NEED SOME CASH?

By Paul A. Rianda, Esq.

Especially in these hard economic times, you may find yourself in need of some extra cash to pay off bills, expand your business or for other activities. Most lending institutions are tightening their credit policies making it harder to get a loan. But, there is one ready source of cash that you may not know about. There are a number of lenders in our industry that will give you a loan with only your residuals as collateral. Below I will explain more about these residual loans and how they work.

What is a Residual Loan?

A residual loan is a type of loan where the only real "collateral" that you put up is your residuals. So, say for instance you are a sales agent and are being paid $10,000.00 a month in residuals from a certain processor for the merchants that you have placed with that processor. There are companies in our industry that are willing to loan you money, if you agree to pledge that residual stream as a potential way for the loan company to collect the debt if you are unable or unwilling to make the required loan payments.

The amount of money you can obtain is directly related to the amount of the residuals. Again, each lender has different criteria but most will lend you up to about 10 times the amount of your monthly residuals. So, continuing our example from above, if you have a residual stream of $10,000.00 per month, you could theoretically, get a loan for around $100,000.00. As you can imagine, given the potential risk of repayment on these loans, interest rates are very high.

These types of loans often carry interest rates of 25% or more. The repayment plans are usually fairly flexible wherein you have the ability to choose to pay back the loan quickly (say in one year) or you can choose a longer repayment period (3 years or more). The choice is up to you as to how quickly you want to repay the loan.

Why Should You Get Such a Loan?

Even at a high interest rate, these types of loans are a good potential alternative in this credit market. Generally, without any collateral, your only option to raise cash is usually to sell your residuals outright instead of taking out a loan. Obviously, if you sell your residuals they are gone forever and someone else is going to make money from all your hard work.

By running the numbers, you can see that a loan may make a lot more sense than selling your residuals. Back to our $10,000.00 per month example, if you were able to get a $100,000.00 loan at 25% interest over three years, the monthly payment amount would be $3,975.98. So, you would be able to divert about 40% of your residuals for three years to pay off the loan and get the up front cash you needed instead of giving up 100% of your residuals forever which would be the case if you sold them.

From the perspective of the lenders, they are willing to make these types of loans if they are familiar with the bankcard industry and because for the most part they can guarantee repayment of the

loan through the residual payment. In the example above, the monthly residual payment in questions would have to fall over 60% in order for the amount of the residuals to fall below the amount of the loan payment of $3,975.98. This gives lenders some comfort that something would have to go dramatically wrong in your portfolio in order for you to default on the loan.

How Does it Work?

The way that the residual is pledged can vary depending upon the requirements of the lender. Some lenders require that you sign an agreement that states that if you default on the payment of the loan, then you agree that the lender can ask your processor to pay 100% of the residuals to the lender instead of you. If a default occurs, the lender would send the agreement you signed to the processor and ask the processor to pay 100% of the residuals to the lender. Once the lender is paid in full, then the residuals would revert back to you as the agent.

Some lenders require that you agree that 100% of your residuals are paid to the lender for as long as there is an outstanding balance on the loan. The lender gets 100% of the residuals each month, takes the agreed upon monthly loan payment out of the residuals and then sends you the balance. Again, if you default on the loan the lender would be entitled to keep 100% of the residuals until the loan is paid in full. There are many other ways to structure the transaction such as stating in the agreement that the lender is purchasing your residuals and that later you have a right to buy them back. Lenders are usually flexible and willing to enter into innovative transactions as long as they get the return they are expecting.

As with all types of loans, you should expect that you will be signing a lot of very complicated documents that are somewhat onerous.. My experience is that most loan documents are drafted that way and there is not a whole lot in the documents that the lender will be willing to change. There is usually a loan agreement, promissory note and then the lender almost always will make you sign a personal guarantee. There will also be an assignment agreement that addresses the issue of the payment of the residuals to the lender during the term of the loan or upon your default under the loan documents.

The main thing to look for in reviewing the loan documents is to make sure that everything in them is factually accurate. By that I mean there are provision in the loan documents called "covenants" that must be true or you are in default of the loan agreement. For instance, the loan documents may state that you must maintain a ratio of assets to debt of 2 to 1. If your current ratio is only 1.5 to 1, you should ask to have that provision modified to reflect your actual business practices. Also, make sure all the information about you is accurate and that the main deal terms (interest rate, time for repayment, loan amount, etc.) are all accurate.

Other Considerations:

One thing you need to make sure of ahead of time is that you build into your agent agreement with your processor a provisions that states you are able to take out such a loan. These types of loans are fairly common in the industry but there are some processors that will refuse to allow you to take out such a loan. They can do that by not agreeing to allow the lender to be paid 100% of the residuals

if you default on the loan. By taking that position, a processor can effectively keep you from getting a loan, since that is obviously the critical thing that the lender wants.

Residual loans are a good alternative to traditional loans in this tight credit market. In addition, they are a much better alternative to financing your company by selling residuals which can be an endless cycle. Because they offer great benefits to both agents and lenders, you can expect residual loans to continue to be an important financing source in the bankcard industry for the foreseeable future.

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