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WHAT'S INSIDE

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PURCHASE ORDER FINANCING TO THE DEBTOR IN POSSESSION

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The lender's dilemma: After months of sputtering along, your borrower has finally exhausted its existing facility and is contemplating filing for bankruptcy to conduct an orderly wind down. Suddenly it receives a reprieve, a long sought-after purchase order for its most profitable product, from its best and most stable customer. Like manna from Heaven, filling this order could be a reflection that your borrower has hit bottom and can begin its turn around, or it's a last gasp effort enabling the borrower to survive long enough to maintain a going concern value and a good customer relationship. But with the existing lender's line completely tapped out and an immediate need for funds to fill the order, what's the solution? Purchase Order Financing (PO Financing).

In PO Financing, the borrower assigns its right and obligations to its customer's purchase order to a PO Lender. The PO Lender purchases the product (for which the customer has issued a PO) from the manufacturer on behalf of the borrower. After the product has been finished (following inspection, shipment, delivery to a U.S. port, delivery to the customer, then ideally acceptance of the product by the customer) the manufacturer is paid by the PO Lender. The product is "sold" to the borrower by the PO Lender and concurrently sold by the borrower to its customer, which issued the PO. Depending on terms of sale between the borrower and its customer, the customer may pay for the product when it is delivered or at some point of time thereafter. If the terms of sale are payment upon delivery, then upon delivery, the borrower issues an invoice to the customer; the customer pays the borrower and the borrower repays the PO Lender for the cost of the product plus interest and the PO Lender's fees. If the terms of sale between the borrower and the customer are for payment for the product sometime after the customer's receipt of the product, the borrower issues an invoice to its customer and an account receivable will have been created. The PO Lender may retain possession of the invoice or assign the invoice to the borrower's working capital lender. If the invoice is assigned to a working capital lender, the PO Lender will be repaid its advances plus interest and fees by the working capital lender. The customer then will pay the invoiced amount to the working capital lender. Alternatively, the borrower will have assigned the invoice to the PO Lender and the customer will pay the invoice according to the terms of sale to the PO Lender. Upon receiving payment from the borrower's customer, the PO Lender deducts its advances, interest and fees and remits the balance of the payment to the borrower.

Since PO Financing can be used for short-term relief within a bankruptcy or a "first date" that can mature into a longer-term relationship after the bankruptcy (if all goes well in Chapter 11), PO Financing should be high on the list of financing solutions for a business debtor considering, or in, a Chapter 11. PO Financing can provide a much-needed lifeline in Chapter 11 and benefit the borrower who has exhausted availability from the existing lender and desperately needs to preserve going concern value in order to maximize the value of its collateral. All the while the PO Lender has comfort knowing that its risk is being mitigated by utilizing all of the protections that a bankruptcy proceeding provides: a Bankruptcy Court Order confirming the transaction, transparency, the ability to enhance its collateral through the Court Order and assurances that both the risks of dealing with a borrower in financial hardship and cost of enforcement is reduced since the borrower is already in a forum where the PO Lender can enforce its rights if the need arises.

1 This article is adapted from Scott N. Schreiber and Gary Edidin, "Purchase Order Financing to the Debtor in Possession," *ABL Advisor* (June 12, 2019), available at https://www.abladvisor.com/articles/16483/purchase-order-financing-to-the-debtor-in-possession

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The Process, Obstacles and Benefits of Providing PO Financing to the Debtor in Possession

The challenge for many PO Lenders is navigating the several legal hoops that one has to go through to make PO Financing to a Chapter 11 debtor in possession mutually beneficial. The hoops and some of the pitfalls are described below:

The Borrower

The first step is convincing the PO Lender and its existing lender that the profit margins built into selling the product will support PO Financing. Does the manufacturer have access to all raw materials? Are there any risks that the product will not be produced on schedule and on time? Is there a risk of non-payment for the finished product? If the product is being manufactured abroad, does the PO Financing need independent support, e.g., letters of credit? All these issues go into pricing of the PO Financing.

Separately, the cost of paying for the bankruptcy process must ultimately be reflected in the product pricing. And while the borrower may be capable of projecting product pricing information (reflecting the product's salability) absent reorganization expenses, when scrubbing the borrower's projections, the PO Lender must consider if the borrower's pricing still yields sufficient profit margin to pay for the additional costs inherent in a Chapter 11 bankruptcy case?

Since the borrower's customer may be "spooked" by the sudden appearance of the PO Lender especially in this day of credit schemes and the borrower's bankruptcy, the borrower should be prepared to facilitate complete communication between its customer and the PO Lender.

Similarly, the borrower may look at the PO Lender as a potential source for exit financing after it emerges from its Chapter 11. The borrower should carefully examine whether the PO Lender has the ability to be more full-service: Can it provide additional lending facilities, such as factoring or asset based lending, upon the borrower's exit from bankruptcy or is it just a one trick pony?

The Existing Lender

The need for PO Financing is premised on the assumption that the borrower's existing lender has deal fatigue, is unfamiliar with DIP Financing issues, or is unable to provide additional overline or DIP support, and/or does not have the administrative expertise to monitor a PO Financing transaction. More specifically, few lenders have in the house expertise to understand and support international payment methods, shipping documents, and logistics procedures. The PO Lender is not just providing a financing alternative but is adding intrinsic value to the borrower by enhancing its cash flow and/or going concern value, and thus the existing lender's collateral. The existing lender should be prepared to carve out the proceeds generated by the PO Financing from the existing lender's collateral package. That carve-out extends to all rights relating to the purchase order for which the PO Lender is providing financing, the finished product, accounts receivable created by the sale of the finished product and proceeds therefrom. Likewise, the existing lender should fully subordinate their claim to the extent of any advances made by the PO Lender, and its costs.

The PO Lender

The PO Lender needs to ensure that its documents go beyond the protections expected in a traditional relationship; that they protect it as a lender to a debtor in possession with a super-priority, and the ability to seek reimbursement of its advances and fees as a super-priority expense if for some unanticipated reason the whole transaction turns upside-down. PO Lender's counsel must be able to package the DIP proposal and provide full disclosure of relevant information to allow the Court to approve the PO Financing without a contested hearing which will add costs. Counsel must also protect the PO Lender if an alternative lender is introduced to the transaction to make a competing bid to the PO Lender.

This is where knowledge of the bankruptcy process and knowing the line between what's obtainable and what's egregious in the eyes of the Bankruptcy Judge, the Creditors Committee (if one exists) and the United States Trustee comes into play. Since none of those parties are as familiar with PO Financing as the PO Lender and its counsel, it's important to strike a balance between what's fair when providing PO financing to a challenged borrower, and what's unnecessary. The PO Lender typically needs to anticipate how it would dispose of its collateral if the Borrower to default. Where the PO Lender is facilitating a transaction with a debtor in possession, the PO Lender needs to craft its documents to enable it to rely on the Bankruptcy Court, if necessary, to liquidate its collateral, even if for instance the collateral includes licensed goods. And consider whether the appointment of a Trustee under Chapter 11 or Chapter 7, or the automatic stay might affect any of the PO Lender's ability to liquidate its collateral. For instance, if the deal goes sour, the PO Lender may prefer one liquidator over another. The time to negotiate that preference is during the Bankruptcy Court loan approval process, not later.

The PO Lender's documents may provide for all of its fees and costs are paid without further court approval. Whether or not those fees and costs include its attorney's fees, or whether there is a cap on those fees after which court approval is necessary is another topic for negotiation among the parties.

Typical lending agreements provide for a minimum term, or a minimum volume, lest the borrower become liable to pay a fee to the lender. Where those terms are breached as a result of the Debtor converting its case to one under Chapter 7, or simply liquidating, that unpaid fee may become an administrative expense against the debtor's Chapter 11 estate.

Lastly, the PO Lender needs to ensure that it's receiving and reviewing all pleadings and reports filed in the bankruptcy case, including Monthly Operating Reports. The pleadings and report are telling when something is amiss, or about to become amiss in the underlying bankruptcy case.

Conclusion

PO Financing to the Debtor in Possession, while risky, can be lucrative, beneficial and the entry to a longer-term relationship with the borrower following its bankruptcy. Navigating the Debtor in Possession Financing Orders requires familiarity with the nuances of the Bankruptcy Code and ensuring that you've anticipated the unexpected.

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