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Innovations in financing:

The Confluence of Factoring and Leasing

By David Chaitin

Increasingly, we have been witnessing leasing companies stretching the rules of the game in order to accommodate good customers or entering into deals that are progressively more removed from leasing, deals begin to encroach on other forms of financing.

I call this "Chaiton's first law of commercial finance":

1. "Saturated markets show a tendency toward contractual entropy"

Formal rigidity softens and gives way to non-traditional terms

Has the effect of supporting or increasing pricing to offset perception of increased risk

What makes this all possible? Once you stray from those comfortable forms, is it a lease anymore, or does it even matter? Will my commercial expectations be met if I agree to modify my deals to satisfy my customer?

This inquiry leads directly to Chaiton's second law of commercial finance:

2. Entropy encourages the evolution of our legal forms of commerce

Market pressures lead to fresh ways of thinking and new rules develop around the way in which we do business

This process is mediated by legislation, innovative drafting and litigation

Charles Darwin observed species changes in the natural world and concluded that it was not a completely random affair. He called it "natural selection".

This brings us to Chaiton's third, and final, law of commercial finance:

3. The forces of entropy in commerce are asymmetrical yet do not act randomly

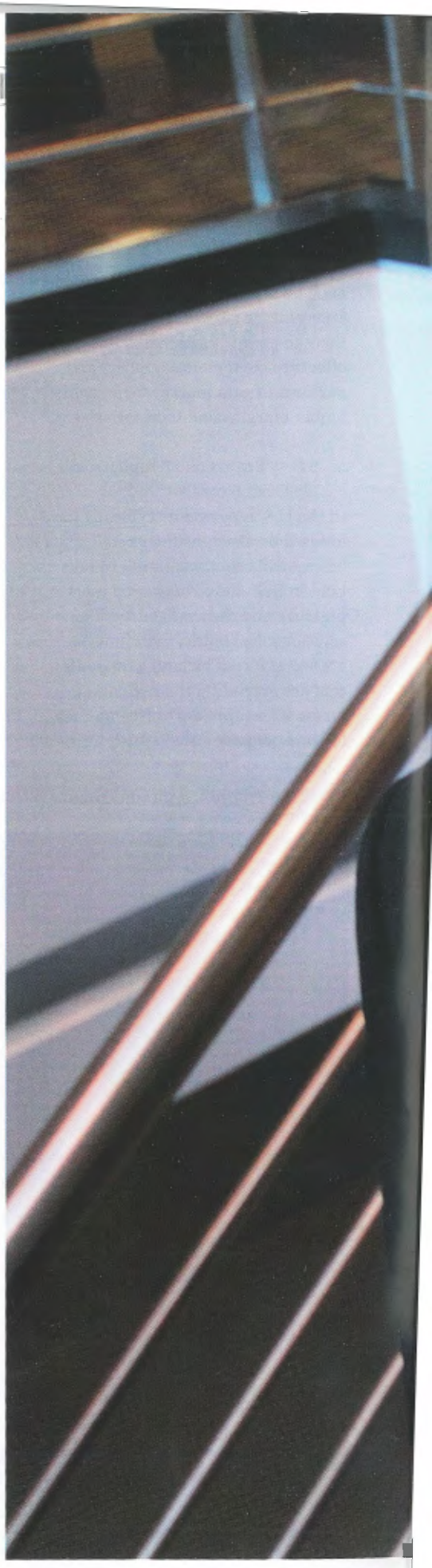
Changes occur because of demand

Demand is directional

Not everything demanded occurs—hidden operators include public policy eg. Illegal contracts; consumer laws; usury laws

I offer up Chaiton's three laws of commercial finance as an explanation of the conditions which hasten product innovation and diversification in finance.

Why talk about these abstractions? Because there have been many changes in the fabric of the leasing business community over the last several years.: Some consolidation has taken place, a number of new entrants have arrived, a tightening of credit during the recession put pressure on all of us just to survive and now we see a breakout from those restraints. Conditions for more rapid, dramatic change are evident everywhere and it merits a look at some of the ways these might affect us. I do so under the general rubric of "Innovation: the Confluence of Leasing and Factoring" as a backdrop for a discussion of their impact, but know this: these pressures



have led to a more pervasive re-thinking of long-accepted rules. Finance companies are becoming more broadly-based, innovative participants, many of whom have recently expanded their operational scope to include factoring and similar forms of asset based lending. How are traditional lease operations suited to the requirements of factoring, and, importantly, what are the areas of divergence you need to know about if you're considering expanding into other opportunities?

The tightening of credit over the past 5+ years opened gaping holes through which more entrepreneurial lenders walked with ease, comparatively free of competitive pressures relative to the largest institutions. Now that they are back the goliaths of competition are once again calling the shots in most forms of commercial finance. However, achieving the consistency, customer focus, product knowledge and flexibility to compete effectively in accounts receivable financing is tricky, although National Bank of Canada stands out as the indisputable leader in this arena in Canada. Even so, certain forms of asset based lending are much better suited to specialty firms which have traditionally found a home in the detritus of lumbering giants.

Historically, A/R has been viewed as but one of a number of supporting elements in commercial credit, undeserving of any special treatment. Standard formulas abound, by which big banks margin A/R quite restrictively: by aging, composition, customer density, industry concentration, and so on., And then typically, only allowing between 50% and 75% advances against fresh receivables, decreasing rapidly from there to a point where big banks consider them valueless for lending purposes. Even insured receivables!

In the meantime, borrowers have had to fend off attacks on two fronts as similar pressures were brought to bear against manufacturers and distributors by their own customers who, for similar reasons, were having trouble securing sufficient credit from their own big banks as a result of credit and economic tensions which supported broad-sweep, lending policy changes. They too looked elsewhere for easier credit and found it in their own supplier base: delaying and discounting payables became more pervasive and normalized. It's a simple idea: "I'll keep the cash I have for a longer time, so I'll need less credit from the bank, and I'll do it because I can: my suppliers need my business. This kind of bullying has been described as "just business"" but who are the losers: manufacturers and distributors, who at one time were the bulwark of the Canadian economy. These companies simultaneously suffer a pronounced slowdown in receivable turnover, and because of that unfortunate lending base formula of choice, which regards their A/R as increasingly exempt from margining, a double-whammy cut in available credit lines. At the centre of this whirling dervish of destruction--ultra-conservative credit policies that force customers to create quasi-credit by deferring payables.

Is there a legal device or artifice that will allow us to capitalize on this gap in A/R financing? If so, what conditions and processes gave rise to it?

"For a very long time, the progression of commerce was seriously hobbled."

The pledge

The first form of security device known to civilization was the pledge. A pledge is simply the delivery of personal property to another to be held by him until some debt is paid or obligation fulfilled. The efficacy of the pledge is best appreciated from the fact that it continues to be so popular today. Consider, for example, the following:

Pledge of securities
Escrow agreement
Lockbox arrangements
A pawn

All of these are modern examples of a very ancient security device. What better security can you have than actual money/thing of value in the hand? And barring the unforeseen, the typical pledge is a complete assurance of payment.

So, why did we need to conceive of anything more than or different from a pledge?

Let's imagine a farmer somewhere in Ancient Mesopotamia. Agriculture has just caught on. Man now has a way to feed himself even when scarcity prevails locally, just by saving and storing for a rainy day the grains he could grow.

But our farmer, let's call him Fred, doesn't have a plough to help him till the land. He'd seen his buddy Sam, who had this device called a "plough" and with it, he witnessed how Sam was able to plant ten times more seed than Fred. What to do? Fred embarks upon one of the earliest recorded buy/finance decisions. He would really prefer to buy it, but the plough is out of reach for a farmer of his means. So, Fred will have to borrow the shekels he needs to get a plough and heads over to Harry the lender,, to ask for a loan. Harry, who was quite happy to oblige so long as Fred gave him good security in pledge, thought that the plough itself would do quite nicely.

But how would that help Fred? He still wouldn't have the use of the plough if he did that deal until everything was repaid. Even so, it was better than nothing at all—at least he would eventually get hold of the plough once it was paid off. And it was a great deal for Harry because he would have the use of it until that time. That's the way pledges worked in those days.

Birth of the chattel mortgage

What was needed was a mechanism under which the use of the plough might be given to the borrower even while the loan was outstanding, while still encouraging payment. Thus was born the chattel mortgage, which allowed the farmer to use the plough while making payments, but if he failed to make payment promptly when it fell due, the lender was entitled to obtain possession of the plough under his chattel mortgage security. It was too late for Fred's deal, however, as the chattel mortgage did not become a part of our law until around the 1600's.

So for a very long time, the progression of commerce was seriously hobbled. You would not believe the hoops that the law had to jump through in order to recognize the creation of this form of security. First, it had to explicate the legal nature of the relationship between the parties. To achieve this, the courts invented the notion of equitable or beneficial title [which is what the debtor in possession had in relation to the plough] and legal title, held by the lender, which carried with it all the traditional rights associated with ownership, save for a conditional carve-out of the right of possession. The notion of "ownership" comprised the idea that property could be divided into an infinite number of interests. He who continued to own rights after all other interests were accounted for [was the person we would regard as the true owner. Consider now the ramifications of this reasoning: it permitted a separation of ownership and possession. You are all familiar with the phrase, "possession is nine tenths of the law" It means many different things in many different situations, but fundamentally underscores the importance which our law attaches to physical possession of a thing. Chattel mortgages also introduced efficiencies that were not present before by permitting the use of personal property even before it was owned outright by the user. Its elucidation put the economy on warp drive and led to the facilitation of the industrial revolution.

This same sort of story can be told about conditional sale contracts; hire-purchase agreements and even leases, although leases came well before most of these devices., The earliest known reference to the rental of agricultural implements occurred in the ancient Samarian city of Ur in 2010 BCE, where priests let them out to farmers and recorded their agreement on clay tablets. Several of these were discovered as recently as 1984. In 1750 BCE Babylon, the great king Hammurabai acknowledged leases of personal property in his famous code of laws. So advanced had the underlying analytics become that in about 550 BCE the Greeks' and Romans' Justinian Codex actually distinguished between finance leases and rental agreements. The Phoenicians made and chartered ships under long term bare boat charter agreements that actually contained "hell or high water" payment provisions!

In summary:

1. The "forms" that you use in business had their origins a long time ago and were conceived and developed in response to the needs of commerce.
2. Legal innovations and market innovations go hand in hand—one propitiates the other.
3. More recently, this second proposition, linking legal and market innovations, is best seen in the rapidly developing area of intellectual property. The idea used to be that a picture is worth a thousand words; now it's that a picture is worth a thousand bucks, or more! The ability to traffic in IP rights (ie license and sell) depends entirely on the legal recognition they receive. For example, when taking a security interest in artwork, you need to get a waiver of "moral rights" alongside the security agreement if you want to vary the work in any way: ie put a moustache on Mona Lisa; streamers on a sculpture (Snow v T. Eaton Company Ltd.)

The next business opportunity will most likely involve some corresponding development in legal thought. Perhaps the very best illustration of that proposition is the Personal Property Security Act, ("PPSA"), which completely re-vamped our ideas about security, describing all the old forms, and by extension, anything yet to be devised, as "security agreements". Now, any form of agreement that in substance creates a "security interest" in personal property will be recognized as a viable form of security, regardless of its form or the person who holds title. Only creative drafting separates us from the clever relationships which have yet to be thought up in lawyers' and financiers' offices throughout PPSA jurisdictions everywhere.

ABOUT THE AUTHOR: David is widely recognized as an expert in equipment financing, leasing, asset-based lending, corporate finance and banking matters, has been involved in complex bankruptcy and receivership engagements and represents banks, insurance companies, leasing companies and other purveyors of financial services. A director of the Canadian Finance & Leasing Association, David is a member of its legal committee and was recognized for his contribution to the development of the vehicle leasing and equipment finance industry in Canada when he received its member of the year award.