



Factoring Your Receivables – Risky Proposition

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INTRODUCTION

Whether or not you believe media reports that the economy is recovering, one simple fact holds true in every area of construction – liquidity is rare and credit is just not available. Since 2008, many contractors have struggled to complete projects with little or no margin and now, collecting retainage, contract balances and overdue change orders is a tedious, costly and extremely slow process. To make matters worse, owners hold between 5% and 10% retainage from contractors on projects which include only 2% or 3% margins. The very nature of the business puts contractors in a position of collecting overdue balances on projects that, by their very nature, began in a deficit position. General contractors, construction managers and owners are quick to excuse the problem and blame the banks, which are more cautious than ever with capital. Fault may lie with the banks, but laying blame does not help subcontractors that are required to pay union employees on a weekly basis and suppliers on thirty-day cycles. Unlike other players in the construction industry, subcontractors do not have the option of extending payroll or material costs more than thirty days. Unfortunately, the general contractors, construction managers and owners are not the solution because they are also suffering from the banks' cutting or refusing to extend lines of credit to them. Other than selecting a new line of business, there are few options available to subcontractors. One option some subcontractors have chosen is factoring receivables.

The purpose of this article is to assist subcontractors in understanding some of the risks of factoring receivables and to present some of the questions subcontractors should ask if factoring is an option being considered.

FACTORING IN GENERAL

Factoring in one form or another has been a way for companies in every area of business to quickly raise capital, typically to pay for overhead expenses where other forms of credit are lacking. There are typically three primary parties in any factoring relationship: (1) the

"factor", (2) the "seller" and (3) the "payer". With respect to construction factoring, consider the "seller" to be a subcontractor and the "payer" to be an owner, general contractor or construction manager. A typical factoring transaction involves an invoice or requisition or a series of invoices/requisitions (i.e. the "receivable"). Once a factor is approached, it typically applies a fee scale based upon a pre-determined percentage of the receivable value and likelihood of timely payment. Once the receivable is verified by the "payer" and the "payer" agrees to assign the receivable to the factor, the factor would then pay a pre-determined percentage of the receivable to the "seller" (i.e. the subcontractor). The pre-determined percentages may vary dramatically but often range between 70% and 90% of the receivable. This amount is called an "advance". Eventually when the receivable is paid by the "payer" to the factor, the factor pays the remainder of the value of the receivable to the trade contractor, minus the factor's fees and administrative expenses.

THE PROBLEM OF FACTORING IN TODAY'S MARKET AND THE DANGERS OF ARTICLE 3-A OF THE LIEN LAW

While cash flow is a problem for all New York contractors, recent market conditions have resulted in contractors seeking options not previously considered, such as factoring. The economy itself makes factoring even more risky. The reason for the additional risk is that instead of maintaining comfortable margins on construction projects, subcontractors have been trying to competitively bid projects with only a few points for overhead and profit. Often, projects are bid solely to break even in order to create cash flow to maintain critical overhead so that if the market does in fact improve, contractors are not caught understaffed or underfunded. Unfortunately, because of this dynamic, subcontractors have no room for error in bidding and executing projects. When a subcontractor becomes involved with a factor, that margin for error is removed entirely because Article 3-A of the New York State Lien Law is unforgiving.

Article 3-A of the Lien Law of the State of New York broadly describes monies received by a subcontractor on a project as trust funds which must be allocated for payment of that subcontractor's material suppliers and employees. See e.g. Lien Law §70. Simply put, a subcontractor has a fiduciary obligation not only to keep particular and specific records of all trust funds received (Lien Law §75), but to ensure that the subcontractor's trust beneficiaries (employees and material suppliers) are paid first from all receivables on a project. These beneficiaries are to be paid before that subcontractor takes any of the funds for itself. The New York State Legislature is so adamant about trustees on construction projects maintaining proper records and ensuring that trust funds are not misappropriated, that Article 3-A states that misappropriation of trust funds is considered larceny and punishable under the penal law of the State of New York. See Lien Law §79-a.

A subcontractor may therefore wonder – is assigning trust funds to a factor in exchange for “advances” considered trust fund diversion? Would using a factor automatically make a subcontractor guilty of larceny? The answer is not as straight-forward as the question may seem to imply.

The New York State Legislature created Lien Law §73 to allow lenders to apply trust funds to repay loans for previously advanced funds to trustees of Article 3-A trust funds. See Lien Law §73. When lenders apply trust funds to repay a loan, they are required to file a “notice of lending” prior to applying trust funds to the repayment of those loans. See *Aspro Mechanical Contracting Inc., et.al. v. Fleet Bank, N.A.*, 1 N.Y.3d 324; 805 N.E.2d 1037; 773 N.Y.S.2d 735; 2004 N.Y. LEXIS 140 (2004). The lenders who involve themselves are also deemed to be statutory trustees of the Article 3-A trust funds. See *Local No. 4, International Association of Heat and Frost and Asbestos Workers, et al., v. Buffalo Wholesale Supply Co., Inc., et.al.*, 2008 NY Slip Op 2362; 49 A.D.3d 1276; 854 N.Y.S.2d 610; 2008 N.Y. App. Div. LEXIS 2319 (4th Dept. 2008). The filing of a “notice of lending” is considered an affirmative defense for a subcontractor to a trust fund diversion claim. See Lien Law §73. However, the failure to file a “notice of lending” may subject both a factor and its subcontractor “seller” client to a trust diversion claim under Article 3-A of the Lien Law which otherwise may have been avoided.

Three major problems exist with respect to factoring receivables. First, very few factors understand or follow the requirements of Article 3-A of the Lien Law. Second, even fewer factors actually file “notices of lending” to prevent them or their clients from trust fund diversion claims. Finally, if a project is underbid and the factor and the subcontractor agree to factor under-funded receivables,

that factoring arrangement by its very nature would not be able to fully recompense beneficiaries of the underfunded trust. By factoring underfunded receivables, the factor and the subcontractor may unwittingly be committing trust fund diversion by doing nothing other than allowing a factor to take as part of its fee trust funds due to proper beneficiaries.

CONCLUSION – BE CAUTIOUS AND COMPLY WITH THE LIEN LAW

There is no easy solution to the unprecedented funding problems that subcontractors are experiencing in today's economy. If other options are lacking, subcontractors can and will turn to factors to fund projects. If you have no choice but to use a factor, make certain of the following five rules: (1) use a reputable factor that is versed in the Lien Law; (2) make certain that you have sufficient capital return in to fully pay all beneficiaries of Article 3-A trust funds; (3) make certain that all “notices of lending” are properly filed in accordance with §73 of the Lien Law; (4) keep meticulous books and records in accordance with §75 of the Lien Law, and finally, (5) seek quality counsel at the first sign of trouble.

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