Structuring Financings Using Physical Commodities and Documents Representing Them – Some Issues and Potential Solutions

Simon Cook
Partner, Sullivan

February 25 2021

SULLIVAN & WORCESTER

What this talk will cover

- Brief overview of structuring and risks
- Lending based structures
  - Risks, issues and potential solutions/mitigation
  - Role of collateral managers, warehouse operators and other third parties
  - Security
- Bank/SPV repo structures
  - Owner issues
  - True sale
  - Title transfer
- Looking forward
  - E-B/Ls and E-Warehouse Receipts

Structuring is all about risk

- Identify
- Evaluate
- Eliminate, reduce, mitigate, allocate
- AIM: Balance parties' expectations and needs

Lending structures – commonality and differences

- PXF, prepayment and tolling vs Pre/post-shipment and warehouse finance
  - How do they work?
  - What about the goods?
  - What risks apply?
    - Differences

Sullivan
SULLIVAN & WORCESTER

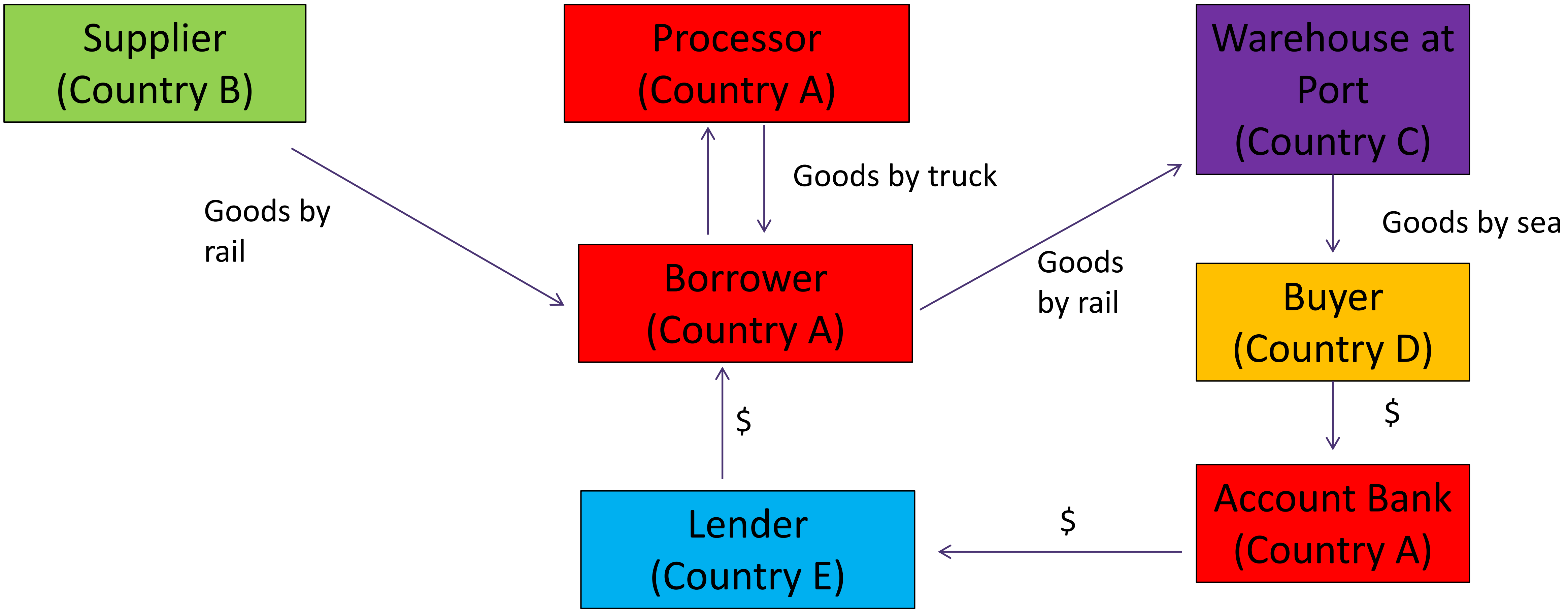
Common risks and how to mitigate?

- Some common risks
  - Payment/Price risk
  - Risk stages associated with goods
    - Storage
    - Transport
    - Processing
- Potential mitigants
  - Third parties?
    - Warehouse operators
    - Collateral managers/logistics service providers
  - Security?
  - Insurance?
  - Finance agreement terms?

Who is involved?

- Most transactions are going to involve third parties including:
  - Transport companies
  - Freight forwarders
  - Warehouse owners
  - Collateral managers or stock monitors
  - Account banks
- In addition to the practical role they play, these parties may be relevant to:
  - Competing security interests over the secured assets
  - Perfection of the security holder’s security
  - Monitoring and control of the secured assets

Example trade transaction (2)



Storing the goods (1)

- Types of warehouse
  - Private?
  - Public/regulated?

- Issues around storing goods
  - Fraud
  - Interference/lack of control
  - Loss, deterioration etc

- Who is going to be responsible for the goods?

Storing the goods (2)

- What should financers be looking for?
  - Satisfactory agreement
  - Monitoring and control
  - Insurance
  - Security

Making sure your security 'bites' on the assets to be secured

- Security giver must be the owner
- Is the type of security appropriate for the asset type?
- Does the security document identify the asset adequately and accurately?
- Does the asset exist and is it where you think it is?
- Level of control required to maintain security
  - Segregation
  - Commingling
  - Transformation
- Who (apart from the owner) could have or obtain priority rights over the asset?
- Do not underestimate the importance of due diligence onshore
- Due diligence can be complex and time-consuming and can require local law advice

Potential issues with security over goods

- Proprietary vs possessory interests
- What is possession?
  - Attornment
  - Constructive possession
- Fungible goods
- Commingled goods
- Future goods
- Liens trust receipts, bills of lading and passing of title/risk
- Warehouse receipts/financing

Future, commingled and fungible assets

Future assets

- Validity of pledge over future assets differs greatly between jurisdictions.

Fungible and commingled goods

- Fungible goods are often stored in bulk and commingled with goods of other depositors
  - Depositor has contractual right to re-delivery of same quantity and quality of goods deposited rather than return of exact goods deposited
  - Requires warehouse operator / collateral manager to have appropriate processing and grading capabilities

Liens, trust receipts, bills of lading and passing of title/payment obligations (1)

- Liens
  - No right of sale
  - Unlikely to be part of a lender's security package
  - BUT, may be relevant in the context of third parties involved in transaction

- Trust receipts
  - Need for a pledge
  - What does it achieve?
  - Recognition of trusts necessary?

Liens, trust receipts, bills of lading and passing of title/payment obligations (2)

- Bills of lading
  - How do they work?
  - Documents of title?

- Title/risk passing and payment terms
  - Why important for security?
  - When does it pass?
    - Documentation
    - Retention?

Nature of warehouse receipts

- Warehouse receipts, warrants, holding certificates
- A document issued by a warehouse operator, collateral manager, or other storage operator that provides proof or evidence of existence and ownership of commodities stored in a warehouse or other storage depository or evidence that a collateral manager is holding commodities under the terms of a collateral management agreement
- A warehouse receipt may be:
  - A document of title, or not
  - Negotiable or non-negotiable
  - Transferable or non-transferable
  - Receipt confirming deposit of goods
  - Single / dual receipt
- Format
  - Legal requirements for negotiability / transferability
  - Format prescribed by law or public / private regulation

Financing using warehouse receipts

- A type of warehouse financing where the secured commodity is represented by a warehouse receipt
- Holding a warehouse receipt should give the lender, in the case of a default, recourse to the sale of the underlying commodity to obtain repayment of the loan
- Goods are stored in a licensed warehouse and a warehouse receipt issued and a pledge is created over the goods and warehouse receipt which is delivered to financier to perfect the collateral
- Rights of financier against warehouse operator and other parties who might claim interest in goods
- Financier should be able to dispose of the financed goods without court proceedings

Warehouse receipt systems

- Regulated systems that provide for financing of goods using warehouse receipts as collateral
- Systems might be created through legislative reform or arise through voluntary systems of regulation
- Key elements for a warehouse receipt financing system:
  - Warehouse receipt specific laws / rules
    - Rights and obligations of the parties
    - Enforceability of collateral
    - Registration of financier’s interest / collateral
  - Regulation, licensing and insurance of warehouses
  - System to guarantee performance of warehouses
    - Financier protected from potential fraud or negligent behaviour of warehouse operator (outturn guarantee, indemnity system)
    - Funding of guarantee / indemnity system

Is enforcement of security always the answer?

- Things you hear: “Security means my deal is better. Security means that if the transaction goes wrong I get paid, doesn’t it?”

- Costs and delay

- What about alternatives?

Use the documents

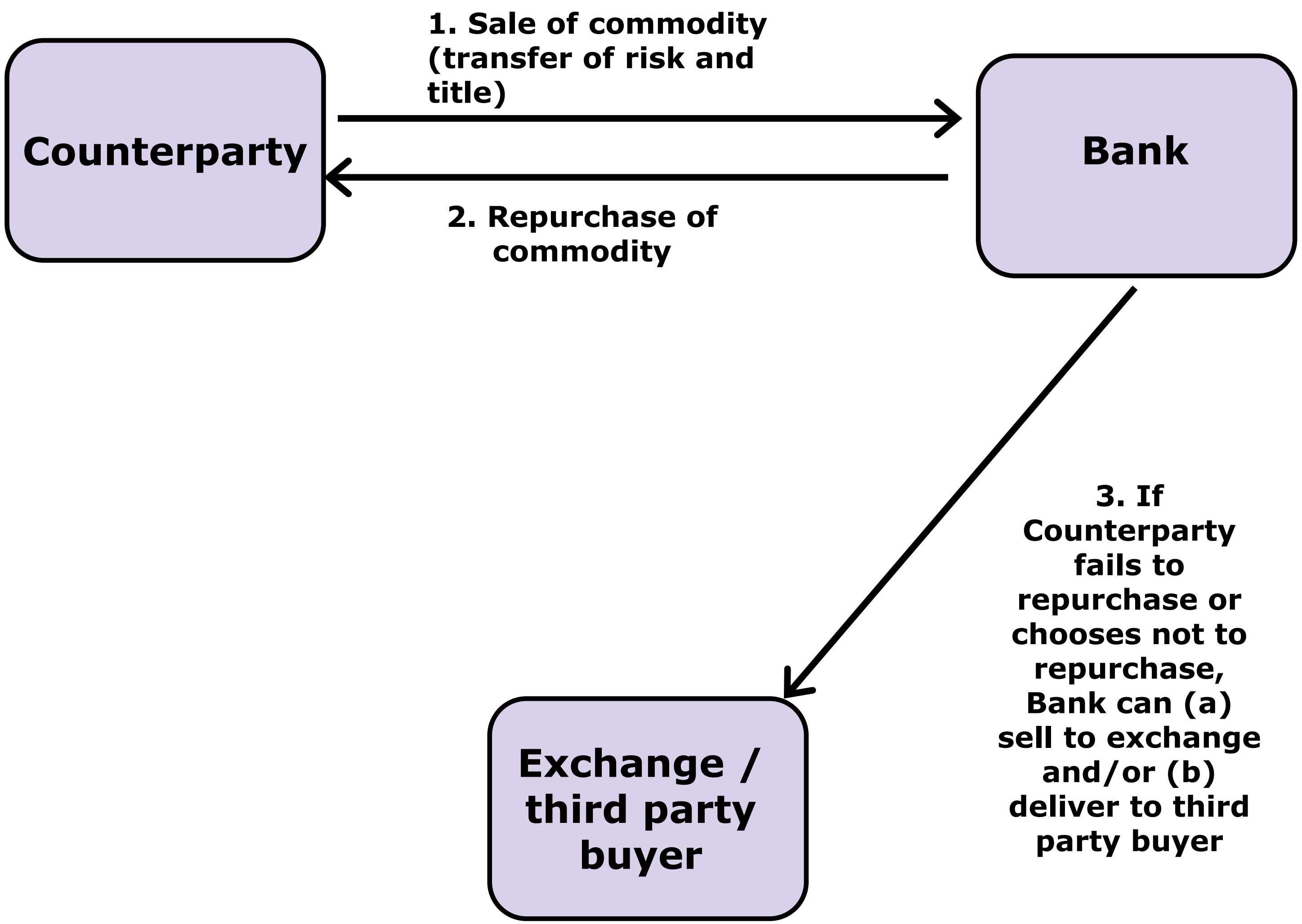
- Look at control of goods in asset conversion cycle
- Have third parties locked in to help
- Agreements should reflect how the transaction should proceed
- Much better to secure support from all parties to cover delays and problems
  - Have provisions to cover problems
  - Defaults and remedies not necessarily the solution
- Lender to have “rights” under all documents
  - Keep the flow going
  - Avoid anything that interrupts flow

Introduction to the repo

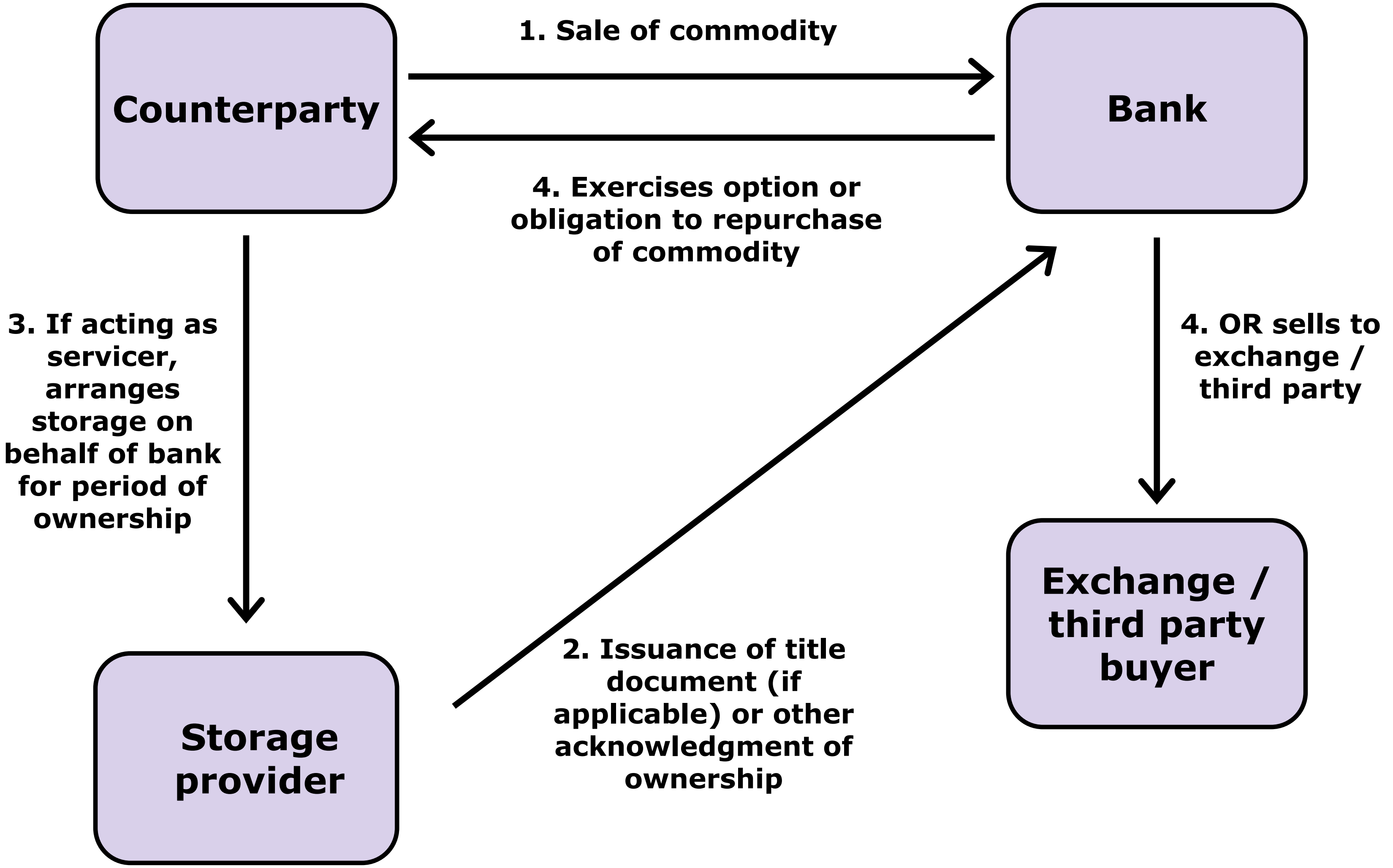
- What is a commodity repo?
  - Sale and purchase of commodity with a Counterparty
  - Counterparty transfers title to the Financial Institution. Refer to “Banks” in this presentation but there are other financial institutions that are also engaged in this type of business

- Why are commodity repos used?
  - Clients are looking for funding but may be limited internally by borrowing limits, etc.
  - Off-balance sheet treatment for Counterparty
  - Ownership of commodity may be easier to recover losses than enforcing security?
  - Ownership “respected” more than secured creditors in many jurisdictions

Basic structure of repurchase transaction



Structure of repurchase transaction – where goods in warehouse



Structures and problems/risks for banks? (1)

- Ownership
  - Financier owns itself (few lenders want to take risks of owning unless can mitigate)
  - SPV owner (see below)

- What is an SPV?
  - Set up only for the transaction in question
  - Limited recourse
  - In-house/orphan?
  - Costs, shadow liability

- What are SPVs used for?
  - Ownership of product
  - Ring-fencing of assets/insolvency of true borrower
  - Assist with avoiding exchange controls
  - Standby purchaser

Structures and problems/risks for banks? (2)

- They are owner of commodity and take risks as well as rewards associated with ownership, e.g.
  - Price fluctuation
  - Delivery/storage costs
  - Insurance obligations
  - Third party claims (eg oil spillage/environmental)
- But, these risks can be mitigated in the way any owner of goods protects itself e.g.
  - Hedge price
  - Collateral manager
  - Pass through costs
- Is it a true sale/recharacterisation risk (effect?)

True sale and re-characterisation

- Repos are structured as a sale and re-purchase of goods
- Risk is that transaction will be characterised as a loan secured on the goods
  - Bank will be deemed not to own the goods
  - Commodity will form part of counterparty's estate on insolvency
  - May be subject to priority claims and/or competing claims of other creditors
  - Bank may not have valid security if required formalities not complied with at time transaction was entered into
- *Welsh Development Agency v. Export Finance Co. Ltd [1992]* – leading English case

"It is necessary therefore to look at the provisions in the master agreement as a whole to decide whether in substance it amounts to an agreement for the sale of goods or only to a mortgage or charge on goods and their proceeds" (Dillon LJ)

True sale considerations

- Take all steps to make it a sale BUT risks of ownership
- Solutions?
  - Fall back security may arise automatically – local due diligence into requirements for valid security interest is important
  - Structure the transaction to reduce re-characterisation risk (ability to do this will depend on commercial structure and/or jurisdictions in question)
- The risk of a sale of goods being re-characterised as a loan under English law can be mitigated structurally
- Purchaser should act as any owner of those goods would AND not as a secured party trying to divest itself of any risk in the transaction goods

Structuring considerations

- Some points to consider commercially to achieve a better argument for a true sale:
  - **Intention:** the genuine intention of the parties is to effect a sale – this is a key consideration under English law
  - **Option / obligation:** the seller has an option to repurchase the goods (rather than being obliged to repurchase)
  - **Identity of parties:** the goods are purchased from and then sold to different entities (even if same group)
  - **Insurance:** the bank purchaser obtains its own insurance or is co-insured while it is owner of the goods (rather than just being loss payee)
  - **Relationship with storage provider:** during Bank's ownership, the Bank has a direct relationship with a storage provider to store its goods, and/or the storage provider will only act on direct instructions from the Bank
  - **Price risk:** the bank purchaser takes the risk in the price of the goods it has purchased (but may mitigate this through separate hedging arrangements)
  - **Damage/loss risk:** the bank purchaser takes the risk of damage to the goods occurring (although this may reasonably be mitigated with insurance or properly structured indemnities)

Transfer of title

- Important that title in the goods passes from Counterparty to Bank
- Bank should get title documents (if they exist for the relevant goods in the jurisdiction in question) or best evidence of title, in its name
  - Look at what title documents are available in jurisdiction where goods are located
- *Lex situs* rule: the laws of the jurisdiction where the relevant asset is situated at the time that a property interest is created determines whether such interest is effectively created over that asset
- Possible scenarios in different jurisdictions:
  - Transfer of title occurs at moment agreed between parties
  - Transfer of title occurs on physical delivery of the goods, or of a document of title (such as a warehouse receipt) that represents the goods
  - Transfer of title occurs when warehouseman enters interest on register (for example, where transfer of title occurs in a licensed/regulated warehouse)

Some jurisdictional issues to consider

- We have looked into the true sale position in a number of jurisdictions

- Some interesting issues:
  - Substance over form or vice versa
  - Back-up security possible
  - Do jurisdictions follow the true sale analysis of the governing law of the sale or look at local law issues only for transfer of title
  - True sale analysis may not be straightforward in some jurisdictions

- Next, a look forward…

Electronic bills of lading (1)

- Requirements for electronic bills of lading (e-B/Ls) to work:
  - Technological development for secure transfer of data
  - Adoption of technology
  - Legal regime
- Electronic bills of lading are becoming more widely recognised and technology has advanced significantly but challenges remain
- Whilst it is common for most jurisdictions to have some form of legislation that could be applied or interpreted to apply to eB/Ls it was the words of Lord Justice Clarke in *Glencore Limited* v *MSC Mediterranean Shipping Company* which provides a good summary of the position of eB/Ls not only in the UK but in the wider foreign markets:
  - "[the] *system… is valid…but, if that is to be done, it requires, in my view, either appropriate contractual provision or statutory imposition."*
- Legal regime
  - UNCITRAL model law
  - National legislation

Electronic bills of lading (2)

- Legal issues:
  - Need to be in same position as holder of paper bill of lading would be
  - eB/Ls must be unique and secure and held by one holder at a time
  - Adoption of technology
  - Legal regime
- Carrier acknowledgement help?
- Club arrangements?
- Work in progress

Electronic warehouse receipts

- National warehouse receipt programmes
  - Regulated and licensed
  - Commodity exchanges
  - LME electronic regime
  - BUT, no widespread availability of electronic warehouse receipts
- UNCTRAL and UNIDROIT model law?

Simon Cook
Partner

Simon Cook is a partner in the Trade & Export Finance Group in the London office of Sullivan & Worcester UK LLP. He has experience in a wide variety of banking and finance transactions, including in particular in relation to structured trade finance, trade finance, project finance, invoice discounting facilities and borrowing-base facilities in Africa, the Middle East, Asia and the CIS. His work in the structured trade area covers a range of pre-export and prepayment financings acting for both lenders and borrowers notably in oil, telecoms, soft commodities and metals sectors with particular experience in Africa and the Middle East.

Simon has worked and travelled extensively in Africa and the Middle East, having spent over three and a half years in Dubai. He has participated in a number of structured trade finance and project finance conferences and seminars throughout Europe, the Middle East and Africa, including speaking at conferences on PPP in South Africa; on project finance and structured trade finance at Afrexim's annual structured finance conferences in Cairo, Ghana and South Africa; and at structured trade finance seminars and general finance in London, Paris, Lisbon, Geneva, South Africa, Zambia, Kenya, Uganda, Ghana and Dubai.

Sullivan & Worcester UK LLP
Tower 42
25 Old Broad Street
London EC2N 1HQ
T +44 (0)20 7448 1002
M +44 (0)7783 731247
F +44 (0)20 7900 3472
scook@sullivanlaw.com

Awards & Recognition

Global Trade Review "Best Trade Finance Law Firm" 2020 and 2019
Global Trade Review (GTR) named Sullivan "Best Trade Finance Law Firm" at their GTR Leaders in Trade Awards in 2020 and 2019

Trade Finance Magazine "Best Law Firm of the Year" 2019
Trade Finance Magazine named Sullivan "Best Law Firm of the Year" at its Awards for Excellence, 2019

Trade Finance Global "Best Trade Finance Law Firm" 2019
Sullivan was named "Best Trade Finance Law Firm" 2019 by *Trade Finance Global* at its International Trade Finance Awards, 2019

The Legal 500 UK, 2021
Sullivan is ranked in Tier 1 for Trade Finance by *The Legal 500 UK, 2021* for the seventh year running
Partner Geoffrey Wynne included as Trade Finance Leading Individual in the "Hall of Fame"

Simon Cook and Mark Norris are both recognised as Leading Individuals and Hannah Fearn as a Rising Star

Sullivan is also ranked for Commercial Litigation - Mid-market by *The Legal 500 UK, 2021*

Chambers UK, 2021
Chambers UK, 2021 ranks Sullivan in Commodities:Trade Finance (UK-wide)
Partners Geoffrey Wynne and Simon Cook are Ranked Lawyers in Tier 1 and Tier 2 respectively by *Chambers UK, 2021*

TFR Fellowship Award 2017
Trade & Forfaiting Review (TFR) honoured Geoffrey Wynne with the TFR Fellowship Award in its 2017 TFR Excellence Awards

Suggestions for future topics and webinar dates

Please feel free to send any suggestions for future topics to London Events (londonevents@sullivanlaw.com)

Webinar dates for 2021

- Thursday 25 March
- Thursday 22 April
- Thursday 27 May
- Thursday 24 June

Boston
One Post Office Square
Boston, MA 02109
+1 (617) 338-2800

London
Tower 42
25 Old Broad Street
London EC2N 1HQ
+44 (0)20 7448 1000

New York
1633 Broadway
New York, NY 10019
+1 (212) 660-3000

Washington, DC
1666 K Street, NW
Washington, DC 20006
+1 (202) 775-1200

Tel Aviv
28 HaArba'a Street, HaArba'a Towers
North Tower, 35th Floor
Tel Aviv 6473925
+972 74 7580480

sullivanlaw.com

@sullivanlaw

What's Your Next?

Move forward with Sullivan

Sullivan
SULLIVAN & WORCESTER