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Rethinking 'Worthless' Charge-Offs:
Can a Pile of Uncollectibles Really Turn Into a Pot of Gold?

In these days of thinning profit margins, selling so-called "worthless" charge-offs can produce another source of revenue for leasing companies. Since these sales are booked as recoveries, the proceeds go directly to the bottom line. That's good news for those looking to enhance their annual profits.

By Robert Boehm

For finance industry executives facing both thinner profits in this last fiscal quarter and the prospect of growing defaults caused by today's climate of tightening credit and vanishing liquidity, transforming a liability into a revenue resource is an increasingly popular proposition. That's why many commercial lenders are discovering gold — or at least profits — in an often-overlooked area of their business: their pile of uncollectible past-due commercial lease or loan obligations, commonly referred to as "charge-offs."

Many equipment leasing and finance companies mistakenly believe that once the charge-offs they've relegated to their collection agency have come back as uncollectible, they're worthless. These companies are often surprised to learn that they still have value. By purchasing them for attractive prices and paying the entire purchase price at the time of sale, companies that specialize in buying charge-offs are showing these leasing and finance companies how to tap into this overlooked revenue stream.

Growth by Default

The real benefits of selling charge-offs begin to accrue immediately for the seller. In these days of thinning profit margins, selling "worthless" charge-offs will produce another source of revenue for lessors. Since the sales of these charge-offs are booked as recoveries, the entire sales proceeds are profits and go directly to the bottom line.

Therefore, one of the most significant benefits of the charge-off sale is that the seller is liquidating an asset it has determined has no value. Many lessors look to liquidate their charge-offs at the end of the fiscal year to enhance their annual profits.

According to a recent report by the Equipment Leasing and Finance Association (ELFA), today's changing marketplace could mean leasing and finance companies will see a growing number of past-due accounts — many of which will become charge-offs. The ELFA reports that portfolio quality showed some softening in August and, "While current receivables [less than 30 days] remained virtually unchanged from July of this year, those in the 61- to 90-day and over-90-day buckets increased when comparing both the prior month and year-earlier month's data." Losses were up as well when comparing both periods, according to the ELFA.

The bottom line? Leasing and finance companies should anticipate having more charge-offs to deal with in the near term.

Reaching Higher for Profits

Unlike collection agencies, which are often motivated to pick only the low-hanging fruit of the charge-offs they are given, charge-off buyers are experts at reaching higher by identifying collectible charge-offs and successfully collecting on them. Because of their expertise at recognizing value, they are able to offer substantial prices for the charge-offs they buy — and do so up front, at the point of sale. Moreover, the due diligence and purchase processes are not complicated and require very little time and effort by the seller.

Here's How It Works

Do Your Homework First

Those interested in selling their charge-offs need to understand the fundamental principles of how the process works.

Almost all charge-off sales fall into one of two types of transactions. The first is a one-time purchase of a pool of charge-offs or a single purchase with no anticipated continuing purchases. The second is an initial purchase with the creation of an ongoing relationship through which the parties intend to continue these transactions periodically, usually monthly or quarterly.

In either instance, the seller's due diligence process is easy and is normally performed in the buyer's offices. To complete its due diligence tasks, the buyer will need basic information about the accounts it is purchasing. This information, usually amassed in a simple Excel spreadsheet, should contain the account number, the names and addresses of the lessee or borrower and any guarantors, the unpaid balance, and the date of the last payment.

The buyer will also need to see sample files and especially documents that are typical of those being offered for sale. Approximately 20 of these files should be sufficient for the buyer to determine whether the documentation would be adequate for the collection process. As soon as the buyer receives this information, it would normally need two to four business days to evaluate the portfolio and develop a price for the charge-offs. Once the parties agree on a price, the buyer will conclude its due diligence and close the transaction.

If the parties anticipate that additional charge-off sales will be continuing periodically, no further due diligence will usually be required beyond the first transaction. For each subsequent sale of a pool of charge-offs, the seller will simply e-mail the buyer a spreadsheet of accounts it wishes to sell, showing the account number, the name and address of the lessee, the names and addresses of any guarantors, the date of last payment, and the balance. The buyer will then overnight a check or make a wire transfer of the purchase funds.

Keep Thorough Documentation for Smooth Transactions

Once the due diligence process is completed, the parties will enter into an asset sale agreement. For continuing sales, the agreement will provide the terms applicable to each sale. In that case, the only document to be used for each sale, after the first transaction, will be a bill of sale referring to the agreement. It can be attached as an exhibit to the spreadsheet of new accounts being purchased.

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The typical asset sale agreement will contain provisions concerning the price for the initial transaction and any subsequent purchases, standard representations and warranties (which usually relate to title and right to sell), when and how documents are to be provided, adjustment of the purchase price for non-conforming accounts, and restrictions on the use of the seller's name.

Providing necessary documentation is an integral part of the transaction because the buyer cannot enforce collection without appropriate documents. The documents needed are usually hard files, computer scans or a combination of both. For the scanned documents, the seller will usually provide the documents electronically at closing or at a reasonable time thereafter.

Expect the Unexpected

The buyer knows that the accounts it is purchasing have the potential for surprise, and the seller should also be prepared for unanticipated events that may affect the outcome.

For example, non-conforming accounts are usually those in which fraud or forgery is claimed, a guarantor (if there is one) has filed bankruptcy or is deceased, or the account has been settled and paid in full before the purchase. If, after the transaction, accounts with these defects are found, the seller will repurchase those accounts that it agrees are non-conforming, and the parties will work out the issues on any claimed non-conforming accounts the seller disputes.

Establishing a protocol for dealing with non-conforming accounts is very important, though. If the parties do their due diligence homework before the purchase (i.e., the seller eliminates those accounts that would be non-conforming if purchased, and the buyer performs due diligence to eliminate those accounts that are unacceptable), there should be very few, if any, non-conforming accounts. In any event, provisions for how to address non-conforming accounts should be negotiated to acceptable terms by the parties at the outset of their relationship.

Sometimes the provision for repurchase of non-conforming accounts is eliminated from the purchase agreement when the buyer has had access to sufficient information to satisfy its finding that none of the bases for a repurchase exists for the accounts being purchased. In that event, the buyer will be buying the accounts "as is."

In any event, the buyer may not require repurchase of any non-conforming accounts after a certain date, usually 180 days after closing of the transaction.

Another important provision is the limitation of the buyer's use of the seller's name in the buyer's pursuit of the obligors on the accounts. The buyer is usually restricted to using the seller's name for two purposes only: first, to identify the buyer as the assignee of the seller on the initial correspondence to the obligors on the account so that the obligors know who the buyer is and how the buyer claims that the account in question is payable to it and, secondly, to identify how the buyer acquired ownership in pleadings filed in a court proceeding to collect the account.

The charge-off purchase agreement will sometimes prohibit the buyer from reselling the accounts. This gives the seller confidence that the buyer will be the last person dealing with the account and will act appropriately, especially regarding the limited use of the seller's name. Also, the seller may want the buyer to agree not to sell information about the obligors.

Additional Benefits of Selling

One of the great benefits of selling charge-offs on a continuing basis is realized in budgeting and business planning. The seller can include the anticipated revenues from charge-offs to be sold as additional profits for each year.

Selling charge-offs that collection agencies have failed to collect converts a "worthless" asset into profits with very little effort. Although buying post-agency charge-offs is a relatively new business, many of the largest leasing companies have already recognized its value and have included selling charge-offs as part of their business plan. It's a plan that's showing many leasing and finance company executives how to create revenue from a readily available liability. **m**

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