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Software Vendor Finance

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Overview of Presentation

- What is Vendor Finance?
- Why provide Vendor Finance?
- Structures where Vendor offers extended payment terms to customers:
  - Referral Program (easiest way for Vendor to get started)
  - Assignment Program (True Sales and Recourse Loss Pools; Purchase Price definition)
  - Example: First Loss Reserve Pool
- Documentation issues:
  - Performance Risk vs. Credit Risk
  - Recourse
  - True Sale vs. Secured Loan

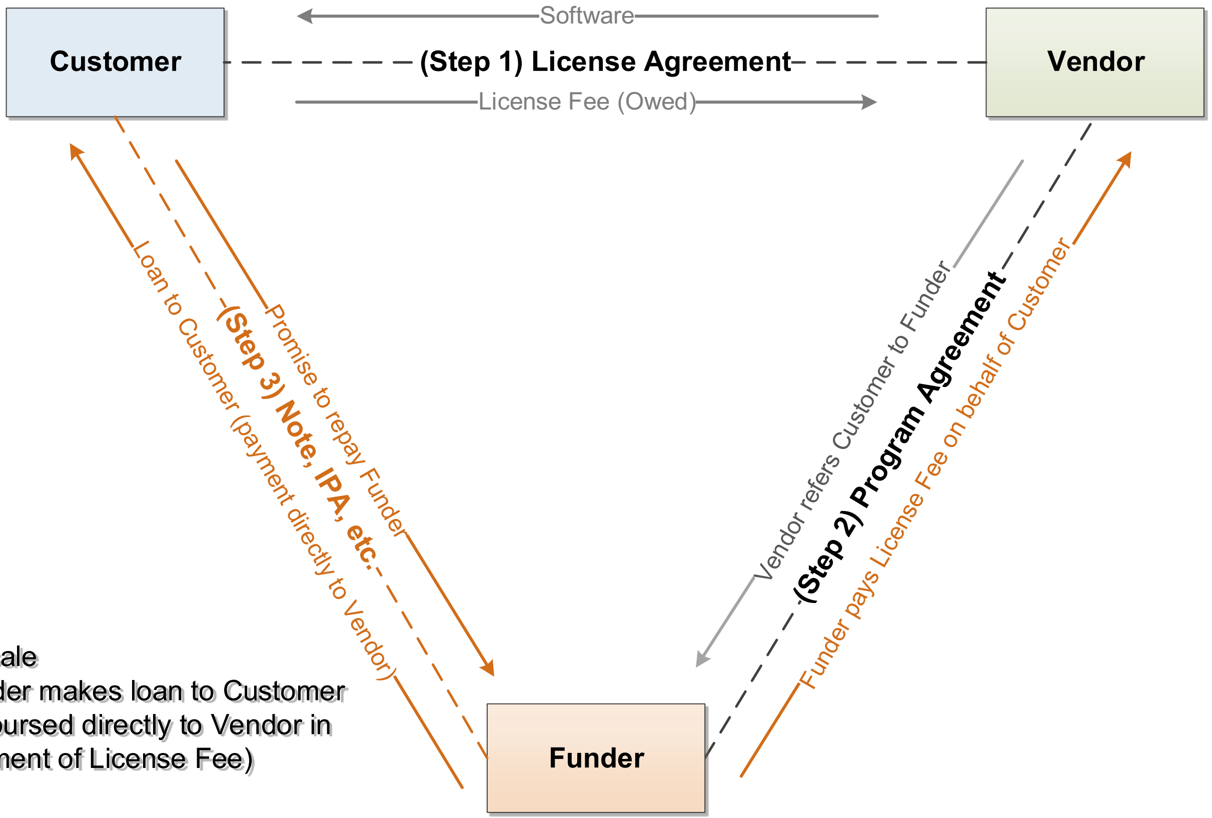
What is Vendor Financing?

- It is:
  - A program that enables Vendors to arrange for credit to their Customers for the license of software or purchase of goods/services, through a third-party funding source
  - Useful for financing hardware, software, and other equipment
  - Offered via a referral or assignment method (details in following slides)
- It is NOT:
  - "Factoring:" debt to vendor disguised as a sale of a receivable
  - A loan to Vendor (such as an accounts receivable secured facility)
  - On Vendor's balance sheet

Why Provide Vendor Financing?

- Close sales faster
- Increase Average Order Value (AOV)
- Shift non-payment risk to funder (eliminate churn!)
- Improve cash flow and Customer Acquisition Cost (CAC) payback
- Reduce Days Sales Outstanding (DSO)

Referral Program

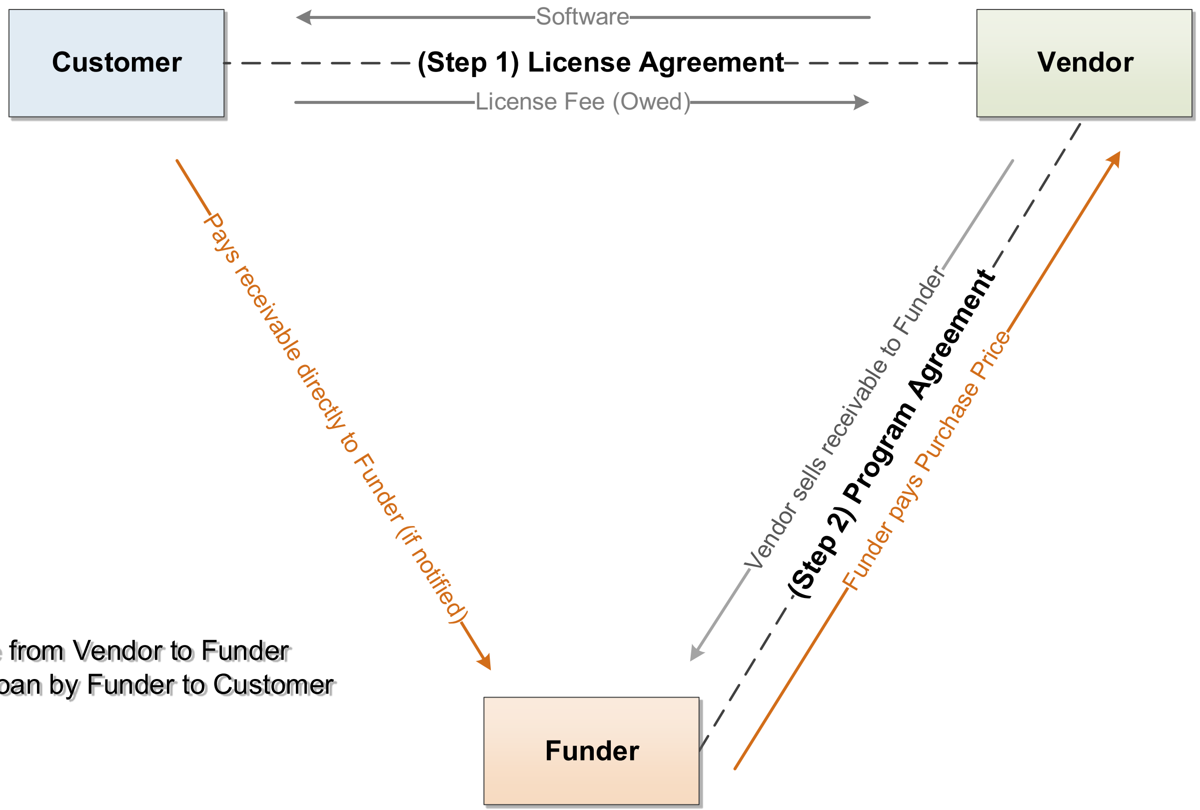


- No sale
- Funder makes loan to Customer (disbursed directly to Vendor in payment of License Fee)

Referral Program

- **Characteristics**:
  - If Customer asks for financing, Vendor refers Customer to the Funder
- **Documentation**
  - Program Agreement + Funder’s standard form note or installment payment agreement with the Customer
- **Advantages**:
  - It’s the easiest way for the Vendor to start a finance program, especially if Vendor’s Customer documentation contains unattractive provisions (*e.g.*, cancellable, no late payment fees, no acceleration on default, etc.)
  - No sale of receivables, so no true sale opinion required
  - Off-balance sheet to Vendor because not a financing of Vendor (as opposed to an A/R loan)
  - Funder does not take Bankruptcy risk of Vendor (so long as Vendor has fully performed)
- **Challenges, Risks and Legal Issues**:
  - It is more difficult to structure ways for the Vendor to support the program (*e.g.*, it’s difficult to create pools of receivables)
  - Funders used to use “blind discounts” or an “agreement to buy down the rate,” but trends in disclosure requirements warrant more disclosure to the Customer; risk of misrepresentation by the Funder if full disclosure is not made to the Customer

Assignment Program



- Sale from Vendor to Funder
- No loan by Funder to Customer

Assignment Program

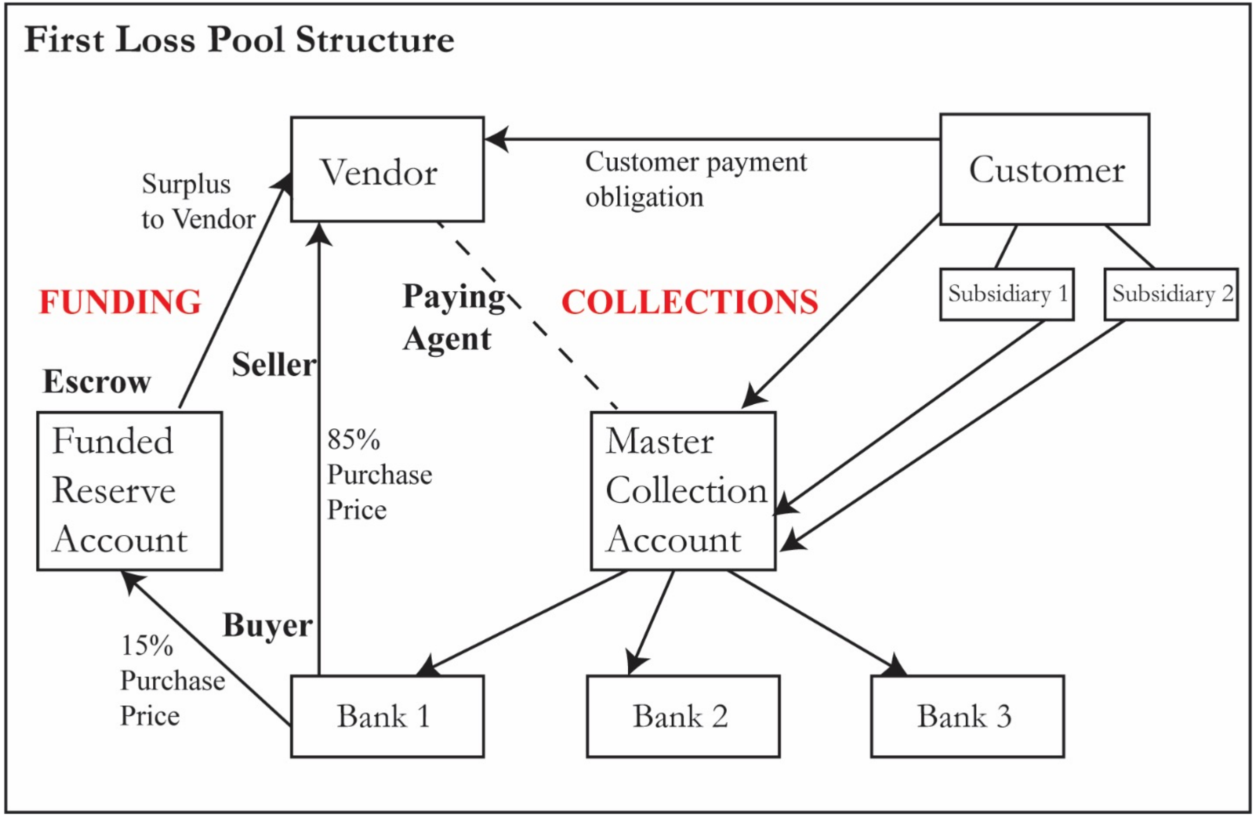
- **Characteristics**:
  - Benefits and burdens of ownership of the Receivable are transferred from Vendor to Funder
  - Funder assumes credit risk of the Customer, rather than the Vendor
  - “Off balance sheet” accounting treatment for Vendor
  - Receivables purchased in a true sale should not be subject to Vendor performance risk (true sale accounting may not be available for unperformed services)
  - Consider a hybrid loan/true sale program: Funder makes a loan to Vendor for ineligible receivables (*e.g.*, low credit Customers); true sale for eligible receivables
- **Documentation**:
  - Receivables Purchase Agreement (Vendor—Funder) + License Agreement or note/IPA (Vendor—Customer)
- **Advantages**:
  - Easy to create pools of receivables with a discounted purchase price
  - Vendor can offer extended payment terms to Customer; can receive cash flow more quickly
  - Two party transaction between Customer—Vendor; no third party (i.e., Funder) involved in initial transaction
- **Challenges, Risks and Legal Issues**:
  - If there is any recourse or continuing involvement between the Vendor and the Funder, or the Vendor and the receivables, then Vendor may need a true sale legal opinion to get off-balance sheet treatment
  - In order to recognize revenue, the Purchase Price paid by the Funder must be fixed or determinable
  - If not a true sale, default legal treatment as secured loan (leaving Funder with Bankruptcy risk of Vendor, rather than Customer)

True Sale Opinions and Recourse Issues

- Accounting test for True Sale has three parts:
  - ***Legal Isolation**: beyond the reach of the Bankruptcy trustee for the Vendor/seller (true sale legal opinion is one way to satisfy this requirement);
  - The Funder/buyer has the ability to pledge or exchange the transferred assets; and
  - The Vendor otherwise no longer maintains effective control over the assets

  See, Deloitte "Securitization Accounting" 11th Ed. (March 2020)
  https://www2.deloitte.com/us/en/pages/risk/articles/securitization-accounting-insights.html
- Benefits and burdens of ownership must be transferred to the Funder, without excessive recourse to the Vendor
- What constitutes recourse?
  - Guaranty, deferred purchase price, security interest in other assets of the Vendor, etc.
- Permitted Recourse
  - Recourse for breach of Vendor representations and warranties made as of the date of sale
  - De minimus recourse (no bright line test, but 5% may be acceptable)
  - If properly drafted, a Parent Performance Guaranty (guaranty of permitted recourse items of Vendor), with an exclusion for Customer insolvency or financial inability to pay

Example: First Loss Reserve Pool



Case Study: First Loss Reserve Pool

- **Characteristics**:
  - Designed to support the sale of middle market and lower credits
  - Funder directs 15% of the Purchase Price into an escrow account / first loss reserve to cover losses on the pool
  - Collections flow into a master Collection Account where funds owing to multiple funders are commingled
- **Documentation**:
  - Program Agreement and Funded Pool Agreement
  - Paying Agency Agreement (if Vendor collects payments from Customer)
  - Escrow Agreement (if reserve not held at Funder)
- **Advantages**:
  - Allows the Vendor to support weaker credit receivables with a defined amount of recourse
- **Challenges, Risks and Legal Issues**:
  - The 15% reserve account is a bad fact in the True Sale legal analysis, and may not qualify for True Sale treatment; the recourse amount is too high and strong assets (*i.e.*, cash and paying receivables) are used to support weaker assets (Note: If True Sale treatment not critical, reserve % could go higher!)
  - Legal issues re escrow include: perfection by control, waiver of escrow bank set-off rights
  - Collections are often commingled with collections owing to other funders; legal issues include perfection by control, intercreditor agreement, back-up servicer agreement

Risks to Funder in Vendor's Customer Documentation

- **Nature of Customer's payment obligation**: absolute or conditional?

  Funder will perform due diligence of License Agreement/IPA and Vendor's practice

  - Setoff: Is Customer permitted to setoff payments due to Vendor?
  - Disputes: What is Vendor's historic rate of disputes?
  - Vendor performance risk: Has Vendor fully performed by the time of funding?
- **Addendum to License Agreement** (three parties: Vendor, Funder, Customer) acknowledging Funder's funding of the software and allowing Funder to terminate License Agreement for nonpayment of note/IPA

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Interaction with Vendor’s other financing arrangements

- Restrictions on asset sales: May need carveout to permit sales of receivables
- Restrictions on liens: May need carveout to permit liens in favor of Funder
  - Precautionary liens
  - Financing statements (A true sale factoring transaction is not a secured loan, but still is a “**secured transaction**” within the meaning of the Uniform Commercial Code and, as such, **must be perfected** by filing a UCC financing statement.)
- Existing liens: May need release of existing secured lender’s lien on receivables sold to Funder
- Restrictions on bank accounts: May need carveout to permit collection account controlled by Funder (not existing lender)

Other Resources

- Catherine Hagerty, "Making your customer receivables more 'financeable' for a Receivables Purchase Facility," *The Banking Law Journal* (2020): https://www.nortonrosefulbright.com/en-us/knowledge/publications/f51bc46c/making-your-customer-receivables-more-financeable-for-a-receivables-purchase-facility
- See, PLI, Equipment Leasing – Leveraged Leasing, 6th Edition (March 2020): https://www.pli.edu/catalog/publications/treatise/equipment-leasingleveraged-leasing
  - Chapter 12 Software Leasing and Finance (Veatch)
  - Chapter 21 Vendor Finance (Veatch)

Questions

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