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The Impact of COVID-19 on Supply Chain Finance

Since December 2019, the rapid spread of COVID-19¹ has caused significant global upheaval. While many questions circulate unanswered, and while a variety of global initiatives to stem the spread of the virus are implemented and modified on a day-by-day, hour-by-hour basis, the impact on global trade and manufacturing has been severe and is expected to profoundly intensify. This consequence—albeit only one of many consequences of the rapidly unfolding events—is having and will continue to have a significant impact on the supply chain and supply chain finance.

SUMMARY OF SUPPLY CHAIN FINANCE

The supply chain is the process through which goods are produced and sold to the ultimate end user, from the acquisition of raw materials, to the production, transport and warehousing of the final product, to the final purchase. While a supply chain can be made up of many links (e.g., carbon fiber being sold from a carbon fiber production house to a manufacturer of aircraft wingtips, then aircraft wingtips being sold to the manufacturer of an aircraft wing, then an aircraft wing being sold to the manufacturer of an aircraft, then an aircraft being sold to an airline or aircraft leasing company), at each link in the chain there is a supplier (who supplies the item being sold) and a buyer (who buys the item being sold).

The need for a supply chain finance solution arises from the combination of two characteristics often found in trade transactions:

- (i) the time period that runs between delivery by the supplier of the goods and issuance of the associated invoice, and when the buyer is obligated to make payment for such item (that is, the invoice's "maturity date"); and
- (ii) the credit profile of the buyer is often more favorable than that of the supplier, with the consequence that the supplier will have stronger sources of capital and will be able to obtain cheaper funds if can access the buyer's credit rather than its own.

Suppliers in the supply chain rely on payments owed to them by their buyers—some more than others—and the time period between



production and delivery of the product, combined with the supplier's cost of capital, oftentimes creates a working capital burden on the suppliers. Equally, while one might expect that the buyers have a vested interest in pushing the envelope in deferring the due date for payment to their suppliers, there are some critical business reasons why buyers don't push too far—first, buyers need their suppliers to remain a viable economic concern to ensure stable and regular supply of the items that buyer needs, and second, if extended beyond their market term, trade payables could arguably be recharacterized as debt on the buyer's books.

In response to this financing gap, supply chain finance has arisen, taking advantage of characteristics from international trade transactions and structured finance transaction, by financing the accounts receivable of suppliers due from buyers, thereby providing stability within the supply chain by creating favorably priced liquidity to suppliers before payment on these receivables is due from buyers.

TWO MAJOR TYPES OF SUPPLY CHAIN FINANCE

There are two main types of supply chain finance transaction structures: “supplier-led” transactions, and “buyer-led” transactions². There are critical structural and practical differences between these two types of facilities, and those differences result in the impact of COVID-19 being felt differently in supplier-led transactions than it is in buyer-led transactions. Each of supplier-led transactions and buyer-led transactions are discussed further below. However, it is important to note that in both types of supply chain financing structures the challenges of COVID-19 will impact buyers and suppliers more intensely than third party financing parties; bank purchaser is rarely committed to purchase receivables offered for sale by a supplier and may accordingly stop purchasing at any time and for any reason.

SUPPLIER-LED SUPPLY CHAIN FINANCE TRANSACTIONS

In a supplier-led supply chain finance transaction, the supplier approaches its relationship banks requesting those banks to acquire receivables owing to that supplier by certain specified buyers. If the buyers are not notified of the sale of those receivables, the transaction is referred to as a “non-notified” or “non-disclosed” transaction. If the buyers are going to be notified of the sale of those receivables, the transaction is referred to as a “notified” or “disclosed” transaction³. Over the past decade, we have seen a significant shift from supplier-led notified transactions to the now more common supplier-led non-notified transaction.

The supplier makes a series of representations and warranties regarding the nature of the receivable being purchased, and effectively indemnifies the bank for any losses on the receivable other than as a result of the buyer's financial inability to pay (that is, while the credit risk of the buyer to pay the amounts it owes on a receivable is transferred to the bank, the transactional risk of the purchase and sale of goods between the supplier and the buyer remains a risk of the supplier). Absent the occurrence of any of the specific non-credit risk events triggering supplier recourse, the bank looks at the receivable being purchased as a payment obligation of the buyer, and as a result, can price its credit risk in a way more closely aligned with the credit of the buyer than that of the supplier. However, since the supplier does retain transactional based risk (such as an indemnification obligation resulting from dilution or dispute), there remain circumstances under which the bank may be exposed to the supplier's credit, so the ultimate bank analysis uses a blended approach, i.e. marrying the credit risk of the supplier with that of the buyer.

This allocation of risk and ultimate path of recourse is a fundamental difference between supplier-led transactions and buyer-led transactions and is a major reason that COVID-19 may more severely impact supplier-led transactions.

BUYER-LED SUPPLY CHAIN FINANCE TRANSACTIONS

In a buyer-led supply chain finance transaction, a buyer establishes a program with one of more of its relationship banks and invites its suppliers to join that program and sell receivables payable by the buyer to those banks. Buyer-led



programs typically involve a technology platform—whether proprietary, web based or more recently, blockchain based—which buyer's banks and suppliers join, and under which suppliers can login, offer certain identified receivables for sale to the banks, and effectuate the sale of those receivables should the banks elect to purchase. Unlike the supplier-led transactions, the purchasing banks typically do not have pre-existing relationships with the suppliers (although they do enter into a receivable purchase agreement as part of the program documentation); their relationship is with the buyer.

The banks purchasing receivables payable by the buyer from those suppliers are doing so because of three main factors: first, the obligor on the receivable (that is, the entity actually required to make payment of the receivable on the due date) is the buyer, who is in turn the bank's customer and is well known to the bank; second, implementation of buyer-led programs is usually undertaken by large corporates with the kind of ratings, credit history and receivables payment history that will support the bank's exposure; and third, under the program documentation the buyer agrees that it will pay the receivable purchased by the bank on the maturity date in all circumstances (that is, without dilution, set-off, dispute or any other defense to payment). That assurance from the buyer—often referred to as the buyer's "independent payment obligation" to the bank—means that in buyer-led transactions, there is no real risk of dilution or dispute which would result in the bank seeking relief from the supplier, and, in turn, allows the bank to book the exposure related to a specific receivable purchased from a supplier as credit exposure to the buyer and not to that particular supplier. Consistent with that approach and because of the effectiveness of the independent payment obligation, in buyer-led transactions the bank can price its credit risk consistent with the credit of the buyer (typically at a significant discount to rates that the supplier would have otherwise been able to obtain).

IMPACT OF COVID-19 ON SUPPLY CHAIN FINANCE

Macro-Economic Impact

While this alert speaks to the impact of COVID-19 on supply chain financing facilities from a legal viewpoint, we would be remiss to not mention the very real toll on global society generally, as well as that from a non-legal perspective, the varied, and at times, tragic practical consequences arising from the disruption of the global supply chain, many of which will impact related financing structures from a macro perspective. For example, while we discuss how a specific receivable owing from a large hardware retailer to a small hammer company that has been purchased by a bank pursuant to a supply chain finance facility will be legally impacted, we should not lose sight of the fact that such a legal viewpoint is only a part of a larger supply chain, and that larger supply chain is only a part of a larger local economy, and that local economy is only part of a larger national and global economy. If customers aren't coming to stores to buy hammers, or aren't going to restaurants, or if people aren't traveling on airplanes and staying in hotels or going on cruises, the disruption to the demand patterns in our economy will have a distorting impact on business and industries, resulting in flow-on effects for supply chains and, by extension, the financing structures that support them. While this alert is not intended to discuss those factors, it should be read and considered in that context.

Uncommitted Nature

As mentioned above, supply chain finance transactions are typically uncommitted facilities, meaning that a bank may unilaterally cease purchasing receivables from a supplier at any time for any reason. While, of course, a sudden cessation of purchases will have an immediate and potentially serious business impact on a supplier and, in the longer term, on the buyer, the pricing and broad availability in the market of supply chain finance is premised on the bank's ability to box out their risk and limit its forward-looking exposure to the tenor of the receivables previously purchased. As an example, if a buyer pays on 60-day terms (that is, the buyer pays an invoice owing to a supplier on the date that is 60-days after the invoice is delivered), a bank can stop purchasing receivables and, assuming that the buyer continues to meet its obligations, have no remaining exposure under the program once that 60-day period ends. Accordingly, given both the uncommitted nature of these facilities as well as the very short-term tenor of supply chain finance exposures,



the principal risk posed to supply chain finance by COVID-19 epidemic falls on the shoulders of buyers and suppliers, not the banks.

Force Majeure

Once a receivable has been purchased, however, the critical legal and credit challenge posed by COVID-19 focuses on the buyer's obligation (and continued capacity) to pay that receivable on the maturity date. In a buyer-led transaction, if the agreement executed by the buyer and containing the aforementioned "independent payment obligation" also contains a *force majeure* clause, there is a question to be asked as to whether (a) that clause applies, and (b) if it does apply, what it excuses. While language varies between agreements, a typical *force majeure* clause in a buyer agreement related to a buyer-led transaction will read something like this:

Neither Party shall be deemed to be in default of any of the obligations required to be performed by it under this Agreement to the extent that performance thereof is delayed, hindered or becomes impossible because of any act of God or public enemy, hostilities, war (declared or undeclared), sanctions, terrorist activities, act of sabotage, earthquake, flood, hurricane, storm, explosion, fire, labor disturbance, strike, riot, epidemic, act of government or its agencies or officers, power interruption or transmission failure, or any cause of a similar nature beyond the control of such Party

Taking the above example, we specifically note: (i) this provision does not excuse performance absolutely—that is, the buyer remains obligated to perform and make payment—and instead the provision merely provides that the temporary non-performance does not cause a default event⁴; (ii) this provision is only applicable if non-performance is caused by the identified categories of (broadly drafted) events; and (iii) once the specified event no longer is delaying, hindering or making impossible the performance of the related obligation, the buyer remains required to complete performance of its obligations.

Would the global spread of COVID-19 trigger a clause like this, excusing a buyer from making payment on a receivable that has been acquired by a bank? Firstly, it would seem that we are firmly in the "epidemic" category (as well as some other categories—although less directly—and the general "catch-all" category often found in *force majeure* provisions): according to the CDC, an "epidemic" is defined as an increase, often sudden, in the number of cases of a disease above what is normally expected in that population in that area. Although not specifically listed in the foregoing *force majeure* provision, "outbreak" has the same meaning as epidemic except is often used for a more limited geographic area, while "pandemic" refers to an epidemic that has spread over several countries or continents, usually affecting a large number of people. The CDC has reported that it is likely that the COVID-19 epidemic will develop into a pandemic (although as we go to press on this alert, reasonable minds could conclude that this threshold has already been crossed).⁵ We would expect that there will be a push in the market to expand the list of related terms in a typical *force majeure* provisions by including terms like "pandemic", "outbreak" and any number of other synonyms. One could, however, question whether adding such additional categories operates to expand the provision beyond the coverage already provided by the very board and general term "epidemic".

Presuming the occurrence of an epidemic, though, is not sufficient. This example provision would only excuse a default if there is "causation" - that a direct causal nexus between the non-performance of obligations and the COVID-19 epidemic – evidencing that such non-performance of obligations was directly caused by (or arguably, the direct result of) the COVID-19 epidemic. While there are many obligations in the supply chain more generally, in the specific world of supply chain finance, the buyer really has only one obligation—to pay the receivable on the maturity date. Short of an actual inability to send funds (e.g., the buyer has only one office from which payment can be sent, and that office is located in a place where a quarantine exists, no-one is permitted to access the office and there is no remote access option), the above *force majeure* clause would arguably not be triggered. If payment were able to be sent from another



office or remotely on time, then the COVID-19 epidemic won't have caused any delay. While it could be argued that the business impact of the COVID-19 epidemic (and the panic and fear surrounding it) could result in a financial burden on the buyer, rendering a buyer unable to meet its obligations, such a circumstance would be better characterized as a credit event, not a *force majeure* event.

Impact on Supplier Creditworthiness

As noted above, in buyer-led transactions, the buyer has specifically waived dilution, set-off, dispute or any other defense to payment. Accordingly, even if a buyer was able to claim it no longer had an obligation to make payment on a receivable, the buyer's separate contractually based independent payment obligation in favor of the bank means, that to the extent that the bank purchased the receivable, the Buyer would remain obligated to make such payment.

In supplier-led transactions, however, the buyer makes no such assurances. Instead, if the buyer asserts a dispute or seeks to apply dilution, set off, or any other defense to payment other than financial inability to pay, the bank would have recourse to the supplier. Indeed, in a supplier-led transaction, all the other market challenges we set aside in our buyer-led transaction analysis, such as interruption in raw material and parts deliveries, inability to ship, quarantine of essential personnel – all very real events occurring today – come directly into play. While not always the case, the supplier tends to be of a lesser credit quality than the buyer, and accordingly the bank's exposure profile is impacted, sometimes materially, by any claim by buyer of dilution, set-off, dispute or any other defense to payment. In the COVID-19 context, the macro economic impact of the epidemic is likely to have a more profound effect on the finances of the supplier than the buyer, which in turn negatively impacts the bank's credit profile on supplier-led transactions.

CONCLUSION

The COVID-19 epidemic is having and will continue to have a significant impact on local, national and global economies. Far from being immune to the uncertainty that has resulted and will further develop, the supply chain finance industry will be feeling these changes viscerally. While buyer-led transactions are structurally less susceptible to the COVID-19 epidemic than supplier-led transactions, the intimate connection between trade and the financing of trade would suggest that times ahead will present challenges. Banks participating in these facilities should review the strength of the "independent payment obligation" clauses, their *force majeure* clauses for possible application (depending on drafting), the recourse structures between suppliers and buyers, and recourse rights of the bank against suppliers and, where applicable, buyers, and continue to monitor buyers and suppliers in their programs to control risk profiles and credit exposure and to promptly address any negative developments in payment patterns.

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¹ Notwithstanding the generic “COVID-19” reference, the virus is actually named “SARS-CoV-2” and the disease it causes is “coronavirus disease 2019” (abbreviated to “COVID-19”) – for further information, see the CDC website: <https://www.cdc.gov/coronavirus/2019-nCoV/summary.html>.

² From a nomenclature perspective, supplier-led transactions are also referred to in the market as “supplier-centric”, “seller-led” and “seller-centric”, while buyer-led transactions are also referred to in the market as “buyer-centric”.

³ Under the UCC, unlike some non-US jurisdictions, banks purchasing receivables perfect their position in those receivables by filing a UCC1 financing statement, and not by giving notice to the buyer. Accordingly, while there are many reasons why a transaction in which a buyer is notified of the sale of receivables might be preferable from a credit or structural perspective, that decision is not driven by perfection needs.

⁴ In the sample language, it's somewhat unclear what the ultimate impact of a permanent “impossibility” event would be – while not excused from performance, the provision would excuse the consequence of non-performance which for a permanent “impossibility” event would leave the parties in a legal limbo. While this question is not relevant to the COVID-19 outbreak – COVID-19 would not present a permanent impossibility to performance – the question is an open question that would need to be analyzed in the context of the actual provision and the circumstances of the underlying transaction and non-performance.

⁵ According to the CDC, COVID-19 has met “two of the criteria of a pandemic” [severe illness, including illness resulting in death and sustained person-to-person spread in several places]. The CDC further states: “As community spread is detected in more and more countries, the world moves closer toward meeting the third criteria, worldwide spread of the new virus”. This worldwide spread would convert the epidemic into a pandemic. See further: <https://www.cdc.gov/coronavirus/2019-nCoV/summary.html>