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Co. Directors Must Beware Dangers Of Reverse Factoring

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Los Angeles Locke Lord Partner **Amin Al-Sarraf** co-authored an article for Law360 with Jill Basinger, Chief Legal Officer of Discovery Land Company, and Garland A. Kelley, Partner and Chair of the Securities Litigation Practice at Looper Goodwine P.C., on what company directors must know about the perils of reverse factoring. Al-Sarraf, Basinger and Kelley write that, in the past, when a third-party vendor sent an invoice to a company, the company paid the invoice in 30 or 90 days. To address cash flow concerns, many companies began using a financing method called reverse factoring (also known as supply chain financing), which involves selling unpaid customer invoices to a third party, often at a small discount. The company then receives payment immediately, while the third party collects the full value of the amount owed over time. When abused, however, reverse factoring can and has driven several companies into bankruptcy.

“Among the ways reverse factoring can go wrong is if influential insiders within a company attempt to leverage their company’s creditworthiness for another company for personal benefit. The difference here, however, is that the secondary company receiving the goods or services is not the company at risk. The primary company has become a party to a reverse factoring contract and agrees to provide a contractual type of backstop, so if the other company does not pay the third-party lender, it has now agreed to pay the amounts owed,” Al-Sarraf, Basinger and Kelley write.

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Co. Directors Must Beware Dangers Of Reverse Factoring

By ***Garland Kelley, Amin Al-Sarraf and Jill Basinger***

As of the first quarter of 2023, compliance with new Financial Accounting Standards Board requirements began to shine a light on billions in hidden liabilities on corporate ledgers.

The new requirements, adopted by the FASB on Sept. 29, 2022, govern the disclosure of so-called reverse-factoring programs, including “sufficient information about the program to allow a user of financial statements to understand the program’s nature, activity during the period, changes from period to period, … potential magnitude [and] outstanding confirmed amount as of the end of each interim period.”

And these requirements have brought significant revelations — Bloomberg reports that “[a]bout 80 companies in the S&P 500 reported at least $64.1 billion worth” of reverse factoring-related obligations.[1]

And The Wall Street Journal reports that these companies include The Coca-Cola Co., The Boeing Co., AT&T Inc., General Electric Co., Kimberly-Clark Corp. and General Motors Co., among others.[2]

Indeed, it turns out that “[b]everage maker Keurig Dr Pepper’s program, for instance, represented about 79% of its $4.95 billion in total accounts payable for the first quarter.”

Until recently, reverse factoring, or supply-chain financing, was not even on the radar. But its abuse has driven several companies into bankruptcy, including Spanish engineering firm Abengoa SA, British consulting services firm Carillion PLC and Emirati health care provider NMC Health.

These once-large public companies with multibillion-dollar valuations succumbed to what could have been a perfectly legitimate financing arrangement.

Enter Reverse Factoring

What is this hidden danger? In yesterday’s world, when a company received an invoice from a third-party vendor, it paid that invoice in perhaps 30 or 90 days.

The common way to deal with that is by using factoring — i.e., selling unpaid customer invoices to a third party, often at a small discount. The company then received payment immediately, while the third party would collect over time the full value of the amount owed.

Reverse factoring moves that factoring concept to the other end of the spectrum, and it reverses the concept back to the company's vendors and suppliers.

For example, sometimes those third-party vendors need liquidity to fulfill a purchase order. Reverse factoring allows third-party lenders or specialty finance companies to pay suppliers upfront at a slight discount, and then receive payment from the company over time at the full amount.

Multiple reasons exist for using reverse factoring. Among its benefits are significant savings that can accrue to large companies that have sprawling and complicated third-party vendor needs, allowing so-called debt to be financed at a lower effective interest rate.

That said, on the books, reverse factoring is not categorized as debt, but rather as an operating liability, such as accounts payable. When done correctly and disclosed, reverse factoring can be a legitimate and useful mechanism.

Exploiting Reverse Factoring

Among the ways reverse factoring can go wrong is if influential insiders within a company attempt to leverage their company's creditworthiness for another company for personal benefit.

The difference here, however, is that the secondary company receiving the goods or services is not the company at risk. The primary company has become a party to a reverse-factoring contract and agrees to provide a contractual type of backstop, so if the other company does not pay the third-party lender, it has now agreed to pay the amounts owed.

These backstop obligations embedded in some reverse factoring arrangements are often undisclosed and lay dormant, never scrutinized because the others perform as expected, and therefore the company's backstop obligations are never called upon.

Nonetheless, these obligations exist and can often be enormous, dwarfing all of a company's other standard debt financing arrangements combined — or, indeed, the entire market value of the company itself.

Legal Ramifications

The legal and financial consequences can be far-reaching if these arrangements are not reviewed, approved and disclosed. Delaware court decisions emphasize the risks.

For generations, the general standard applied by Delaware law was that directors had no duty "to ferret out wrongdoing which they have no reason to suspect," as articulated by the Delaware Supreme Court's 1963 decision in Graham v. Allis-Chalmers Manufacturing Co.[3]

Rather, being aware of — but then ignoring — potential wrongdoing resulted in director liability.

That standard expanded somewhat in the well-known Delaware Chancery Court decision from 1996, In re: Caremark International Inc. Derivative Litigation.[4]

Under Caremark, directors had an affirmative obligation to make sure adequate reporting systems existed that could provide potential red flags about wrongdoing.[5]

Following Caremark, so long as such reporting mechanisms were in place, lawsuits alleging director misconduct were routinely and promptly dismissed, which the Delaware Supreme Court would routinely affirm.[6]

Recently, however, the Delaware Supreme Court signaled to directors that it would no longer tolerate general monitoring devices to satisfy a director's obligation to be adequately informed of potential risks.

The court suggested in its 2019 Marchand v. Barnhill decision[7] that something more robust was required, particularly with regard to the company's core operations or where the company may face significant risk.

In 2020, the Delaware Chancery Court further reinforced this signal in Hughes v. Hu[8] when it denied a motion to dismiss a lawsuit alleging failures of proper director oversight.

Indeed, the misconduct at issue in Hughes concerned the accuracy of the company's financial reporting — such as would be at issue with the use of reverse factoring. And the mere existence of an audit committee and outside auditors was insufficient to obtain dismissal of the lawsuit.

So, company directors should not rely on the audit committee or the stamp of approval from outside auditors.

Rather, if you sit on the board of directors of a publicly traded company, go check your company's books — has there been an unexplained jump in year-over-year accounts payable line items on your balance sheet? Have your payables grown in a very short period of time?

If so, your company may be engaged in reverse factoring.

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[1] https://news.bloombergtax.com/financial-accounting/new-rules-reveal-64-billion-of-hidden-leverage-at-big-us-firms.

[2] https://www.wsj.com/articles/companies-unveil-details-about-supply-chain-financing-under-new-rule-cceb9d8d.

[3] Graham v. Allis-Chalmers Manufacturing Co. (Del. 1963).

[4] In Re Caremark International Inc. Derivative Litigation (Del.Ch. 1996).

[5] Id. at 970.

[6] See Stone ex rel. AmSouth Bancorp v. Ritter (Del. 2006).

[7] Marchand v. Barnhill (Del. 2019).

[8] Hughes v. Hu (Del.Ch. April 27, 2020).

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