Failing brokerages, asset-based lending imperil carriers, says OTR Solutions

Factoring company white paper outlines Chapter 11 threat to funds meant to pay trucking companies

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The growth of asset based lending is seen by a factoring company as creating risks for carriers to get paid. (Photo: Jim Allen/FreightWaves)

With brokerages closing and some filing for Chapter 11 protection, a major factoring company has published a white paper on how the bankruptcy process might leave carriers unpaid for services they already provided.

OTR Solutions' paper, "Securing the Integrity of the Supply Chain: Safeguarding Carrier Payments Amidst Freight Broker Payments," was released on Monday. Core to its message is the concern that some funds forwarded to brokers for later payment to carriers might get caught up in bankruptcy proceedings, with ultimate compensation tied up for months or disappearing altogether.

Read the white paper here.

The paper says the freight industry has always operated on a “long-standing precedent, which has consistently guaranteed compensation to the end carriers for their services whether from the freight broker or the ultimate shipper of the freight.”

One widely known Chapter 11 filing by a significant brokerage is making its way through the court system: Surge Transportation, which filed for protection in July. Surge is not mentioned in the white paper, and it is possible that other bankruptcies caught OTR Solutions’ eye.

“Allowing brokers to complete a Chapter 11 restructuring by their payment obligations to carriers, while simultaneously removing the carriers’ right to collect from the shipper and attempting to justify the use of those carriers’ funds to ‘reorganize’ violates the bedrock rule” of the carriers always getting paid. “Even more worrisome, it threatens to disrupt the integrity of the supply chain if it becomes common practice.”

At its root, factoring is designed to get money into the hands of a carrier quickly, but for a fee that bankers and finance people colloquially refer to as a “haircut.”

Factoring does not have one type of system, and that is the problem that OTR Solutions highlights. It identifies two specific types of payment processes in factoring. Supply chain finance (SCF) is one method, and while it can involve a lender sending money through a brokerage as an intermediary on its way to the carrier, that is generally not the case.

OTR Solutions sees no issue with SCF. It is a relatively short-term solution to pay carriers in a timely manner when there is an inconsistency between payment terms in the supply chain, such as between broker and carrier and broker and lender. While the funds can go through a broker — and a bankruptcy of a broker is the key area of concern in the white paper — the more likely scenario, according to the paper, is generally that "funds deployed are provided to the supplier, and in the world of freight brokerage, the suppliers are most often trucking companies."

The other, more worrisome system identified by OTR Solutions is asset-based lending (ABL).

In ABL, according to the white paper, financing is extended from a lender to brokers on the basis of "carrier payables." ABL sees the funds that carriers will ultimately get paid by their shipper — the payables — as an asset that can be used as collateral. OTR Solutions says that the funds being extended by the lender are not assets as such. They are short-term liabilities for the broker because the 3PL still needs to pay the carrier.

"When carrier payables are advanced to the freight broker instead of to the carriers directly, it alters the SCF structure and creates an opportunity for mismanagement of carrier funds," the paper explains. When that occurs, if the broker does not properly handle those funds and instead views it as a method of financing its larger business, there is a big risk for the carriers when it's time for them to get paid.

"The broker must ensure that they are planning appropriately and reserving sufficient liquidity to pay their carriers when the time comes, because they've already pulled forward that cash flow previously," OTR Solutions says. "The broker is borrowing against the carrier's money today, with that invoice coming due at a later date." That time period generally is 30 days, according to the white paper.

When freight markets are strong, ABL lending poses little risk, according to OTR Solutions. It's when the market turns sour — like now — that problems can arise.

ABL has been growing in brokerage and factoring the past few years, OTR Solutions says. "When a freight broker is making money on every transaction, they accrue equity and can maintain positive cash flow, ensuring there is sufficient liquidity to pay their carriers, even while borrowing against those carriers' funds," the white paper says.

But in the current market, "the supplier funds being advanced to freight brokers have a very high likelihood of being improperly allocated toward covering those operating costs." And given that costs in the current market often are not being covered by the transaction, it is possible that "there is no longer sufficient liquidity to pay motor carriers for the work they have completed."

The issue could come to a head in a bankruptcy. The paper says there have been four significant brokerage Chapter 11 filings, though it does not name them.

Ensuring that the funds advanced to the Chapter 11-hobbled brokerage ultimately make it into the wallets of the carriers they were intended for is at risk. "Legal maneuvers have been deployed aggressively in the bankruptcy proceedings, specifically aimed at impeding carriers from recovering payments for delivered freight from shipper customers of the now-bankrupt broker," according to OTR Solutions.

The scenario could result in the finance company going through the bankruptcy court to claw back what it lent to the broker, "even though the carrier has not been paid."

The white paper is stark in describing the current situation: It "poses a grave threat to our industry." Carriers, especially smaller ones, "[rely] on the broker to absorb credit risk and provide timely payments so they can focus on successfully transporting freight."

"In recent years, brokers have overleveraged themselves and utilized funds intended for carrier payments to support their growth," the paper says. There have been losses already as a result of this, and without a reversal in fortune, there will be more, "jeopardizing the stability of many industry participants' supply chains."

The remedy recommended by OTR Solutions is for bankruptcy courts to understand that carriers in an action are not just creditors of a brokerage that has filed for Chapter 11. They are vital for that company to emerge from bankruptcy, because if carriers refuse to work with a particular broker because of payment issues, there's no way the 3PL can climb out of its hole and be reborn as a going concern.

And the courts have that power, according to the paper. It cites a precedent from 1990 involving Eastern Airlines and its Ionosphere travelers clubs that allows a bankruptcy court to authorize payment of "pre-petition" debt if such a payment is needed "to facilitate the rehabilitation of the debtor."

The OTR Solutions argument is that the debtor, which is the 3PL, can never be "rehabilitated" unless the carriers want to do business with them. And if the carriers aren't getting paid for previous work because the lenders are trying to reclaim monies they financed to the 3PL, the brokerage will never be able to recover.

In an email to FreightWaves, Clayton Griffin, OTR executive vice president and chief strategy officer, said of the audience for the white paper that OTR Solutions is focusing on "making more industry participants aware of these topics, which will hopefully lead to productive conversation and action to address and remedy the concerns before they snowball into something bigger."

“We as an industry need to have transparency into how these issues will be settled, so we can make appropriate decisions in our businesses, and visibility into the fact that these problems even exist will help us get to that place of transparency more quickly,” he said.