FINTECH & INVOICE FINANCING: MITIGATING THE RISK OF FRAUD

Interest in invoice financing has grown tremendously over the last few years, particularly in the online peer to peer lending space in Singapore. Many fintech platforms are keen to service the small and medium enterprises seeking quick access to financing, filling the gaps left by traditional banks, lenders or factoring houses ("**Traditional Lenders**") that are unwilling to provide credit to businesses for a variety of reasons.

Traditional Lenders are typically reluctant to provide credit to companies that do not have fixed assets to provide adequate security, or due to the difficulty involved in obtaining and administering a fixed charge over the potential borrower's entire ledger of book debts. As a result, Traditional Lenders have found that the most secure way of providing financing to such companies is through a 'factoring' or 'invoice discounting' arrangements.

Many businesses often require quick access to financing, particularly young or fast-growing businesses or those in the technology and services sectors, to meet their working capital needs. Such companies are not necessarily 'high risk borrowers' but require quick access to financing because of the difference in payment terms extended to their customers (typically between 30 – 90 days), and the payment terms provided by their suppliers (payment is typically due within 30 days of date of invoice). For example, Company A supplies goods to a large supermarket chain that has standard payment terms of 90 days but Company A needs additional working capital in the meantime to purchase stock to meet new sales orders and to pay their employees. However, because Traditional Lenders are unwilling to provide credit to Company A, Company A cannot purchase new stock for the next season until they receive payment from their large supermarket chain customer.

However, companies that provide credit under invoice financing arrangements are particularly susceptible to fraud. Standard Chartered plc lost between $35 - $200 million in 2014 due to fraud perpetrated by a private metals trading firm that used fake warehouse receipts to obtain multiple credit facilities secured against one single cargo shipment in Qingdao Port[1]. The Transportation Alliance Bank ("**TAB**") of Utah was reportedly duped of 'millions' in a USD 28 million accounts receivables purchasing transaction entered into with the Arrow Trucking Co, despite the TAB's best efforts to investigate irregularities. Arrow had apparently perpetrated this fraud by preparing one invoice for their customers and submitting a duplicate, inflated invoice to the TAB and also managed to obtain USD 1.18 million in 'emergency' financing from the TAB to sustain the business. Arrow's entire fleet of trucks and trailers remain missing and untraceable to date[2].

Factors and invoice discounters or financiers ("**Invoice Financier(s)**") typically seek an assignment of a client company's ("**Seller**") debt, evidenced by an invoice. To reduce the Invoice Financier's risk, the invoice financing contract also typically requires that all proceeds of debts received by the Seller are held on trust pending payment by the Seller to the Invoice Financier, or payment of all proceeds of the debt into a trust account maintained for the benefit of or in the name of the Invoice Financier.

[1] See http://www.reuters.com/article/us-standard-chartered-qingdao-idUSKBN0FJ0QX20140715
[2] See http://www.monitordaily.com/article-posts/arrow-trucking-fraud/

Common Instances of Fraud in Invoice Financing

Invoice Financiers are nevertheless commonly susceptible to various types of fraud perpetrated by Seller clients including:

1. the submission of phony 'fresh air' invoices that do not relate to true debts owed to the Seller or commercial transactions. This is a particular risk in transactions where an Invoice Financier has an existing relationship with a Seller that seeks to exploit this existing relationship by including phony invoices intermittently, or on account of the Invoice Financier relaxing its standard verification processes for new Sellers.
2. dishonest failure of the Seller to give a notice of assignment to the end-debtor so that the Seller can continue to demand and receive payment, keep the proceeds for the Seller's own use instead of passing these proceeds on to the Invoice Financier. This is a particular risk in 'undisclosed invoice financing' transactions where no notice of assignment is given to the end-debtor, which allows Sellers to divert payments rather than pay them into the trust account as agreed with the Invoice Financier.
3. multiple or duplicated financing of the same invoice to different Invoice Financiers.

Invoice Financiers such as fintech platforms that choose to enter into 'spot' or single invoice financing transactions are at higher risk of exposure to such fraudulent transactions since Sellers are less likely to establish a long-lasting relationship or have a long-standing history of transacting with the Invoice Financier. It is not uncommon for such Sellers to go through elaborate frauds by setting up fictitious businesses, falsifying records and engaging actors to verify transactions with the Invoice Financier.

Legal Action required to Protect an Invoice Financier's Position in event of Fraud

Once an Invoice Financier discovers or suspects a fraud, it must take urgent legal action to pursue the various avenues for recovery such as seeking to reduce its exposure by enforcing the *bona fide* debts and its contractual rights against a solvent Seller, and pursuing an action for fraud or breach of trust. Beyond taking action against the Seller company, the individuals involved in the fraud are also potentially liable for conspiracy, deceit and procuring breach of contract. If they have dealt with or received trust monies, such individuals may also be additionally liable in dishonest assistance and knowing receipt.

The above causes of action available to an Invoice Financier are only personal and give rise to a money judgment which requires further enforcement, pending which the Invoice Financier is at risk of the insolvency of the judgment debtor. Also, if the Seller becomes insolvent and the debts purportedly sold and assigned to the Invoice Financier are for whatever reason found not to be the assets of the Invoice Financier (a particular risk in 'undisclosed' invoice financing), then the Invoice Financier must prove as an unsecured creditor, subject to any prior security held by secured creditors.

Recent technological developments by Invoice Financiers to mitigate risk of fraud

Establishing a common database of invoices that have been financed is another method developed by Invoice Financiers to mitigate the risk of duplicate financing of an invoice. In December 2015, DBS, Standard Chartered, and IDA successfully cooperated to launch TradeSafe, an electronic ledger of invoices supported by blockchain technology[3]. Invoices and bills of lading stored on this electronic

[3] See https://www.bloomberg.com/news/articles/2016-05-22/stanchart-dbs-s-trade-finance-distributed-ledger-how-it-works

ledger are allocated unique identifiers based on invoice details and the idea is that each Invoice Financier can upload the processing status relating to a specific invoice. A potential Invoice Financier would therefore be alerted to invoices that have already been pledged or assigned to another Invoice Financier.

Maximising Recoveries for an Invoice Financier

In addition to robust verification and due diligence processes instituted by an Invoice Financier in its business operations, it is critical that an Invoice Financier's proprietary and other legal rights are enforced immediately in the event of a suspected fraud or potential default, before the Seller's financial position continues to deteriorate. Sometimes these rights must even be enforced against administrators or liquidators who are often reluctant to provide copies of the relevant documents and records to the Invoice Financier its proprietary claims can be substantiated with complete and accurate evidence of assignment of the respective debts.

Recoveries in the event of fraud or default can be enhanced by swift legal action taken to effectively defend the Invoice Financier's various proprietary or contractual claims against the respective parties. It is critical that the Invoice Financier's rights are enforced immediately, before the Seller's financial position continues to deteriorate.

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