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CLIENT ALERT

First Brands: How to Avoid Being Two-Timed by Your Collateral

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Background

First Brands Group, LLC ("First Brands") is a leading global manufacturer and supplier of automotive aftermarket parts, having acquired its portfolio of 25 aftermarket leading brands largely through the incurrence of third-party debt.

On September 28, 2025, First Brands and certain affiliates filed voluntary petitions for bankruptcy relief. In connection with the filings, First Brands disclosed $6.1 billion in aggregate principal amount of on-balance sheet outstanding funded debt obligations (including an asset-based loan facility), $2.3 billion in aggregate "off-balance sheet" financings incurred through special purpose vehicles, and about $800 million in unsecured supply chain financing liabilities. First Brands, additionally, had about $2.3 billion in factoring liabilities.

The extent of First Brands' liabilities had not previously been known because a significant amount of its liabilities was comprised of off-balance sheet liabilities such as factoring arrangements. Under U.S. generally accepted accounting principles, factoring arrangements may not be required to appear on a company's balance sheet because ownership of the asset has been transferred and the seller has no right or obligation to repurchase the asset. In addition, when a company arranges factoring programs for its own customers, those arrangements may be classified as off-balance sheet if the supplier's obligation to the company remains a trade payable.

While financing sources were caught off guard by the extent of First Brands' liabilities, query whether those financing sources should have been given the extensive amount of debt that First Brands incurred in connection with its acquisition strategy. First Brand's high leverage, its ability to obtain debt from private capital sources speedily with limited diligence and the general ability to maintain debt off-balance sheet made masking financial difficulties a realistic outcome.

The real surprise for financing sources in the First Brands case came when allegations were made that First Brands had not transferred proceeds of receivables to factors and some invoices were financed more than once. These actions by First Brands should be the catalyst for financing sources to try to put themselves in the best position possible to detect and prevent double counting or evaporation of collateral.

How financing sources accomplish those twin goals and understanding the relevant types of working capital financings implicated are the focus of this client alert.

Understanding Relevant Types of Financing

Asset-Based and Other Lending Arrangements	
Asset-Based Loans	An asset-based loan is a financing secured by a company's valuable assets, notably accounts receivable, inventory, equipment or real estate, in contrast to reliance on cash flows. This type of financing is typically considered more secure than cash flow lending because availability is tied to the existence of the underlying assets. Accounts that are sold in, or sometimes simply subject to, a factoring arrangement as described below are typically excluded from the borrowing base of an asset-based loan. Such an exclusion is to avoid double counting of assets that are being sold in a factoring arrangement.
Cash Flow Loans	While cash flow loans often are secured, the loans are generally not as dependent on a recovery from collateral as are asset-based loans. Any disappearing collateral, however, will inevitably affect recovery of all types of loans.

Factoring Arrangements	
Factoring Arrangements Description	Factoring arrangements are relatively common in the automotive aftermarket space, in part due to lengthy payment terms negotiated by customers. Factoring generally is a mechanism used by companies to bring in cash from the sale of accounts receivable earlier than the standard payment terms for those receivables.
Third-Party Factoring	In a third-party factoring arrangement, the company sells ordinary course accounts receivable to a financial institution (not affiliated with a customer) at a discount. In this arrangement, the company transfers the proceeds of the receivables to the financial institution and owes the associated liability, if any, to the factor. In the First Brands case, the parties intended the transfers of receivables to constitute true sales, the obligations were largely nonrecourse and there was no resulting liability on First Brands' balance sheet.
Supplier Financing/Customer Factoring	In a "supplier financing" or "customer factoring" arrangement, the company sells the receivables to a financial institution aligned with a customer for shorter terms of payment. In this type of factoring, the customer pays the receivable to the financial institution directly and not through the company. Some customers require suppliers to enter into these arrangements to increase the supplier's capacity to sell to the customer and permit the buyer to negotiate lengthy repayment terms (up to 365 days).
Unsecured Supply Chain Financing	First Brands also had unsecured supply chain financing arrangements where First Brands arranged for its suppliers to enter into factoring arrangements similar to the "supplier financing" described above except that First Brands was the buyer.
Recourse or Nonrecourse Factoring and Balance Sheet Effects	Factoring can be on a recourse or nonrecourse basis. Nonrecourse factoring arrangements are not debt on a company's balance sheet if they meet certain criteria and may be considered true sales. The company adds

	cash to its balance sheet from the proceeds of the receivables without credit risk with respect to the receivable. In a recourse scenario, the company is obligated to buy back receivables that are not paid.

Practical Tips to Protect Against Double Counting and Evaporation of Collateral

Many observers believed that the nature of First Brands' liabilities as off-balance sheet financings was the reason for the demise of the business; however, ultimately, the over-leveraging of First Brands was the real culprit. Whether a financing is an on- or off-balance sheet liability, lenders and factors need to take steps to understand the company's entire "debt" position and to keep track of collateral.

Due Diligence Is Crucial

Lenders need to make sure not to shortchange fully verifying collateral. Speed of execution is a benefit to getting deals done but should not stand in the way of completing robust financial and other diligence.

Lenders and factors should go beyond standard audits of collateral and demand comprehensive financial disclosures. First Brands allegedly prevented lenders from inspecting collateral, which is an obvious red flag.

Implement an Early Warning System

While financial covenants act as a "canary in the coal mine" in most deals, those covenants can be manipulated. When relying on collateral, ongoing monitoring of collateral and independent verification of accounts receivable can avoid disappearing collateral and improper recordkeeping. When factors did not receive some meaningful amount of expected proceeds from the receivables sold to them, early warning mechanisms should have resulted in alarm bells ringing.

Independent Oversight

As businesses grow (sometimes aggressively as was the case with First Brands), corporate governance needs to include at least an independent director and auditing committee. Independent oversight of collateral, including agreed upon procedures, adds an extra layer of transparency.

In First Brands, the founder and his brother, the chief financial officer, allegedly had a history of limiting information to financing sources[1] and there were prior lawsuits against the founder claiming that he hid information. Having independent oversight may have helped prevent (or at least raise concerns over) the lack of transparency.

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[1] Eliza Ronalds-Hannon, Irene Garcia Perez, Davide Scigliuzzo, Reshmi Basu, and Jonathan Randles. "First Brands Collapse Blindsides Wall Street, Exposing Cracks in a Hot Corner of Finance," *Bloomberg News*, October 9, 2025, https://www.bloomberg.com/news/articles/2025-10-09/first-brands-how-jefferies-ubs-ended-up-exposed-to-its-collapse. (Updated on October 10, 2025 at 10:24 AM EDT)

Lenders'/Factors' Toolkits

To understand the full scope of a company's liabilities, a lender should request disclosure of factoring arrangements, limit the amount of factoring and require granular collateral schedules, annual updates of same and notice of duplicate invoices. A factor should understand the scope of competing liabilities and require collateral verification. While some of these safeguards rely on the company being forthcoming, these concepts are a good start to an effective "tool kit" of action items. Lenders and/or factors also should require updated UCC lien searches and random inspection of collateral.

For greater control, a lender and/or factor should require a dedicated account for the collection of receivables that are pledged to it such as a lockbox or an account subject to exclusive control. In some asset-based loans and in factoring arrangements (particularly those that are nonrecourse), proceeds then should be swept daily for application to the outstanding debt or forwarding of payment to the factor.

As set out in the Receivables Purchase Agreement filed with the court, First Brands acted as the "servicer" or "collection agent" of/for the accounts receivable which were required to be deposited into an account over which the factor had control or, if the factor agreed, in another company account. Upon receipt of the proceeds into the applicable account, First Brands was required to forward those payments to the factoring counterparty within a prescribed period of time. First Brands did not comply with its obligation to forward proceeds of the sale of the receivables. To avoid this possibility, a company should not be permitted to be the sole servicer for the collection of receivables in a factoring arrangement as it was in the First Brands matter. An account that is merely subject to control or relies on the company to forward proceeds may not be sufficient to ensure the company delivers the proceeds.

<u>Conclusion</u>

While it is hard to protect against fraud, implementing protective measures to avoid double counting or disappearance of collateral can reduce lenders and factors' exposure.

If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

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