Supply Chain Finance Primer

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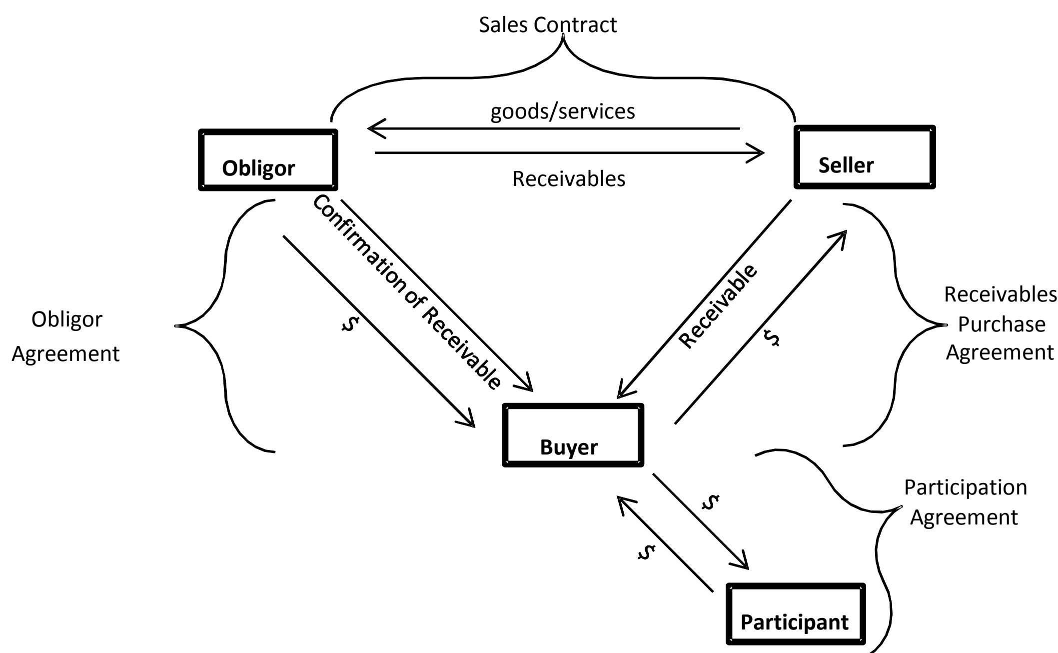
Introduction

Today, more than ever before, companies are under pressure to improve the cash efficiencies of their businesses. In recent years, many supply chain finance solutions have emerged as a key tool for companies looking to optimize their supply chains. Likewise, because of the effects of ever more stringent laws and regulations on bank capital and leverage, many large financial institutions are increasingly looking to gain exposure to segments like supply chain finance which have both low capital allocations and few, if any, funding commitments.

Some of the industries in which supply chain finance programs are most popular are retail, manufacturing, automotive, chemicals and pharmaceuticals. The three common characteristics of companies in those industries that make them good candidates for supply chain finance are that (1) all of them have extensive supply chains that tend to be global in scope, (2) all of them have significant lead time from the time inventory is ordered to the time a purchase order is approved and (3) many companies in these industries are larger and have a more favorable credit rating than most of their supplier bases.

This article explores one of the more common types of supply chain finance programs (an "***SCF Program***") in which a third-party financier (often a bank) (a "***Buyer***") provides liquidity to suppliers by leveraging their buyer's higher credit rating—an arrangement that typically involves the use of a technology platform to automate transactions and provide visibility into the invoice approval status to all parties involved. In recent years, these types of programs have evolved from a product utilized only by the largest and mostly highly rated global companies to one that may be utilized by any company with a solid credit rating and a diverse supplier base.

Typical SCF Program



Terminology

The typical SCF Program is depicted above. SCF Programs almost always revolve around a single company or corporate group (the "***Obligor***"). The Obligor will be the party ultimately responsible for the Buyer's repayment and whose credit risk is being underwritten. The top level parent company will usually guaranty the obligations of its subsidiaries.

SCF Programs are administered by a standalone technology company or a bank that develops and services a technology platform (the "***Interface***") in which receivables are submitted, approved and financed. We call the provider of the Interface the "***Platform Provider***." The Platform Provider and the Buyer are often the same entity.

The financing component of an SCF Program requires a sale of goods or services to the Obligor from a vendor or supplier (the "***Seller***"). We use the term Seller because it connotes both actions the party performs: it sells goods to the Obligor and sells the related receivables to the Buyer. There are typically a large number of Sellers in each SCF Program.

When a Seller sells goods or services to the Obligor, it does so pursuant to a purchase order and acknowledgement, invoice or other contractual agreement (each, a "***Sales Contract***"). Sales Contracts have varying degrees of formality, even within individual SCF Programs. In exchange for the sale of goods or services to the Obligor, the Seller is entitled to payment within a period of days after issuing its invoice (such payment right, a "***Receivable***").

Many suppliers may lack the financial ability to enable them to finance their operations independently of the cash flow from the sale of the goods. Such Suppliers may have an immediate need for cash and, therefore, an incentive to convert their Receivables into cash sooner than the payment period under the Sales Contract. In order to monetize that payment more quickly, the Seller may elect to offer the Receivable for sale to a Buyer through an SCF Program. Such sales are usually made pursuant to a "***Receivables Purchase Agreement***" and are sold at a discount from face value to the Buyer. Only Receivables that have been confirmed as valid on the Interface by the Obligor (a "***Confirmed Receivable***") can be offered for sale to the Buyer. In most SCF Programs, the Buyer can elect, in its discretion, whether or not to purchase such Confirmed Receivable. If a Confirmed Receivable is sold, at the end of the applicable payment period, the Obligor makes payment in the amount of the full face value of such Confirmed Receivable to the Buyer. The difference in the discounted amount paid by the Buyer to the Seller for a Confirmed Receivable and the full face value of such Confirmed Receivable received by the Buyer from the Obligor represents the Buyer's fee on each sale.

The Platform Provider, the Buyer and the Obligor will enter into one or more contracts setting forth the terms of the SCF Program. This type of agreement is typically referred to as a "buyer agreement" or a "payment services agreement." In this article we refer to such an agreement as an "***Obligor Agreement***." In SCF Programs where the Platform Provider and the Buyer are not the same party, there is also an agreement between the two that sets forth the funding obligations and repayment mechanics for the Buyer.

Key Terms of Customary Documentation

There are various documentation models for SCF Programs in the marketplace. In general, most of those models are similar in substance if not form.

1. **Obligor Agreement**. The Obligor Agreement is the primary contractual document setting forth the rights and duties of the Obligor. It is made by the Obligor (as well as any guarantor of the Obligor's obligations) in favor of the Buyer and any further assignees or participants of a Confirmed Receivable. This document typically includes at least six primary contractual agreements:

    (i) The Obligor agrees that it will confirm to each Seller, through the Interface, the (a) amount, (b) payment due date and (c) invoice number or other relevant identifying information of each receivable (thereby making such receivable a Confirmed Receivable).

    (ii) The Obligor acknowledges that the Seller may, in its discretion, transfer the Confirmed Receivable to the Buyer in exchange for early payment.

    (iii) The Obligor agrees that it will make sufficient funds available to the Buyer by the applicable payment due date to enable the Buyer to fully pay either itself (in cases where the Seller has sold the Confirmed Receivable to the Buyer) or the applicable Seller and that the Obligor's obligation to make such payment is absolute and unconditional and shall be made without any claim, abatement, deduction, reduction or setoff of any kind.

(iv) The Obligor and the Buyer agree to the technical procedures for administration of the SCF Program via the Interface, and the Buyer may grant to the Obligor a license to use the Interface.

(v) The Obligor will make various representations which include: (a) standard organizational, power and authority, due authorization and no conflict representations; (b) accuracy of information representations; (c) enforceability representations as to the agreements and each confirmation of a confirmed Receivable; and (d) representations as to the nature and characteristics of the Confirmed Receivables.

(vi) The Obligor will provide customary indemnities including for any failure by the Obligor to comply with the terms of the Obligor Agreement or any breach of representations or warranties.

2. **Receivables Purchase Agreement.** The Receivables Purchase Agreement is the document entered into between the Buyer and each Seller pursuant to which such Seller may transfer Confirmed Receivables to the Buyer. Usually, a Receivables Purchase Agreement will be a more robust document than the other documents in the SCF Program. This document typically includes at least nine primary contractual agreements:

(i) Seller may offer to sell, and the Buyer may elect to purchase, Confirmed Receivables, each in their own discretion.

(ii) The sale is non-recourse to the Seller (i.e., the Seller does not guaranty payment by the Obligor) and is explicitly articulated as a true sale and not a financing.

(iii) The Seller and the Buyer agree to the technical procedures for sale offers and acceptances and the related mechanics for consummation of the sale of Confirmed Receivables. All of these activities will generally be done through the Interface, and the Buyer may grant to the Seller a license to use the Interface.

(iv) The Seller and the Buyer will agree on a calculation for determining the purchase price of purchased Receivables, including the calculation and mechanics of any reserves.

(v) In addition to each purchased Receivable, the Seller will also transfer to the Buyer certain other ancillary rights which will include all of the Seller's rights under the Sales Contract, any collateral for such Receivable and any insurance proceeds or other proceeds of the Receivable and such ancillary rights.

(vi) The Seller will make various representations which include: (a) standard organizational, power and authority, due authorization and no conflict representations; (b) accuracy of information representations; (c) enforceability representations as to the agreements and each confirmation of a Confirmed Receivable; and (d) representations that Confirmed Receivables meet various eligibility requirements.

(vii) If a Confirmed Receivable was not in fact an eligible Receivable at the time of sale or if the Seller breaches any of its other representations with respect to such receivable, the Seller is obligated to repurchase it.

(viii) The Seller will provide customary indemnities including for any failure by the Seller to comply with the terms of the Receivables Purchase Agreement or any breach of representations or warranties.

(ix) The Seller will authorize the Buyer to file a Uniform Commercial Code UCC-1 financing statement evidencing (and perfecting) the sale of the Receivables.

True Sale and Bankruptcy

Under Section 541(a) of the Unites States Bankruptcy Code, the commencement of a bankruptcy case creates an estate consisting of all of the debtor's then owned legal and equitable interests in property. Such estate can only be disposed of with the consent and approval of the bankruptcy court. Upon commencement of a bankruptcy case, an "automatic stay" is imposed on creditors of the estate such that creditors must seek bankruptcy court approval to take any enforcement actions of any kind. If the bankruptcy court determines that the transfer of Receivables by the Seller to the Buyer represents a sale, as opposed to a loan, such Receivables and their proceeds will not fall into the bankruptcy estate of the Seller and not be subject to the automatic stay. If, on the other hand, the transactions are characterized as a transfer of the Receivables as security for a loan by the Buyer to the Seller, then the Seller's estate would have an interest in the Receivables and the Buyer would be treated as a creditor of the Seller. It is for this reason that the transfer of Confirmed Receivables from the Seller to the Buyer is documented to achieve a "true sale" of such Receivables.

The Bankruptcy Code governs whether any particular interest in property constitutes property of a debtor's estate. However, state law and other applicable non-bankruptcy law generally defines the existence and nature of the debtor's interests in property and, correspondingly, the bankruptcy estate's interests. As such, the determination of whether the Seller's bankruptcy estate would include the Receivables depends chiefly on the characterization and treatment of the transactions under applicable state law. Very broadly, the primary factors courts consider when determining whether a given transaction is a true sale or a secured loan include: (i) the intent of the parties, (ii) whether the seller has transferred the risks of ownership, including confirming that the seller has not retained any material amount of credit recourse on the Receivables, and (iii) any other factors indicative of a sale or a loan. Of these factors, the requirement for the absence of credit recourse is by far the most complicated because credit recourse can take many forms including explicit guarantees, guaranteed rates of return puts and calls.

Participations

A Buyer typically purchases Confirmed Receivables from the Seller for the Buyer's own account. However, when the quantity of Confirmed Receivables exceeds the Buyer's funding limits or desired exposure for a particular Obligor, a Buyer will often seek to off-load exposure to other financial institutions. Most commonly, this is accomplished through the use of a participation structure where the Buyer will sell participation interests in the Confirmed Receivables to participants (each a "***Participant***"). The participation will most often be documented in a "***Participation Agreement***" between the Buyer and the Participant and enables the Participant to obtain the purchase economics of certain of the Confirmed Receivables acquired by the Buyer from the Sellers. Thus, similar to a typical loan participation, the Participant's actual

contractual counterparty is the Buyer, but the primary underlying credit risk party is the Obligor.

The Participation Agreement provides the rules governing the creation and termination of the participation relationship (including the content and mechanics of funding requests) and sets out the key terms related to the creation and adjustment of payment obligations by each party. Participation Agreements are almost always entered into on an uncommitted basis by Participants.

The Participation Agreement will typically provide that the Participant will receive the benefit of and be entitled to any indemnities and repurchase payments received by the Buyer and any amounts from the exercise of remedies or recoveries from an Obligor to the extent of its participation interest. The Buyer also typically contractually agrees to administer and manage the participated Receivables with the same degree of care which it normally does for its own account.

Conclusion

In recent years, a number of factors have led to the increasing popularity of all types of SCF Programs. These programs have evolved from being useful only to the largest global companies to financing tools that can be utilized by any company with a solid credit rating and a diverse supplier base. It appears likely that even for smaller companies various types of SCF Programs will over time become an attractive alternative to more traditional asset-based loan financing programs.

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