria, Virginia. He can be reached at 703-360-1089.*

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**BEWARE continued from page 1**

paragraph (d) is:

1. *Subject* to any right of setoff; and
2. Limited to an amount not greater than the amount of any cash proceeds received by the debtor within 10 days before the institution of the insolvency proceeds less the sum of:
  - a. The payments to the secured party on account of cash proceeds received by the debtor during such period; and
  - b. The cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subsection.

Based on subsection (4), if your proceeds are deposited and do not get commingled with other funds you're in good shape; if they do, your rights are severely limited.

If you have any comment or questions about this article please e-mail me at [ullmanpa@msn.com](mailto:ullmanpa@msn.com).

<sup>1</sup> We also discussed the Internal Revenue Service's lien rights and issues of lien priority over the factor but we'll leave that subject matter to another article.

<sup>2</sup> Each state may have a different section number or reference to these uniform provisions.

*Mike Ullman is a Principal with Ullman & Ullman, P.A. in Boca Raton, Florida. He can be reached at 561-338-3535.*

# War Story

by Sally Stark

I had a client in the personnel staffing business that placed people both permanently and on a weekly contract basis. "Joanne" had horrible credit along with a history of prior tax liens and judgements, but what she did have was a great debtor – American Express.

I confirmed every invoice, both verbally and in writing, with the manager at the local American Express office. Invoices went out stamped with the factor name and address on them, and notification was sent to the payables office.

One day Joanne came in and dropped off her invoices and told me she would be gone on vacation for a couple of weeks. Her son had just graduated high school and was starting college in Arizona. She mentioned several times "how expensive it was" to send him to that school. Both of us made collection calls to the A/P on her account and updated the other one. When she came in she told me that two checks were on the way to me.

A couple days later, a check showed up which was paying the second oldest set of invoices. I called the A/P department and they told me yes, two checks had been recently sent out and gave me the check numbers and dollar amounts. I called back a few days after that and told them that the check (for \$11,000) still hadn't shown up. I confirmed that my address was in the system and was told to call back in 10 days if the check hadn't shown up so they could put a stop payment on it.

I called back in 10 days and was told the check was cashed and it wasn't by the factor! The A/P manager had done some research and found the client had called and had the check fedex'd to her home address. I started pulling canceled checks and found that she cashed them at a local check cashing center. A call to the check cashing company confirmed that, yes indeed, they had cashed a check for that exact dollar amount several weeks before.

American Express put a stop payment on the check, recouped the cash from the check cashing company and in return, reissued the check to me. The next time Joanne went to cash her checks, she was placed under arrest. She is now a convicted felon and had to make restitution to the check cashing company. I wonder how she explained that to her son.

The moral of the story is you can't confirm too much! Listen to your clients, and most of all, do a civil and criminal background search prior to signing them up.

Sally Stark is with Momentum Financial in Houston, TX. She can be reached at 713-426-3399.

## FACTORING TIPS OF THE MONTH

by Dan Robbins

### November

Contracts only keep honest people honest.

### December

Stay between the lines, the lines are your friends.

### January

The first law of Factoring is never lose principle.

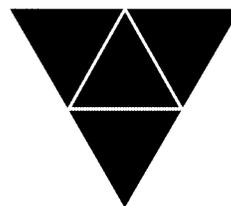
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The International Factoring Association and Distinctive Solutions Corporation are pleased to host the 6<sup>th</sup> Annual Factoring Conference on April 6-8, 2000 in Austin, Texas. This is the only conference dedicated solely to companies that offer financing through factoring. Now in it's 6<sup>th</sup> year, the conference continues to grow and provide you with more opportunities to learn from experts and network with other factors. Speakers and topics confirmed for this year's conference so far are as listed to the right.

The Hyatt Regency on Town Lake in Austin, Texas will host this year's Factoring Conference. Austin is known as the "Live Music Capital of the World" and is home to more restaurants and bars per capita than any other American city. In addition to gaining valuable knowledge and contacts at the conference, you're sure to enjoy the atmosphere of Texas' capital city.

For more information on the conference, look for the conference brochure coming in your mail soon, or visit the Factoring Conference web site at [www.factoringconference.com](http://www.factoringconference.com).

SPEAKER	TOPIC
<b>Bob Zadek, Esq.</b> <i>Attorney</i> Buchalter, Nemer, Fields & Younger	<b>Current Factoring issues</b> Revised Article 9 of the UCC code
<b>Dr. Edmond Seifried</b> <i>Professor</i> Lafayette College	<b>Economic analysis and projections</b>
<b>Matthew Gravelle</b> <i>Special Agent</i> Federal Bureau of Investigations	<b>Investigation of fraud claims</b>
<b>Mike Ullman, Esq.</b> <i>Principal</i> Ullman & Ullman, P.A.	<b>Your rights when your client deposits your check</b> Usury and it's implications to Factors.
<b>Arnoldo Cavazos, Esq.</b> <i>Attorney</i> Cavazos, Hendricks, Poirot & Dewey	<b>Your clients file for bankruptcy, what are your rights?</b> DIP financing, how is it done?
<b>Internal Revenue Service</b>	<b>Proper use of form 8821</b> Working with the IRS when your clients have problems
<b>Gary Miller, Esq.</b> <i>Attorney</i> Boyar, Simon & Miller	<b>Purchase and Sale Agreements</b> Participation Agreements
<b>Richard Worthy</b> <i>President</i> Metro Factors	<b>Making the transition from a small to large factoring operation</b>
<b>David Lowenkopf</b> <i>Partner</i> Okorie Ezieme <i>Senior Manager</i> Deloitte & Touche	<b>Risk Management &amp; Controls</b> Operational pitfalls, improving efficiencies, limiting exposures The importance of audit oversight
<b>Marketing Panel</b> Dr. Bill Carner <i>Marketing Professor</i> University of Texas <b>Lewis Faber</b> <i>President</i> Yale Capital Group <b>Laurence Pino, Esq.</b> <i>President</i> Pino Training Organization	<b>Ideas on how you can grow your business through new marketing techniques</b>
<b>Funding Panel</b> Various Funding Sources	<b>Various options for you to receive funding to help grow your portfolio</b>
<b>Saturday Operations</b> Roundtable Meeting	<b>Discuss different aspects of operations with other Factoring professionals</b>

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# Factoring Healthcare Accounts Receivable

by James R. Irwin, Jr.

## Background

Healthcare is the nation's largest single industry with estimated 1999 expenditures exceeding \$1.2 trillion, representing 13% of Gross Domestic Product. And with the progressive graying of America, the size of the industry continues to grow. Ironically, at a time when the need for capital by healthcare providers is greatest, it is also the least accessible. Factoring, though common in and embraced by other industries, is still poorly understood and underutilized as a funding tool in the field of healthcare. But, born by necessity, this is beginning to change.

The nation's healthcare system is at a financial crossroads. Economists suggest that the financial foundations of healthcare providers extending from nursing homes to physician groups have been seriously compromised. Realizing this, traditional sources of capital are making debt, line-of-credit, and equity capital less available than ever before. Factoring, however, represents a realistic funding option to capital constrained healthcare providers for whom bank loans and other traditional financing vehicles are unavailable.

## Factoring as an attractive funding option.

Since lines of credit and debt are based largely on the financial health of the borrower, a weakened financial condition is likely to reduce the availability of these financing options, particularly in the current environment. On the other hand, accounts receivable, which are eventually converted to cash, can be utilized to meet liquidity needs. Although improving billing and collecting efficiency can mitigate the problem, it does not offer immediate cash for accounts receivable, whereas factoring does.

The sale of accounts receivable at a discount, commonly known as factoring, has been slow to gain acceptance within the field of healthcare. The stigma attached to factoring within healthcare is largely a result of misperception, historical abuses during the 1970's, and the Towers fraud case. Healthcare providers often need to be educated about factoring, including the protections to the provider as a result of these cases. The benefits of selling accounts receivable, particularly compared to a loan, are numerous. Lenders often impose restrictive covenants, which may restrict the provider's

ability to incur additional debt and may require the pledge of all of a provider's receivables. The sale of receivables typically will not reduce financial flexibility or violate negative pledge clauses. Additionally, since the sale of accounts receivable is considered to be an off balance sheet funding, it often improves financial ratios, which are often scrutinized by investors. And probably most important, factoring often represents the only funding option available to a cash constrained healthcare provider.

The following is a discussion of the characteristics of a healthcare accounts receivable factoring program.

## Description of a Factoring or Purchase Program

*Definition of a Healthcare Account Receivable.* A healthcare receivable claim is an account receivable created through the delivery of a health-related service by a healthcare organization (e.g. hospital) or healthcare professional (e.g. family practitioner) to a patient whose obligation to pay the claim may be covered in whole or in part by health insurance or another third-party payor.

Payors, or obligors, are generally grouped into seven financial classes: (i) Medicare or other state plans; (ii) Medicaid; (iii) other governmental receivables such as those generated through the Civil Health and Medical Program of the Uniform Services (CHAMPUS) and the Civil Health and Medical Program of Veteran Affairs (CHAMPVA); (iv) BlueCross/BlueShield; (v) traditional commercial health and medical insurers such as Aetna/US Healthcare, Travelers and Cigna; (vi) managed care plan organizations such as HMOs and PPOs; and (vii) patient-pay.

Most purchasers of accounts receivable will purchase classes (i) through (vi) and, depending upon the purchaser's source of funds and the nature of the receivables, purchase receivables aged out to 150 days from the date of service.

*Conditions to Purchase Receivables.* The terms of a sale of a provider's receivables may vary depending on the provider, the purchaser and the purchaser's source of funding, but certain terms of sale are generally applicable to most sales of accounts receivable by healthcare providers. A healthcare provider who wishes to sell receivables must comply with certain conditions before entering into a sale agreement. At a minimum these generally include an execution of all appropriate documents; commitment to direct collections to a lock box; commitment to correctly bill all payors and to provide all required data regarding the receivables.

*Calculation of a Purchase Price.* The single most difficult aspect of purchasing healthcare accounts receivable is the ability to correctly value, track and monitor purchased receivables. Self-pay receivables are the most difficult to value and thus are seldom purchased.

As a prelude to establishing a purchase price for the receivables, an agreement on

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# Commercial Credit Reporting . . . Yes or No?

by Tim Clawson

"Why should I report? How does it affect my customers?" The decision to report account information to a credit bureau is a sensitive one for many businesses. Some think they can only report their delinquent accounts, while others feel they are betraying their customers. Nothing could be further from the truth. Reporting to credit bureaus is a safe and effective way of sharing credit information. In fact, thousands of firms you deal with day to day have been doing it for 10 to 15 years. You are rewarding your good accounts for their prompt and conscientious payment. Simultaneously, you are encouraging prompt habits in all of your accounts. Good credit is a valuable commodity in today's economy, and reporting to Experian, Dun & Bradstreet, NACMs (National Association of Credit Management) and other bureaus rewards your customers' investment in their financial future. Reporting to bureaus also has the added benefit of solidifying your portfolio and strengthening your company's financial health.

"What's in it for me? How does it affect my business?" When you pull bureau credit reports you are accessing the information received from all of the business's credit grantors who have contributed information to the respective bureau database. Those credit grantors realized the importance of a complete, accurate business credit record to both their customers and other businesses. The business customer benefits by a demonstration of its credit worthiness. Credit grantors including you, benefit by being able to accurately gauge risk, determine terms, and make credit granting decisions. Your inclusion on the database provides an even more complete picture of a company's financial obligations. Your good customers will appreciate your contribution to their credit history, while your delinquent accounts may be inspired to be more conscientious about their payment. Chances are, many of your delinquencies have similar credit relationships with other credit grantors who do not report. If they had, would you still have granted them credit or purchased their portfolio?

A credit bureau can be simply defined as a company that collects and collates credit information and then makes it accessible to subscribers. "Credit decisions" are not made by the bureaus. Credit is neither denied nor granted. Information that has been gathered is only reported. Where does this credit information come from? From companies just like yours. Those companies that contribute information to bureaus came to the realization of the benefits of reporting their information while addressing the concerns that are also associated.

Dun & Bradstreet and Experian each have over 6,000 companies participating in their trade tape program. The product of Experian's focus on key markets is exceptional data coverage in the following industries: Banking, Financial Services, Leasing, Factoring (close to 800,000 debtors being reported), Transportation, Telecom, Construction, Office Supply/Paper, Electrical/Electronic, Healthcare, Ad Media, Food Services, and Utilities, just to name a few.

In the last several years, Dun & Bradstreet and Experian have come a long way in building the quality of the information in their databases. Both companies realize that without quality data they would soon be out of business. The result of this realization can be seen in the additional benefits offered by Experian and Dun & Bradstreet to participants in their trade tape programs.

Dun & Bradstreet offers: D&B D-U-N-S Number of your files, legal name and street address of your customer, a summary of

your customers' credit histories and invoice stickers. A participant also can select one additional incentive from the following: career training, the Ultimate Parent D&B D-U-N-S Numbers of each parent company on your company list (its name, and the city and state in which it's located), the Compare Report, and a telephone number match to your company list.

Experian rewards contributors with Management Reports (segment your portfolio so you can see how your slow payers are paying other vendors and how specific industries or regions pay their bills), On-Line Warnings (alert you when a customer files for bankruptcy, or has a tax lien filing, judgement or is sent to collections), and Stickers- which you can use on your invoices stating that you report credit data to Experian. Additionally, a company that reports over 5,000 debtors can participate in Experian's Data Exchange Program. A contributor can choose either the Experian Debt Recovery Analysis (Portfolio Scoring) that provides a current risk score and up to 14 additional credit/public record elements indicating the current credit status of commercial debtors which can reveal their likelihood of paying outstanding items or the Experian Business Marketing List that matches your criteria of SIC code, geographics, sales or employee size from the Experian Business Marketing Database. These complimentary rewards are a great way to "test" both companies' products and databases with little time or money invested on your part.

Now that the benefits of reporting have been covered, it is necessary to spend some time addressing the common misperceptions and concerns that surround the decision to report. Data security is the primary concern that seems to come to mind for a lot of companies. Security has several issues involved in it. The fear that a company's customer list getting onto a marketing list or in the hands of a competitor is the most commonly voiced worry. Addressing this issue is easy. As providers of third party credit data, bureaus rely tremendously on companies to feel comfortable and secure in reporting accounts receivable data to their credit files. To sell any client's customer list in its entirety would jeopardize their very existence.

Another security element involves the protection measures that the bureaus have in place. Neither company divulges company names. On Dun & Bradstreet's website they state, "Your information is confidential. Your company name is not revealed to our customers when they access files in the Dun & Bradstreet database, nor is it identified in any customer report. Upon request, businesses can obtain an alphabetized listing of all trade vendors, which would include Automated Trade-Reporting Participants. However, the specific references are not matched to the particular company that provided the information."

Experian's practices mirror that of Dun & Bradstreet, as can be seen in the following quote from a brochure, "At Experian Business Credit Services, reducing the risk is what data reporting is all about. Experian Business Credit Services maintains strict confidentiality standards designed to limit access, check the integrity of new information, secure its privacy, and verify the data. Experian is devoted to making this process as simple and safe for businesses as possible. After all, more information makes everyone's decisions more complete and reliable. Experian uses the most sophisticated security methods to safeguard your data once it leaves your office. The

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The IFA is conducting a survey of Factoring companies in order to compile a list of industry standards. To participate, please fill out this survey and mail it anonymously to the address at the bottom. To assure the confidentiality of all members, please submit all answers anonymously. All participants will be entitled to a copy of the survey. Please include a mailing or e-mail address with your responses.

**Ownership** (private, bank, etc.): \_\_\_\_\_

**Years in Business:** \_\_\_\_\_

**Number of Clients:** \_\_\_\_\_

**Number of Employees:** \_\_\_\_\_

**Minimum Monthly Volume:** \_\_\_\_\_

**Source of Funds:** \_\_\_\_\_

**Industries avoided:** \_\_\_\_\_

**Recourse or Non-Recourse:** \_\_\_\_\_

**Require original invoices:** \_\_\_\_\_

**Require personal guaranty:** \_\_\_\_\_

**Broker Compensation policy:** \_\_\_\_\_

**Average Cost of Funds:** \_\_\_\_\_

**Average Advance rate:** \_\_\_\_\_

**Average 30 day fee:** \_\_\_\_\_

**Gross Revenue as a % of Sales:** \_\_\_\_\_

**Factor Revenue as a % of Total Revenue:** \_\_\_\_\_

**Other Income as a % of Total Revenue:** \_\_\_\_\_

**Loss reserves held as a % of A/R:** \_\_\_\_\_

**Percentage of bad debt based on gross receivables purchased:** \_\_\_\_\_

**Do you see interest rates increasing or declining?:** \_\_\_\_\_

**Other services offered:** \_\_\_\_\_

**Verify before advancing funds?:** \_\_\_\_\_

**Forms of Verification:** (% of time)

on-sight audit: \_\_\_\_\_

verbal: \_\_\_\_\_

written: \_\_\_\_\_

documentation: \_\_\_\_\_

**If Total Revenue equals 100%, please specify the following as a percent of Total Revenue:**

**Advertising:** \_\_\_\_\_

**Bad Debt:** \_\_\_\_\_

**Bank Charges:** \_\_\_\_\_

**Computer Expense:** \_\_\_\_\_

**Commissions:** \_\_\_\_\_

**Credit:** \_\_\_\_\_

**UCC Searches:** \_\_\_\_\_

**Employee Expenses:** \_\_\_\_\_

**Owner Expense:** \_\_\_\_\_

**Interest:** \_\_\_\_\_

**Mailing:** \_\_\_\_\_

**Professional:** \_\_\_\_\_

**Rent:** \_\_\_\_\_

**Travel:** \_\_\_\_\_

**Pre-Tax Income %:** \_\_\_\_\_

**Other:** \_\_\_\_\_

**Other comments?:** \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

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**555 Chorro Street, Suite B**  
**San Luis Obispo, CA 93405**

first time you contribute customer payment information, Experian assigns your company a code. All subsequent entries are merged directly to each customer's account activity file. No trails will lead to you or your personal customer list." Experian has placed a major emphasis on developing database systems that protect the integrity and security of the information in the file. It is important to note that the data you report will NEVER be reproduced and will NEVER be sold to another party in its original form. Once data is loaded, all media is promptly returned to you. To uphold the confidentiality of our database, strict legal and system security guidelines are enforced. Your data is identified only by a contributor number and this number is known only by key Experian personnel. Your trade line is identified by an industry category, not your company name. The access to our data center is limited to authorized personnel and security surveillance is maintained at all times. An array of checks and balances are in place to insure the validity of data. Another company brochure indicates that "To minimize any of our established security procedures would jeopardize the very existence of Experian Business Information Services. We will not minimize our security procedures. In fact, they are under constant review and enhancement as technology evolves." As you can see in the above bureau quotes, great pains are taken to insure the utmost security.

Another misperception involves a company's apprehension in reporting information they feel is "not accurate". In essence, special terms or circumstances where a good client may appear "bad" to the casual observer. These situations are very common and all bureaus can easily accommodate just about any request. The idea is to report the information in a way that makes you comfortable while maintaining a high degree of accuracy and currency of data.

Have you been reluctant to report your accounts receivable information due to "messy" or "unknown issue" accounts? There is no

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better way to clean up your file and bring all the legitimate disputes to the surface than to announce to your clients, very politely, that you will soon be reporting to a national credit bureau...and that you hope to be able to report them in a positive light. This usually initiates a positive response from your clients- they have the desire to show their company in the best possible light and will help you accurately portray their company. Their assistance will increase the accuracy of your portfolio information and insure that accurate information is reported to bureaus. It is a great idea that costs nothing and is continually proven to be effective.

The bottom-line is that Dun & Bradstreet, Experian and other bureaus will help any company work through any issue to help them contribute data that helps the company, their customers and the business community.

Each bureau has unique features when it comes to their data and databases. Dun & Bradstreet's strengths involve family structure and financial information, which is collected directly from a company as their report is being updated and from outside sources. Data is also obtained from companies themselves and from their trade tape program. Companies have the opportunity to add trade references to their credit reports when they are updated and it stands to reason that they will give their "best" references and not include those companies that they are paying slow

"Who's report is better?" When considering which credit bureau to use it necessarily does not mean one is better, it is a matter of several factors. Your specific situation and what is at stake are what should drive a decision on what product, service or bureau should be used. The level of risk is the primary key in making this decision. Ideally every possible means should be used to minimize

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## HEALTHCARE continued from page 9

the appropriate fees must be reached. The fee(s) paid by the provider to establish and maintain a factoring program may be couched in many ways but is often the form preferred by the prospective seller. The most common form is a discount quoted as a percentage of either: gross billings (i.e. face value), expected value (e.g. net of contractual allowances), or actual collections. The percentage generally ranges from 1% to 7% and is driven by speed of collections, size of transaction, perceived risk of the provider and sub-market, and competitive pressures. With many purchase programs, this discount is translated to an actual dollar amount, which will change depending upon the expected performance of the to-be-purchased receivables.

Typically a "purchase price" is established for a "batch" of receivables. The purchase price is a good faith calculation agreed upon by the parties of the "true" value of each receivable or batch of receivables. The purchase price is arrived at by first calculating the Estimated Net Receivable ("ENR") for each batch of receivables, which is typically a weekly aggregation of receivables created by the provider. The ENR is calculated by determining the historical average amount of contractual allowances, deductibles, copayment amounts, and other amounts not reimbursed by the insurer or governmental entity, which is the obligor of the receivables. The ENR is further adjusted to reflect the actual historical collection experience within 180 days from the last date of service (including adjustments for dilution and credit losses, based on historical experience). Thus, the ENR is the basis for the purchase price for a batch of receivables. Upon submission of a batch, the purchaser advances a percentage of the purchase price, usually 60% to 85%, to the seller/provider (this product is often termed the "payment amount"). If all batches of purchased receivables are performing as expected, the deferred portion of the purchase price is paid promptly to the provider once the purchaser has received aggregate collections in excess of the total initial payment for all receivables purchased as a group (i.e. batch).

*Representations and Warranties.* A healthcare provider selling accounts receivable will typically be asked to make certain representations and warranties which do not constitute a tradi-

tional form of recourse. The representations and warranties are limited to the "condition" or "performance" of the batch of receivables and compliance with eligibility criteria at the time that each batch of receivables is sold, as well as standard corporate representations as to the provider's financial condition. None of the representations or warranties relates to the creditworthiness of payors. Therefore, none of the indemnities could reasonably be construed as a guaranty of payment of a batch of receivables.

*Lock Boxes.* Special lock boxes are established to eliminate commingling of collections. Collections from commercial payors are sent to a lock box under the control of the purchaser. Because the sale of Medicare and Medicaid receivables are subject to certain "anti-assignment" regulations, payments can be made only to the provider that rendered the care. (These regulations however do not limit the ability of the provider to sell or transfer ownership of the receivables.) The mechanism that is commonly used is the establishment of a lock box in the provider's name, and to which payment for all government receivables is directed. Lock boxes for the collection of both governmental and non-governmental receivables are swept daily into the account of the purchaser.

*Reserves.* An Offset Reserve may be established to provide minimal protection to the purchaser in the event of an offset of Medicare or Medicaid payments. A Servicing Reserve is a reserve against the obligation of the provider to repurchase a receivable that has been deemed "ineligible" through a breach of representations and warranties.

*Other considerations.* There are several other important considerations that must be examined prior to entering into a factoring relationship. These include but are not limited to: prior liens, a "true sale" opinion, purchaser funding sources, patient confidentiality, and receivables eligibility criteria.

*Summary.* Healthcare providers would do well to consider the factoring or sale of receivables as an alternative, or possibly only available, source of capital. The benefits are numerous and, particularly in today's environment, may offer the opportunity for a healthcare provider to survive into the next millennium.

*James R. Irwin, Jr. is President & CEO of Meridian Capital, San Diego, California, a company that provides funding to the healthcare community. His phone number is (877)220-0033.*

## CREDIT continued from page 12

your risk. However, resources limit the ability to utilize all of the credit decisioning tools that are available. Thus, informed credit decisions that address the above factors can only be made by knowledgeable credit professionals. Circumstances may dictate the use of one report or bureaus over another because of the unique features of a bureau.

There really is no reason not to get involved and begin reporting. You will improve your collections and productivity while supporting the quality of information available to help business decision-makers reduce credit risk. It is not difficult to report information to bureaus since most accept any media type. It can be as easy as downloading the data from your system to the electronic medium of your choice: tape, diskette, cartridge, e-mail, BBS (bulletin board system) or FTP (file transfer protocol). Also most bureaus even accept each other's format.

Experian also actively pursues new and creative ways to facilitate quality data being reported. One of which is partnering with software manufacturers to have them embed the Experian format in their software. This relationship provides the users of the software the ease of a few keystrokes to contribute their data. Time, money and resources are saved in the process.

One company that has the Experian Extract Program embedded into their software is Distinctive Solutions—Factor/PC, at 555 Chorro Street, Suite B, San Luis Obispo, CA 93405, phone (805) 544-8327.

The answer to the question, "Commercial Credit Reporting... Yes or No?" is simple. It makes good business sense to contribute credit data to bureaus because it improves collections and productivity while supporting the quality of information available to help business decision-makers reduce credit risk by participating in reporting trade data to bureaus. Allows you – and other credit grantors – to make more profitable credit-granting decisions. Companies are more likely to pay off debts to those companies that report their credit information. There is increased risk to the business community when data is not reported that would have provided a complete picture of a company's financial obligations and thus helped other credit professionals make an informed decision.

By sharing your customers' trade payment experience with your fellow credit managers, you can help ensure the growth of your company and that of the business community at large. Become an active member of the business community by reporting this invaluable resource today. Share the experience, and see how rewarding it can be.

*Tim Clawson is a Key Industry Software Manager with Experian and can be reached at 800-854-7201.*

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