KING & SPALDING

Prepayment Transactions

August 2020

Prepayment Transactions

Introduction

Prepayment transactions involve the buyer of a product arranging lump-sum payment in advance for future supply of that product. They are commonly used as a financing tool in the commodities industry, including oil, metals and agricultural commodities, but the structure is inherently flexible and has been used in other sectors, including in shipping to finance the completion of vessels for delivery.

In the context of commodities, the prepayment is typically repaid over time through delivery of the relevant product. Transactions of this kind have become an increasingly important source of finance at a time when it is more difficult for commodity suppliers to fund themselves through the traditional banking system.

Advantages

A prepayment transaction enables the supplier to receive payment in advance, providing working capital or funding for capital expenditure. Prepayment structures are inherently flexible, being used to provide short-term working capital with tenors of a few months, sometimes on a rolling basis, and also as a source of long-term capital for expansion or development where the repayment tenor can be up to five years.

Prepayment transactions can be particularly attractive to suppliers in countries with regulatory, tax or exchange control regimes that discourage or prohibit direct lending by international financial institutions.

They can also provide a useful financing solution for suppliers who may find it hard to access other sources of capital, particularly when credit markets experience higher levels of distress like in the current market.

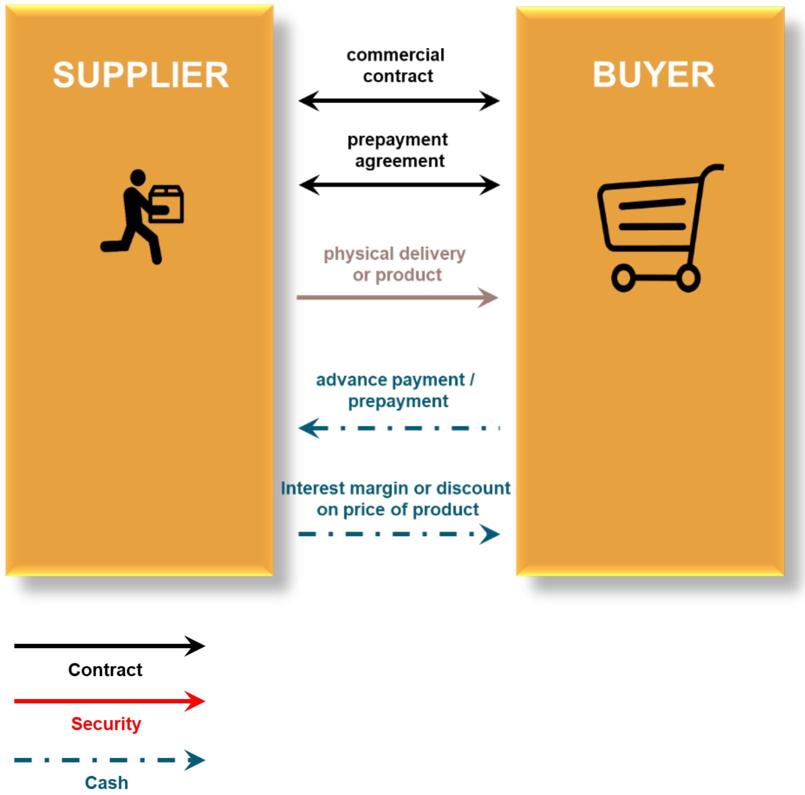
In fact, prepayment transactions could result in suppliers obtaining more favourable terms than they could obtain themselves because of the ability to access the buyers' relationship banking partners. As such, this structure may be a more attractive source of financing than the more typical sources of corporate fundraising such as equity capital.

In addition, prepayment transactions can be a more cost-effective solution than traditional bank lending. Suppliers only need to deal with just one counterparty on all aspects of the transaction (i.e. from product sale to financing) resulting in more streamlined documentation and quicker consummation of transactions.

Prepayment structures are often used by commodity trading houses to secure supply of product, sometimes on favourable terms, and the opportunity to both lock in supply and potentially make a margin on the trading side can enable the buyer to reduce the cost to the supplier compared to a traditional loan.

Structure and documentation

Typically, a prepayment transaction will involve two key documents between the supplier and the buyer: a commercial contract, sale contract or offtake agreement; and a prepayment or advance payment agreement.



The **commercial contract** sets out details of the product to be supplied, any related quality specifications, the pricing formula and payment terms, the origin and (if relevant) permitted destination(s) of the product, and the agreed terms relating to shipping, insurance, and transfer of title.

The **prepayment agreement** sets out the terms on which the prepayment is made, including any conditions which must first be satisfied, such as any security or credit support that the supplier must provide. It also details how the prepayment is repaid (through delivery of product or refund) and how the interest margin for the buyer is calculated: typically either as a dollar discount to a market benchmark price for the relevant commodity (such as Brent Crude or West Texas Intermediate (WTI) for oil and London Metal Exchange prices for metals) or as a per annum percentage in the same way as a more traditional loan.

It will usually include a delivery schedule which requires either a minimum quantity or a minimum value of product to be delivered periodically (e.g. monthly, quarterly). This provides assurance to the buyer that the prepayment will be amortised on a regular basis and is important to (a) provide the buyer with relatively predictable supply for trading purposes and (b) enable predictable amortisation of the prepayment, which is often necessary to facilitate any related financing the buyer is arranging to fund the prepayment (discussed in further detail below).

The prepayment agreement also includes credit protection provisions such as representations and undertakings from the supplier, and events of default or termination events which enable the buyer to step in and take steps to recover the prepayment if the supplier does not perform its obligations.

Provisions relating to force majeure, sanctions, anti-corruption and anti-money laundering may be included in either or both of the commercial contract or the prepayment agreement.

In some transactions, the prepayment agreement and the commercial contract are combined into a single agreement, sometimes called an advance payment and supply agreement (APSA).

Key issues in prepayment documentation

It is critical to ensure that the commercial contract, the prepayment agreement and any related financing that is arranged to fund the prepayment all match up. Failure to get this right can have significant unintended consequences from an operational, legal and financial standpoint.

This issue becomes more acute for buyers dealing with large and experienced suppliers that often have in-house standard form versions of commercial contracts that present little or no flexibility for negotiation. In these types of transactions, the review and negotiation of prepayment agreements is a more involved process and buyers can seek to include a priority or prevail clause in their prepayment agreements to safeguard their interests. This is so that in the event of any inconsistency or conflict, the terms of the negotiated prepayment agreement take precedence over the terms of the commercial contract.

While in some transactions the buyer may trade the product freely to third party end buyers after delivery, in others the buyer on-sells the product to pre-existing customers of the supplier who have been lined up in advance. In the latter case the transaction is focused largely on providing a working capital financing solution to the supplier, and the buyer will also want to ensure that the onward sale contracts with the end buyers are aligned closely with the commercial contract it has with the supplier.

Prepayment agreement

Under the prepayment agreement, ‘delivery’ is typically the point at which the prepayment is amortised or repaid, in an amount equal to the value of the relevant shipment, and the construct used for delivery is therefore a key focus for all parties.

For cross-border transactions, ‘delivery’ is often defined by reference to a set of shipping documents being delivered to, and accepted by, the buyer. These generally include original bills of lading made out to the order of the buyer, together with certificates of weight, quality, origin and so on which are appropriate to the commodity in question, usually provided by an independent surveyor agreed between the parties in the prepayment agreement. Given the importance of the delivery construct to the amortisation of the prepayment, the buyer (and any related finance providers) will often want significant discretion over the acceptability of the documentation, though where this lands is always a matter of negotiation between the parties.

Sometimes, delivery in excess of the minimum requirement will also amortise the prepayment, with the effect that it is reduced more quickly than originally scheduled. Alternatively, the buyer is required to pay cash for ‘excess’ deliveries to preserve the intended amortisation profile. In case of a shortfall in delivery, some prepayment agreements require the supplier to pay the buyer a cash refund of the relevant portion of the prepayment, while others permit the delivery to be deferred for a period of time, so the amortisation is partially postponed until ‘make-up’ quantities can be delivered.

In addition, depending on the pricing benchmark used for the relevant commodity and the timing of price-setting and delivery, it may be necessary to include a ‘true-up’ mechanism to deal with price fluctuations. This generally involves a provisional invoice based on the benchmark price at the time of ‘delivery’ under the prepayment agreement, which is the value used to amortise the prepayment. When the final benchmark price is available for the relevant date, the value of the shipment is recalculated. A shortfall or excess can either be paid in cash by one party to the other or can be carried forward and added to or deducted from the delivery requirement for the next delivery period.

It is also quite common to disapply any right of set-off, except for amortisation of the prepayment by delivery, in order to preserve the full delivery requirement, particularly if there is a related financing.

Credit support requirements in prepayment agreements vary depending on many factors, including the credit status, production track-record and perceived risk of the supplier, the wider economic and sector-specific outlook and any political, currency or other risks associated with the country in which the supplier is located.

Credit insurance, domestic bank guarantees or standby letters of credit (SBLCs) may be required to support some or all of a supplier's delivery and/or refund obligations under the prepayment agreement. In some cases, the buyer may also take security over other assets of the supplier. Financial covenants and related compliance certificate requirements may be included where the buyer wishes to monitor the financial health of the supplier.

Overall, the identities of the supplier and buyer in a prepayment transaction are determinative of the scope of covenants (e.g. fees, representations and warranties, undertakings and termination events) and credit support requirements included under the commercial and prepayment agreements.

Commercial contract

A number of terms in the commercial contract need to be carefully considered to ensure that they fit correctly with the prepayment agreement. These include the following:

- **Title and risk** – should pass at the same time as 'delivery' occurs under the prepayment agreement, to avoid a mismatch where title and risk pass before or after the prepayment is amortised by delivery.
- **Quantity** – must be at least sufficient to fully amortise the prepayment, usually with a healthy level of headroom to provide a buffer against commodity price fluctuations.
- **Force Majeure** – if force majeure provisions under the commercial contract could excuse the supplier of its delivery obligations, it is important to consider the impact on the amortisation of the prepayment. The buyer (and any finance providers standing behind it) cannot wait indefinitely for deliveries to resume and as a result there may be a requirement for the supplier to pay the buyer a cash refund equal to the minimum value of the missed delivery. Alternatively, a force majeure event lasting longer than a specified period (e.g. 3 or 6 months) triggers a right for the buyer to terminate the prepayment agreement and claim a full refund of all remaining unamortised amounts of the prepayment.

Given the interdependence between the commercial contract and the prepayment agreement, it may sometimes be appropriate to include a cross-termination construct so that one contract automatically terminates when the other contract is terminated in accordance with its terms.

Financing the prepayment

Some prepayment transactions are funded entirely by the buyer from its own cash reserves or from its general corporate debt facilities. However, in many cases the buyer will wish to finance the prepayment, either at the point it is made or at a later time, to increase the amount of prepayments it can make available and therefore secure more supply for its trading desk.

Financing – key provisions

If a related financing is being arranged to fund the prepayment, the finance providers will have a keen interest in many of the points outlined above. Key issues that may affect the bankability of the transaction include the following:

- **Back-to-back terms**: It is critical to ensure that delivery and amortisation terms in the commercial contract and prepayment agreement (discussed above) match with the repayment terms of the financing.
- **Assignability**: Depending on the financing structure being used, it may also be important to ensure that the commercial contract and the prepayment agreement can be assigned by way of security to the finance providers.
- **Governing law and enforcement**: The governing law and dispute resolution mechanics should match up across the commercial contract, prepayment agreement and (to the extent possible) the financing documentation, so that any dispute can be dealt with efficiently in a single forum.

Financing options

Two main financing options are used in prepayment transactions: loans and sub-participations. Both of these can be put in place up front, with the proceeds used to fund the original prepayment, or the buyer can fund the prepayment from its own cash first and arrange financing later to free up balance sheet for deployment on other prepayments.

The key features of each option are summarised below.

Loans

- **Borrower**: The buyer arranges a loan to fund the prepayment. The buyer itself is the borrower under the loan, and this can be either the trading house arranging the transaction or a wholly owned special purpose company (SPC). Sometimes, where the finance providers are comfortable with the credit and performance history of the supplier, the buyer will be an SPC established for the transaction in question.
- **Purpose**: The purpose of the loan is to make the prepayment and pay any associated costs and expenses.
- **Credit support**: Usually the lenders will take security over the prepayment agreement and the commercial contract so they can step in and obtain payment or delivery directly from the supplier in the event of the buyer's insolvency or if the loan goes into default for other reasons and (in the view of the lenders) the buyer is not acting in their best interests.
- **Buyer/Borrower liability**: Buyer liability can give rise to a number of issues, as the starting point in the loan market is that the buyer is generally required to repay the loan in all circumstances, even if the suppler does not deliver the product and the buyer cannot obtain a refund of the prepayment from the supplier.
    - However, where the buyer is an entity of substance, it is possible to structure the loan on a limited recourse basis, so the buyer is obliged to repay only to the extent it receives delivery or refund of the prepayment under the prepayment agreement. In these types of transactions, the lenders mainly have recourse to the seller that needs to deliver the commodity flow to the buyer/borrower.
    - This limited recourse structure can give rise to complex issues which need careful review. Points to consider include liability for misrepresentation, future changes in tax which require indemnification or gross-up, and indemnities for lender costs, including any enforcement costs. Finance providers will want to understand how these will be funded if recourse to the buyer is limited and the supplier does not perform its obligations. There are various solutions to these issues, which are generally tailored to the specific transaction.
    - In some cases, the buyer is fully liable for a small portion of the loan, with repayment of the remaining amount being contingent on the buyer receiving delivery or a refund under the prepayment agreement. The buyer may also remain fully liable for the loan in specific circumstances, including buyer repudiation of the prepayment agreement or commercial contract and in some cases where there is a quality dispute in relation to the product or a failure of the buyer to make necessary claims under any credit insurance.
- **Supplier indemnities**: Where the financing is primarily put in place as a fundamental aspect of the transaction for the supplier's benefit, the supplier may give indemnities against these costs in favour of the buyer in the prepayment agreement.
- **Hedging:** The prepayment agreement is structured so that the deliveries are sufficient to fully amortise the prepayments notwithstanding the fluctuation in the commodity price (or, in a worst-case, require that the seller refund any unamortised portion of the prepayment). Consequently, hedges specific to the prepayment transaction are usually not put in place by buyers that can bear the risk of market-based pricing. However, if the buyer is an SPC as mentioned above, commodity hedges may be required in order to mitigate the price risk, such as in the case where bonds are issued to finance the prepayment. While hedging may increase

the cost of the overall transaction, it also provides opportunities for more companies to provide prepayment facilities beyond commodity trading houses or other companies with large commodity trading desks.

- **Multiple lenders**: On the plus side, it is easy to bring in multiple lenders to finance a prepayment through a loan, because the syndicated loan product is widely accepted in the market and there are standard terms for decision-making and distribution of payments. This makes it easier to raise higher amounts of debt for larger prepayments.

Sub-participation

- **Types of sub-participation**: Sub-participation can be arranged on a funded or unfunded (risk participation) basis. Under a funded sub-participation, the participant pays the buyer a portion of the prepayment in cash at the time the sub-participation is entered into. Under a risk participation, the participant does not pay the buyer in cash up front, but only when the buyer suffers a loss due to the failure of the supplier to deliver product or refund the prepayment in accordance with the prepayment agreement.

- **Scope of sub-participations**: Under both types of sub-participation, the participant does not typically provide 100% of the funding or risk coverage, as it wants the buyer to retain some risk on its own books and have a stake in the transaction. Sometimes the sub-participation documentation contains an express stipulation of the amount of exposure the buyer must retain, which cannot be subject to any form of credit support, including any other sub-participation, credit insurance, or credit default swap.

- **'Pass-through basis'**: Generally sub-participations are structured on a 'pass-through' basis. Under a funded participation, the buyer pays to the participant its percentage share of each amortisation of the prepayment and the related interest margin. Under a risk participation, the buyer pays to the participant its percentage share of the interest margin, and the amount of risk cover that the participant provides is reduced by its percentage share of each amortisation of the prepayment.

- **Limited recourse**: In general, sub-participations are limited recourse, because the buyer is only obliged to pay the participant to the extent the prepayment is amortised and the interest margin is received. This often makes sub-participation an attractive and flexible financing option for buyers.

- **Multiple sub-participants**: Unlike loans, sub-participations are typically entered into with a single finance provider, and are more difficult to use when seeking financing from multiple providers as there is no 'market standard' for decision-making, distribution of payments and other matters that need to be regulated in a multi-party financing.

It is possible to document a *syndicated* sub-participation, with an agent to represent the finance providers and drawing on loan-style provisions for decision-making and payments. However, a number of bespoke issues need to be considered including the extent of any veto or control rights the finance providers may have in respect of decisions to be made by the buyer in respect of the commercial contract and the prepayment agreement and how these are to be exercised.

Credit support

Finance providers may require credit support under both types of financing structures, though it is more common in loan transactions than funded participations and is not required in the case of risk participations.

Typical collateral requirements include:

- a security assignment of (i) the buyer's rights under the commercial contract and the prepayment agreement and/or (ii) to the extent the buyer has the benefit of any other credit support for the obligations of the supplier (such as credit insurance, bank guarantees or SBLCs), the buyer's rights under these credit support agreements; and
- security over one or more bank accounts into which the buyer receives (i) proceeds of sales to end buyers, (ii) any refund of the prepayment from the supplier and/or (iii) interest payments from the supplier.

Security can be taken over goods in transit, through custody arrangements in relation to the shipping documents, which may be routed through a representative of the finance providers rather than being held by the buyer. In addition, for a loan transaction using an SPC as buyer/borrower, security may be taken over the shares and other assets of the SPC.

Alternative Source of Financing for E&P companies

As mentioned above, supplier s may find prepayment transactions to be more cost-effective solutions to traditional bank financing and more readily accessible than the equity capital or bond markets. For example, U.S. exploration and production (E&P) companies are facing challenges to liquidity as borrowing base redeterminations under traditional reserve-based credit facilities (RBLs) result in decreased availability or even borrowing base deficiencies. Similarly, access to the public debt and equity markets has been constrained for many U.S. E&P companies.

Prepayment transactions may offer an alternative source of financing for E&P companies with lower cost of funds and transactional costs. Depending upon the seller's creditworthiness, as with an RBL the purchaser may require a lien on the E&P company's oil and gas properties in order to secure the seller's obligations under the prepayment agreement. In the U.S. one would look to state law as to the requirements of obtaining a lien on the E&P company's interests in the oil and gas leases and interests, the production therefrom and the proceeds of such production. In addition, the prepayment agreement may include affirmative and negative covenants, including financial covenants, and reporting requirements similar to an RBL. However, unlike an RBL, a prepayment transaction may also offer the supplier the ability to manage commodity price fluctuations. For instance, if the agreed upon market benchmark price (such as WTI) falls, then the agreement may allow the supplier to deliver more volumes at the lower benchmark price resulting in the supplier receiving the same economic return.

Although not as common, the creditworthiness of the E&P company may be such that the purchaser requires collateral but the E&P company is not able to pledge its oil and gas properties, e.g., if the seller has a concession from a foreign government to explore for and produce state-owned oil or gas. In such cases, collateral could be comprised of other assets of the seller, including its share of oil and gas production after extraction (in pipelines, storage facilities, tanks, etc.) and/or a lien on the account into which the prepayments are made and revenues are collected. In some cases, the collateral package is enhanced by a lien or security assignment over the contractual rights of the seller and/or a pledge of the shares of the seller. In these instances, the law of the relevant jurisdiction(s) would govern the types of assets that could serve as collateral and how to obtain a lien on such assets.

United States Bankruptcy Considerations

As with any financing transaction, prepayment transactions present inherent risks in the instance of a supplier's insolvency – and in no context is it more critical for the buyer to have obtained a security interest in the supplier's assets. After filing for bankruptcy protection, the "debtor" may choose to reject executory contracts at its election during the course of the case. While the U.S. Bankruptcy Code does not define the term executory contract, traditionally it is interpreted broadly to include any contract in which material performance obligations remain on both sides. During this option period, the non-debtor counterparty to the contract must continue to perform according to the terms of the contract and only upon a rejection determination do the obligations of both parties cease. Importantly, the supplier will not be obligated to return the prepayment. Instead the rejection is treated as a breach of the contract which gives rise to unsecured damages claims that puts the counterparty on par with the debtor's other unsecured creditors, often resulting in recoveries on the contract at only a fraction of the face amount. Thus, a buyer in a unsecured prepayment arrangement is vulnerable to losing the full value of its prepayment in a bankruptcy; however, if the buyer has a perfected security interest, it will jump the line of unsecured creditors (although not other secured creditors, depending on priority and perfection) and be more likely to be made whole.

While the debtor may elect to reject its executory contracts, the "automatic stay" under the Bankruptcy Code prevents creditors from unilaterally cancelling or terminating these contracts without permission from the bankruptcy court. However, there are protections for specific creditors if the prepayment transaction is classified as a commodities or forward contract. Under the expansive definitions of commodities and forward contracts in the Bankruptcy Code, ordinary commodity supply contracts arguably fall within these definitions, although bankruptcy courts have provided little guidance on the matter. The Bankruptcy Code protects these creditor counterparties from certain avoidance actions and provides that parties to these contracts may "liquidate" those agreements upon the commencement of bankruptcy – an exception to the general automatic stay rule – so long as the underlying agreements allow for liquidation. Notably, the contracting party is still limited to only the rights that it may have under the contract itself or applicable state law, and what exactly liquidating the contract might mean would be subject to interpretation by the applicable bankruptcy court.

In a prepayment transaction where there may be a separate commercial contract, prepayment agreement and related financing, the supplier may determine to reject the commercial contract and prepayment agreement since it is a direct party to those contracts and they will be considered a part of the debtor's "estate" subject to the restrictions and limitations of the Bankruptcy Code. However, the related financing arrangement between the buyer and third-party financier may remain outside of the bankruptcy process. Particularly in a sub-participant arrangement, likely just the buyer will be determined to have a debtor-creditor relationship with the supplier and the sub-participant may not have standing to enforce its rights in front of the bankruptcy court, instead forced to rely on the buyer to represent its interests. As a result, any third-party financier will want to be aware of the contractual rights and remedies available to it in the case of the supplier's insolvency. Not being subject to the debtor's bankruptcy case is beneficial to the financier if the contract is on a full recourse basis, as the buyer will still be on the hook for its loan obligations and the sub-participant may still take action against the buyer under the loan documents without permission from the bankruptcy court.

Contacts

Andrew Brereton

Partner
Corporate, Finance and Investments

Singapore: +65 6303 6036
Cell: +65 9766 1469
abrereton@kslaw.com

Kim Cagle

Partner
Corporate, Finance and Investments

Houston: +1 713 276 7393
Cell: + 1 713 397 5302
kcagle@kslaw.com

Matthew Warren

Partner
Corporate, Finance and Investments

Chicago: +1 312 764 6921
Houston: +1 713 276 7371
Cell: +1 309 256 6649
mwarren@kslaw.com

Soumya Bhagavatula

Associate
Corporate, Finance and Investments

Singapore: +65 6303 6033
sbhagavatula@kslaw.com

Lindsey Henrikson

Associate
Corporate, Finance and Investments

Chicago: +1 312 764 6924
lhenrikson@kslaw.com

ABOUT KING & SPALDING

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 1,100 lawyers in 22 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality, and dedication to understanding the business and culture of its clients.