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True Sale of Receivables

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A question often asked is what is a "True sale" in the context of receivables finance? True sale is a term used to describe the sale of a receivable by the owner to another person, such that the receivable is protected from claims against the seller's assets in the event of the seller's insolvency.

In this note we examine the legal characteristics of a true sale, the risk of recharacterisation and explain why true sale is an important concept which many receivables finance transactions aim to achieve.

TRUE SALE

Factoring and invoice discounting are both examples of financing techniques that involve the sale of receivables (often at a discount) by a seller to a financier, rather than the provision of a loan secured against the receivables.

Where the financing is structured as a sale, the parties will want the monies advanced by the financier to be characterised as a purchase price and the assignment of the receivables by the seller to be characterised as a sale.

Where a purported sale of receivables fails the "true sale" test, there is a risk that the payment of the purchase price will be recharacterised by the courts on the insolvency of the seller as a loan and the purported sale will be recharacterised as a security assignment. If the seller is incorporated in a jurisdiction where security assignments must be registered, that recharacterisation may lead to the security being void against the seller's liquidator as a security for want of registration. The financier would then be left as an unsecured creditor of the seller.

LEGAL CHARACTERISTICS

Unfortunately, there is no one legal test by which it is possible to determine conclusively whether a transaction amounts to a true sale of receivables, rather than a secured loan.

In the case of Re George Inglefield Ltd[1], the Court of Appeal identified the following essential differences between a sale and a secured loan:

- In a sale transaction, the seller is not entitled to get back the asset it has sold by returning the purchase price to the purchaser. A loan secured by a mortgage or charge of the asset would include this right.
- If a mortgagee sells the secured property for an amount in excess of the outstanding balance of the loan (together with interest and costs), he has to account to the mortgagor for any surplus. In a sale transaction, however, if the purchaser subsequently sells the asset for a profit, he does not have to account to the seller for the profit.
- If a mortgagee sells the secured property for an amount that is insufficient to discharge the outstanding loan amount, the mortgagee is entitled to recover the balance from the mortgagor. In a sale transaction, however, the purchaser has no right to recover any such loss from the seller.

Broadly speaking, the courts will look for evidence that the risks and rewards of ownership of the receivables have transferred from the seller to the financier.

[1] [1933] Ch. 1

ECONOMIC SUBSTANCE

For a receivables purchase transaction, the main risk of ownership is non-payment of the receivables by the debtor. In determining to what extent the risks and rewards of ownership have transferred from the seller to the financier, the economic substance of a transaction will usually be an important factor considered by the courts.

Where the financier has a right to recourse (i.e. sell back) the receivable to the seller in the event of non-payment by the debtor, the courts may take the view that the seller has retained the risks of ownership, such that the economic substance of the transaction is that of a secured loan, rather than a true sale.

The natural tendency of banks is to include as many repurchase events as possible in the receivables purchase agreement (“**RPA**”), as this increases recourse to the seller and is perceived to be less risky for the financier. However, from a true sale perspective, this approach should be resisted, because the more extensive the list of recourse events the greater the risk is of recharacterisation.

This does not mean that the financier cannot set any limits on its exposure to a debtor and it is common to see financiers requiring a right of recourse where, for example, non-payment of a receivable is due to a dispute arising between the buyer and the seller, or due to an alleged breach by the seller of its obligations under the underlying sales contract. The financier is providing working capital finance to the seller, but this does not oblige the financier to take on wider risks associated with the business relationship between the buyer and the seller.

As a general rule, a transaction is more likely to be characterised as a true sale if the financier has no, or limited, rights of recourse to the seller. This is especially true if recourse is limited to matters other than a payment default and those which are within the seller’s control.

OBJECTIVE INTENT

On the basis of the principles set out in Re George Inglefield, Ltd, as considered and applied by the Court of Appeal in Welsh Development Agency v. Export Finance Co., Ltd[2], the threshold for recharacterisation is a high one and a transaction structured as a sale of receivables will generally be upheld as such unless the transaction is in substance a mortgage or charge of receivables and not a sale, or a sham.

If one or more provisions of the RPA are inconsistent with a sale, then the court will look to the provisions of the RPA as a whole to determine the substance of the transaction and the nature of the legal relationship created between the parties.

The courts will only find a transaction to be a sham where the terms of the RPA do not represent the true intentions of the seller and the financier.

OFF-BALANCE SHEET FINANCING

True sale is not only a legal issue, but will have important implications for determining whether or not a transaction can be classified as “off-balance sheet” financing under applicable accounting rules.

“Off-balance sheet” in this context means that the seller is able to remove the receivables it has sold from its balance sheet and can show the payment it receives from the financier as cash. The attraction for the seller of this is an improvement in its liquidity while avoiding the need to report additional liabilities on its balance sheet.

The correct presentation in the seller’s accounts of such a transaction is made by the seller’s accountant, rather than the financier or its lawyers. However, accountants will often require a legal opinion confirming that a true sale of the receivables has been achieved from a legal perspective before a transaction can be classified as off-balance sheet.

HEALTH WARNING

This note is intended for general information only and provides a simplified overview of English law. It should not be used as a substitute for taking legal advice. The law is summarised as of 19 April 2016.

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[2] [1992] BCLC 148

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