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Trade Finance Quarterly Insight

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Trade Finance Quarterly Insight

Welcome to the June edition of this quarterly. The first two articles of the edition examine some existing but increasingly useful and valuable tools that can be deployed in the world of trade financing to help parties navigate their way through the current uncertainty of a post-pandemic world. In the first article, we consider whether to' trust or not to trust' in the context of escrow arrangements, which are valuable tools in supply chain finance, to ensure both parties have absolute trust in their proposed contractual arrangement, where existing supply chains may be disrupted and companies are forced to transact with unknown (and thus untrusted) counterparties. In the second article, we explore how trade receivables securitisation may be an attractive option to companies seeking to maximise their balance sheets in the current climate.

Also featured is an article that was first published in the May 2021 edition of Butterworths Journal of International Banking and Financial Law, which examines the complete security package that is needed to ensure that a commodity financier is as well protected as they possibly can be. The backdrop to this article is the fact that COVID-19 lockdowns have disrupted commodity transactions and consequential enhanced oversight of borrowers' businesses has uncovered fraudulent activities that have brought to the forefront weaknesses in arrangements that might otherwise have gone unnoticed or have been considered sufficiently low risk not to be a concern. In response prudent transaction parties may find themselves needing to revisit previously settled approaches to commodity finance security packages and perhaps adjusting where their cost benefit analysis falls.

The concluding article in this edition focuses on the intricate and very topical issue of diverging obligations between Western sanctions and Chinese national security laws that do not show any signs of relenting. The article sets the scene with the legal background before considering some of the strategies for navigating US and Chinese sanctions and related counter-measures.

Our regular Sanctions and Export Controls update page also features some interesting reads on, including amongst others, the Recast EU Dual-Use Regulation that is due to come in to force on 9 September 2021; the US Executive Order amending the ban on US persons purchasing securities of certain Chinese companies and the US revocation of Executive Orders banning certain Chinese software applications; and the EU Advocate-General's opinion signalling a strict interpretation of the EU Blocking Regulation. There is also a link to the Baker McKenzie blog of the same title.

Finally, we outline our exciting partnership with the LMA and our sponsorship of their Developing Markets Virtual Conference earlier this year.

As always we hope that you enjoy this edition of Baker McKenzie's Trade Finance Quarterly Insight and invite you to reach out to any of the contributors or indeed anyone else in the team (please see enclosed Key Contacts) should you wish to discuss any of the issues covered in this edition or have any other trade finance related queries.

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To trust or not to trust?

Editor Highlights

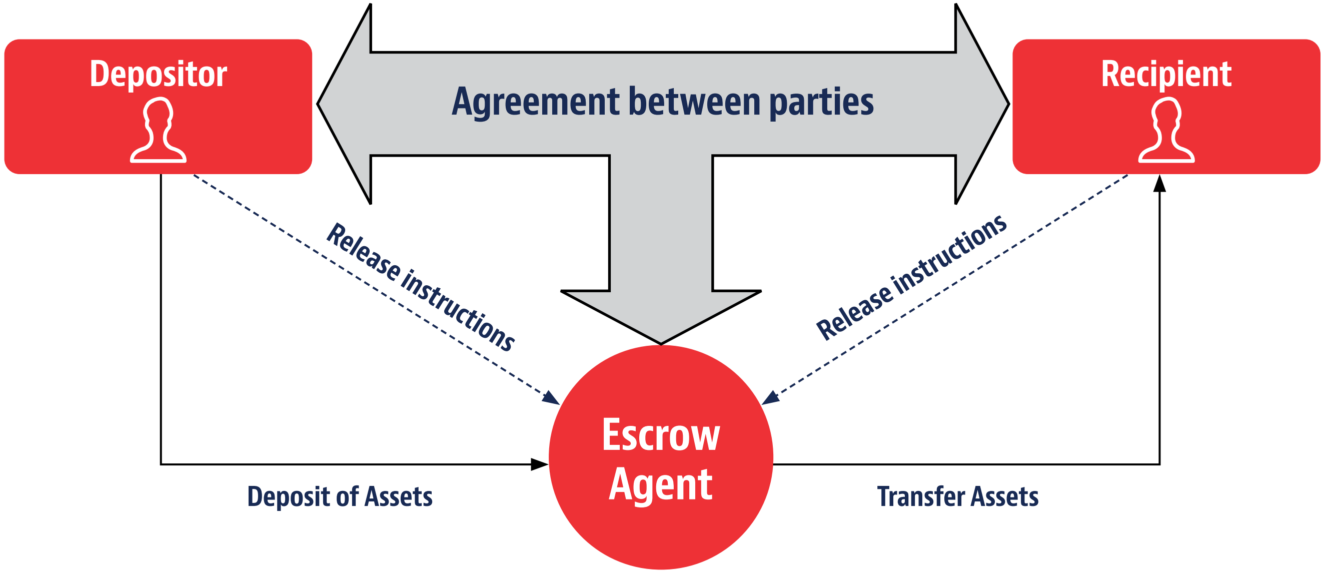
- Escrow arrangements are a valuable tool, particularly in the current environment, to ensure parties have absolute trust in their proposed contractual arrangement.
- Certainty in these arrangements is key - parties should ensure there are clear, detailed and carefully drafted provisions in a stand-alone agreement.
- Although the terms may be used interchangeably an Escrow Agent and a Trustee are distinct concepts - which concept is relevant for any particular escrow arrangement requires careful consideration and agreement between all the parties.

An escrow arrangement can be a useful tool in supply chain finance or trade financing arrangements. It allows the contracting parties to mitigate timing and counterparty risks and to ring-fence funds, pending receipt of the goods or services. In the current climate, where existing supply chains are disrupted and companies are forced to transact with unknown (and thus untrusted) counterparties, it is a valuable tool to ensure both parties have absolute trust in their proposed contractual arrangement.

On the face of it, an escrow arrangement is relatively straightforward. The primary contracting parties (the Depositor, the Recipient and, together, the **Contracting Parties**) source an independent, third-party agent (the **Agent**) to keep safe cash, assets or documents. A set of pre-agreed 'release' conditions are agreed, and the Agent will release the cash, assets or documents when those conditions are met (see Figure 1, below):

Most Contracting Parties will appoint an Agent that is either a trusted market counterparty or a financial institution providing escrow services. These third-party Agents will typically have their own 'standard escrow terms' governing the relationship with the Contracting Parties. However, the Contracting Parties will need to carefully scrutinise the agreement to ensure that it properly addresses their expectations. This is of particular importance on large, complex transactions where the Agent will have limited (if any) visibility on any of the underlying documents or policies governing the relationship between the Contracting Parties. In all instances, the role of the Agent should be limited to

Figure 1: Asset transferral



what has been explicitly set out in the contract governing the escrow arrangement (the **Agreement**).

Having set the scene, what are some of the key considerations for market practitioners when considering an escrow arrangement?

AN AGENT OR A TRUSTEE?

In acting as a non-biased third party protecting the interests of the Contracting Parties, the Agent is often considered a trustee in the transaction. It is a common misconception that a trust and an escrow arrangement amount to the same thing (and the terms are often used interchangeably), but there is an important difference between the two.

The Agent is an impartial party independent from both of the Contracting Parties. It simply holds money, documents and other property as a matter of contract law based on terms outlined in the Agreement. Monies or securities received by the Agent will be held in a segregated account, albeit there is the possibility that funds in that account will be commingled.

In essence, the Agent works as a proctor on behalf of the contract itself, making sure the terms of the contract are followed and the subject matter of the escrow arrangement is released once the relevant conditions have been met. As a result, the Agent's obligations will be determined by the terms of the contractual agreement, with its responsibilities and duties due to the Depositor and the Recipient strictly defined. It is a very narrow, limited relationship.

Conversely, a trustee will have fiduciary duties owed to whichever party is described as the beneficiary of the trust arrangement. For that reason, the Depositor will typically request that the Agent declare itself as the Depositor's trustee in respect of any rights to receive escrow monies and to hold all amounts received for the benefit of the Depositor up to the amount of principal (and interest) due under the underlying transaction. Following the declaration of the trust, the Agent will be the legal owner of the funds in the bank account/applicable assets, with the Depositor retaining a beneficial interest in the funds/assets. The Agent would also be subject to a significant body of both common law and statute prescribing the duties owed to the beneficiary[1] (that is to say, the Depositor and/or the Recipient, as the case may be) by a trustee (such as the Agent).

It is therefore critical that each of the Contracting Parties and the Agent understand whether a trust has been established over the deposited collateral, in order to properly understand the manner in which the assets are being held by the Agent and the extent of the duties and obligations owed by the Agent to the Contracting Parties.

CERTAINTY, CERTAINTY, CERTAINTY

As already highlighted, the Agent is not a party to the underlying arrangement between the Contracting Parties. It is therefore crucial that the Agreement is a stand-alone document that sets out all relevant terms and conditions relating to the deposit and release of the escrow funds or assets, in order to avoid any future misunderstandings. This means ensuring the following are clearly set out.

Subject matter

The exact scope of the assets the subject of the escrow arrangement must be clearly defined without cross-referencing any other documents between the Contracting Parties. This is particularly important if the asset subject to the escrow arrangement is not a fixed cash amount, given there may be additional safe-guarding arrangements that need to be established. Careful consideration needs to be given as to how best to define these assets and any ancillary arrangements that may need to be put in place.

[1] Including (but by no means limited to) the Trustee Act 1925, Recognition of Trusts Act 1987 and the Trustee Act 2000 and the body of common law which dates back as far as *Keech v Sandford* [1726] EWHC J76

All obligations

The Agreement will need to clearly set out what obligations or conditions the assets the subject of the escrow arrangement are intended to cover. It may be the case that funds are deposited until the Depositor satisfies a single condition (such as the supply of goods). However, it is possible that the escrow arrangement covers a number of inter-linked obligations within a supply chain, in which case the Contracting Parties will also need to consider whether it is appropriate to hold all escrow funds in one account or for escrow funds to be held in separate accounts with different escrow amounts and disbursement dates.

Escrow period

There is no set time period for an escrow arrangement. It is possible that the arrangement is established for a relatively short timeframe (for example, funds being held in relation to the delivery of a perishable item) or a much longer period (for example, where incremental payments are made pending the delivery of a high-value product). The document needs to be explicit as to what events will lead to the termination of the escrow arrangement. If there is a longer survival period for certain claims, the Depositor and Recipient will need to consider whether monies should be released at certain milestones, or if the entire deposited amount should be retained until the point at which no obligations remain outstanding.

Pre-conditions to release

The form of the release mechanic will need to be agreed between the parties. There are a number of different approaches that can be taken, and the Contracting Parties will need to consider what is most appropriate in the circumstances. The most common are as follows.

Joint written instructions

The Agent will typically prefer joint written instructions from both Contracting Parties. Properly drafted, joint written instructions should limit ambiguity or conflict. This means including within the Agreement a template release instruction that will include all relevant information, such as the amount to be released, the party to whom the funds should be delivered and account details.

Unilateral instructions

The nature of certain escrow arrangements may require the release instructions to rest in the hands of a single party (for example, in the event of a final, non-appealable court order). In such circumstances, the party who is not providing the unilateral instructions may be given a set amount of time to object before the Agent is obligated to act.

Automatic release

It is possible to construct an agreement whereby the Agent is directed under the terms of the Agreement to release assets upon a certain date. For example, funds held in escrow may be released if the Agent has not been notified of any pending claim or conflict in relation to goods or services supplied. In these circumstances, the Agent would either rely upon notices provided prior to the date of the automatic release or may require one or both of the Contracting Parties to provide a good faith estimate of any amount to be held back from the automatic release.

Authority

Once one has agreed the pre-conditions to release, it is also important to consider who will be the authorised representatives of each Contracting Party to accommodate the Agent's security procedures for any escrow release. This should be pre-agreed from the outset in order to avoid holding up release just when the transaction reaches its most critical juncture.

Duties of the Agent

The Agent has no stake in the outcome, in relation to the underlying arrangement between the Contracting Parties, and will simply look to fulfil its duties as set out in the Agreement. In order to avoid any false expectations on the part of the Contracting Parties as to the performance of the Agent, the duties of the Agent should be very specific. The Agent's role should be to follow instructions only; it will look to disclaim any obligation to advise, recommend or make any investment decisions in relation to the assets the subject of the escrow arrangement.

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Protections of the Agent

The need for clarity extends to the liability of the Agent. The Agent will, understandably, resist any liability incurred in the performance of its duties, other than for direct losses caused by wilful misconduct, fraud or gross negligence (in other words, what has become the market standard approach for agents acting in contracts governed by the laws of England and Wales). Where it is considered liable, the Agent would also seek a cap on its potential liability. As with any agency relationship, the Agent will also require a broad indemnity for any costs it may incur in connection with the escrow arrangement including, for example, the costs of seeking legal advice in connection thereto. Exactly who will provide this indemnity, whether it is the Depositor, Recipient, or the Contracting Parties jointly, and whether the indemnity is provided on a several or a joint-and-several basis should be included within the Agreement. In some cases, the Contracting Parties may agree to allocate their responsibility for losses in accordance with set percentages. If proper care is given to the drafting of the Agreement and the duties of the Agent thereunder, the likelihood of any such indemnity claim will be reduced, which is clearly to the benefit of all parties.

Allocation of the Agent's fees

Who will be responsible for paying the fees of the Agent? The Agreement should document which of the Contracting Parties is responsible for the fees and expenses, or whether the Agent's fees and expenses should be deducted from the escrow account. As an additional protection on top of the indemnity coverage, the Agent may also require a first lien against the escrow account for any such fees and expenses.

Ability of the Agent to resign or assign the agreement

These provisions are often overlooked at the start of an escrow arrangement, but are important to consider from the outset. In particular, if it is envisaged that the escrow arrangement will be in place for any length of time, the Contracting Parties will need to agree with the Agent whether or not it has the ability to resign (and, if so, what notice period is required) and whether any of its rights to compensation or indemnification will be retained following resignation. If resignation is allowed, is it a requirement to have a replacement escrow agent in situ prior to the existing Agent being able to walk away from the relationship? What if the Agent itself becomes insolvent or is downgraded? These issues should be considered by the Contracting Parties from the outset.

CONCLUSION

An escrow arrangement is an incredibly useful tool for counterparties within a supply chain. A properly considered and drafted Agreement that establishes all key issues from the outset can, and should, be an instrument that each of the Contracting Parties and the Agent trust. However, this trust can only be achieved through a rigorous approach to the documentation, enabling all parties to have confidence that the escrow arrangement covers all eventualities and all parties are appropriately protected. Whether that protection is extended such that the Contracting Parties are ultimately beneficiaries of 'a' trust is an entirely different matter. As always, the devil is in the detail, and that detail must be reviewed very carefully.

> **"An escrow arrangement is an incredibly useful tool but its terms do require proper consideration and careful drafting to create an instrument that all parties involved can trust."**
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Trade as an asset class - trade receivables securitisation to the rescue?

Editor Highlights

- Securitisation is a technique designed to monetise income-generating assets, usually involving financing arrangements secured on the cash flows arising from those assets.
- Companies seeking to maximise their balance sheet are viewing securitisation techniques as an increasingly attractive financing option (together with or as an alternative to factoring and other supply chain finance solutions).
- The associated legal, regulatory and compliance burden may be more appropriate for the mid-size or large corporate but recent increased digitilisation in the trade finance sector has prompted the emergence of platforms offering streamlined receivables securitisation solutions enabling smaller entities to participate too.

Receivables resulting from the business activities of operating companies have traditionally been monetised through various techniques, including factoring and supply chain finance solutions.

However, these traditional techniques are not the only tools available to companies wishing to turn receivables arising from trade into immediate liquidity.

Over the years, many different solutions to monetise trade receivables have emerged, the majority of these making use of securitisation technology. As companies navigate the uncertainty of the post-pandemic world, the use of securitisation techniques should become an attractive option to companies seeking to maximise their balance sheet.

What is a trade receivables securitisation?

Securitisation is a technique designed to monetise income-generating assets, usually involving financing arrangements secured on the cash flows arising from those assets. This basic concept is then deployed in a manner tailored to the specific features of the assets and requirements of transaction parties.

Over the years, the securitisation market has developed certain types of structures which are seen to be particularly appropriate for financing trade receivable assets. These structures include asset backed commercial paper (**ABCP**), term securitisation and receivables financing in the context of warehouse transactions with revolving note or loan structures:

- ABCP involves the issuance of short term money market securities (with a maturity typically under 364 days) which are backed by trade receivables. This type of transaction is usually structured as a programme established and managed by a financial entity acting as sponsor that purchases trade receivables from various third-party entities. Some ABCP transactions are structured as "simple, transparent and standardised securitisations" in order to allow institutional investors to benefit from preferential capital treatment when holding ABCP positions, and have, for that reason, become extremely attractive investments;
- Term securitisation (which tends to be more public than the other structures mentioned) will typically involve the issuance of debt securities with maturities in excess of 364 days and which are backed by a revolving pool of trade receivables; and
- Warehouse financing usually entails a lender granting loan finance to a special purpose vehicle borrower secured on a revolving pool of trade receivables, usually structured as a private transaction similar to a bank financing but with more attractive pricing.

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Different structures will attract different types of investors and funders, often resulting in pricing implications for the businesses who wish to finance their trade receivables through securitisation. Whether or not a particular structure is appropriate for a business will depend on the nature of the underlying trade receivables.

How can trade receivables securitisation help?

Trade receivables securitisation may help businesses with trade receivables currently on their balance sheets by providing enhanced liquidity, mitigating the accounting impact of overdue receivables and improving debt ratios (as securitisations generally do not classify as "debt" on a corporates balance sheet).

In addition to the liquidity upsides of monetising future receivables, transferring the economic ownership of certain trade receivables (and therefore the risk associated therewith) may enable businesses to limit the impact of exposure to credit risk relating to their counterparties and assist in managing their accounting and cash flow position, all of which can prove useful in context of the Covid-19 pandemic.

From a business relationship standpoint, securitisation of trade receivables may also allow businesses to keep their relationship with their own clients unchanged, as it is possible that the transfer of economic ownership of the trade receivables may remain undisclosed to the clients (subject to certain considerations and, in particular, the laws governing those trade receivables) and the seller is often allowed to remain responsible for the receivables collection process.

Securitisation may well be available to corporates even when other financing sources are not active (e.g. if banks are unwilling to provide traditional bank debt). There may well be pricing advantages too as securitisation is priced on the expected performance of receivables rather than the corporate's general rating.

How does it work?

In order to benefit from securitisation of trade receivables, businesses will need to sell their trade receivables portfolio to a third party, usually at a discount, to reflect the net present value of the relevant cashflow. The amount of this discount is, as is also the case with factoring and confirming, a matter for commercial discussion with the entities structuring or sponsoring the transaction. It should be noted that certain features may be implemented in transactions in order to mitigate risks and improve pricing, such as taking credit insurance over the pool of trade receivables from a specialised credit insurer or maintaining reserves for certain risks.

Securitisation is a type of non-recourse financing (similar to some types of factoring arrangements), meaning that investors in the debt securities or lenders, as applicable, will typically bear the risk of non-payment and will have no recourse to the seller if there is a non-payment by the obligor under the trade receivables. This non-recourse element is central to securitisation, given the transaction will typically be structured as a sale from the seller to a special purpose vehicle which should be designed to survive any challenges triggered by a potential insolvency of the seller (often called a "**true sale**").

Depending on the type of structure adopted, the associated legal, regulatory and compliance burden may be more appropriate for the mid-size or large corporate than to smaller entities. However, it should be noted that the recent trend of increased digitilisation in the trade finance sector has prompted the emergence of platforms offering streamlined receivables securitisation solutions which enable smaller entities to participate.

What does it take to get started?

Performing comprehensive due diligence on the assets is key to engaging in this type of transaction, since the structural features of the transaction will largely depend on the characteristics of the asset pool.

To the extent that there is a substantial pool of relatively homogeneous income producing assets, a suitable sponsor or structuring entity should be identified and approached.

When determining which structure to adopt, various considerations will be driven by investors and by the sponsor

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or structuring entity. However, the seller will usually be able to input on a number of aspects, ranging from eligibility criteria for the securitised trade receivables to the existence of credit insurance protection and to the servicing and collection of the trade receivables.

The demand for securitised products has shown resilience during the height of the pandemic and this market is expected to remain buoyant. It is anticipated that trade receivables securitisation will become a key tool for plugging the funding gap between the financial markets and the real economy. It is therefore essential for businesses to become securitisation savvy in order to make the most of this thriving market.

First published on Trade Finance Global on 16 March 2021 (https://www.tradefinanceglobal.com/posts/trade-as-an-asset-class-trade-receivables-securitisation-101/)

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Commodity Finance: the complete security package

Editor Highlights

- Locally imposed lockdowns have disrupted commodity transactions. Consequential enhanced oversight of borrowers' businesses has uncovered fraudulent activities.
- A typical commodity finance security package seeks to mitigate lender losses, although fraud may mean little or no prospect of any realisation.
- Putting security in place in every relevant jurisdiction can mean excessive costs - lenders need to strike a commercial balance between obtaining an acceptable degree of credit support and a financing structure that does not unduly restrict the borrower's business.

COVID-19 lockdowns have disrupted commodity transactions and consequential enhanced oversight of borrowers' businesses has uncovered fraudulent activities. Of utmost importance to any lender in a commodity financing is that the commodity exists and has not been financed by another party.

Against this backdrop, in this article, the authors describe a typical security package adopted by commodity financiers under an English law commodity financing.

INTRODUCTION

In its simplest form, a commodity finance transaction involves a borrower using the loan proceeds to finance the purchase of the commodity, with the loan repaid following the onward sale of that commodity at a profit by the borrower. More complex structures involve the borrower producing, manufacturing or converting the commodity (and even outsourcing this process), which may be stored before and/or after being transported to another territory for sale.

Where the borrower's business is operating profitably, a commodity financing will be repaid out of the proceeds of the sale of the commodity that has been financed - in this sense commodity finance is described as "self-liquidating". However, in a default scenario, the lender will look to one of three avenues of realisation:

1. If the commodity has not yet been sold, by taking possession and/or control of the commodity in order to direct its sale to a third party buyer from whom receipt of purchase proceeds can be applied in satisfaction of the debt.
2. If the commodity has been sold to an offtaker but payment is not yet due or remains outstanding, by taking ownership of that debt and directing the offtaker (rather than the borrower) to make payment to the lender directly.
3. If the commodity has been sold to an offtaker and the sale proceeds have been paid into an account of the borrower, by enforcing security or rights of set off over that account and applying any amounts standing to the credit of such an account in satisfaction of the debt.

THE IMPACT OF COVID-19

The abrupt and unanticipated introduction of lockdown measures across the globe has had a profound impact on international trade, and a number of commodity traders have struggled to service their debts. Whilst lenders have looked to their security packages as the principal route of recovery, some have discovered fraudulent activities on the part of their borrower.

Of utmost importance to any lender in a commodity financing is that the commodity exists and has not been financed by another party - without an unencumbered commodity, the lender cannot look to the sale proceeds of that commodity to be repaid. However, removing all risk of fraud while preserving the commercial viability of a financing is challenging. Due

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diligence of the borrower and its business is key. In addition, a key defence for any lender against any fraud, is its ability to make recoveries without the borrower's co-operation. The most obvious method of achieving this is by taking and maintaining an effective security package.

COMMONLY ADOPTED SECURITY PACKAGE

The form of security available to a lender will vary according to the progression of the flow that is being financed:

- At the outset of the flow, where the commodity is being produced or manufactured or has been recently purchased, the lender will take a form of asset security over the commodity to secure the borrower's liabilities.
- Once the commodity is the subject of a sales contract between the borrower and an offtaker, the lender's asset security will need to be released to allow the borrower to transfer title to the commodity to the offtaker, and will be replaced by security over the debt owed to the borrower by that offtaker.
- Once that debt has been discharged by the offtaker making payment of the purchase price, the lender will take security over the monies paid into the borrower's account.

Commodity financings are by their very nature international, and as such secured parties will need to ensure that all applicable law is adhered to in granting and perfecting the security conferred in their favour at each phase.

A typical security package obtained by commodity financiers under an English law commodity financing can be summarised as follows:

Asset security

Following the *lex situs* principle, the governing law of security taken over a tangible asset should be the jurisdiction in which that asset is located. If that asset is transported into another jurisdiction, it follows that a prudent lender will also take security over that asset in that location, i.e. with a security arrangement governed by the law of that new jurisdiction. In many cases, this is impractical and/or uneconomical, and lenders in an English law governed commodity financing may be comfortable with, or resigned to, only taking English law asset security over that commodity. Of course, the lender will run the risk that English law security is not enforceable in the jurisdiction in which the lender might wish to enforce that security, and English courts have indicated they will not restrict another creditor from bringing proceedings in a jurisdiction that does not recognise the English law security.

It is also worth noting that a lender may not recover the full market value of the secured asset from which it intends to make a recovery. Commodity prices are volatile, and a discount is typical when the sale takes place in a distressed scenario (especially if the commodity is perishable). The buyer will also expect indemnities (and/or a price discount) since the seller of goods is not the original owner. If an insolvency practitioner has been appointed, and there is not enough cash in the business to meet its costs, the lenders may have to provide cost cover instead. Finally, a myriad of costs will reduce the recovery, for example storage, tax and transportation costs.

This article considers two forms of English law asset security: a charge and a pledge.

The English law charge
The English law charge is a form of non-possessory security interest - at all times prior to enforcement, title to the asset remains with the borrower and the secured party instead obtains an equitable proprietary interest in the asset by way of security. In other words, the asset cannot be disposed of without the secured party's consent. A charge is created under a charge document, which, if the chargor is an English company, must be registered at Companies House within the stipulated timeframe. English law recognises two types of charge: a fixed charge and a floating charge, and whether a charge is one or the other is determined by how much control the secured party has over the asset.

In the commodity finance context, both types of charge may be appropriate. Where the consent of the lender (or its representative) is required for the commodity to be released from storage, or to be sold to an offtaker,. English courts will likely view the charge as a fixed charge. Conversely, if the borrower does not require the lender's consent, or contractual requirements to obtain such consent are not routinely followed without objection by that lender, the courts will more likely consider the charge to be a floating charge. A fixed

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charge is the stronger security interest - it will always take priority over a floating charge even if taken subsequently. Additionally, floating charge recoveries are diluted by the following statutory deductions:

- to meet the costs of the insolvency process
- to certain protected creditors (such as employees)
- to the unsecured creditors generally in an amount up to £800,000

The parties to a commodity financing will need to weigh up the advantages of a strong security interest against the administrative burden of ensuring sufficient control is exercised by the secured lender of the secured assets.

The English law pledge

The English law pledge is a form of possessory security that falls somewhere between a charge and a mortgage: the pledgor does not have title or ownership to the asset as a mortgagee does, but enjoys stronger rights than a chargee because of its possession ofin the goods coupled with the ability to sue those who wrongly interfere with this possession.

Aside from commodity financings, the English law pledge has fallen out of favour because (subject to limited exceptions) it requires that at all times the secured party retains possession of the secured asset. Given the obvious impracticalities of doing so, and the risk of the security being discharged where possession is lost, it is easy to see why lenders prefer instead to take a charge. However, it remains popular with commodity finance lenders, especially where security is restricted to assets forming part of the flow being financed (and more pervasive credit support such as share security or parent guarantees are not available), who consider that overcoming the administrative burden of maintaining such security to be worthwhile given the importance attached to asset security.

To create a pledge, the pledgor must evidence an intention to create the pledge and the pledgee must take possession of the pledged asset. Unlike a charge, which is in almost all cases effected by way of the execution of a security document, a pledge is created by the action of transferring possession. However, in practice, lenders typically expect to see evidence of the pledgor's intention to create a pledge documented in a security document signed by the pledgor.

In the commodity finance space, English law pledges are taken over two types of asset:

▪ the commodities themselves

▪ documents of title relating to the commodities

Pledges over commodities

The greatest challenge to taking an English law pledge over a commodity lies in conferring possession of that commodity with the secured party and maintaining that possession. How can the borrower process, transport or sell the commodity if its financier has possession of it? The answer lies in the concept of constructive possession, which is achieved by the delivery of the pledged goods into the possession of a third party (such as a warehouse operator), who acknowledges the pledgee's interest in the goods by way of an "attornment" and issues a warehouse receipt evidencing that interest.

Where the goods are stored in a warehouse, silo or similar storage facility, the lender will enter into collateral management agreements with the warehouseman to ensure the goods are attorned in its favour, but also to ensure the goods are stored safely and not commingled, spoiled, damaged or stolen. Such an agreement is particularly helpful where assets are misappropriated in a jurisdiction which does not recognise English law security, or where the local law security has somehow failed, as the lender may have recourse against the warehouseman in breach of its obligations, as confirmed by the High Court last year in the case of *Scipion Active Trading Fund v Vallis Group Limited* [2020] EWHC 1451 (Comm).

Pledges over documents of title

English law has found a similarly practical solution when commodities are being transported by sea. In this scenario, the borrower will typically grant a pledge over the bill of lading - a document issued by the carrier to the shipper, or to the order of the shipper, undertaking to deliver the goods to an agreed

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port of discharge. The holder of this document is deemed to have possession of the underlying goods because only the holder of the document can discharge the carrier's obligation to deliver the goods. To perfect a pledge over goods being transported by sea, physical possession of the bill of lading (in practice a set of identical originals) will need to be given to the lender and endorsed in its favour. Where possible at the port of discharge, the bill of lading will be returned to the borrower (or its representatives) to allow the cargo to be discharged. A trust receipt will be executed to evidence that possession is retained by the pledgor and the pledge is not inadvertently discharged (a neat solution to the requirement that the lender maintain possession of the pledged assets or risk the pledge being discharged). Where returning the original bill of lading is impractical, a letter of indemnity will be executed to hold harmless all parties facilitating the discharge of the cargo without sight of the original bill of lading (since those that wrongly interfere with the goods, including the pledgor, may be liable to the pledgor in the tort of conversion).

Attempts have been made to introduce electronic bills of lading into the market, but offerings have been fragmented and none have become widely adopted. For example, at the time of writing, only Bahrain, Singapore and Abu Dhabi Global Market have enacted the UNCITRAL Model Law on Electronic Transferable Records, which was adopted in July 2017 (for more detail on this subject see Baker McKenzie article Commodities Fraud and Trade Finance Digitisation featured in Trade Finance Quarterly available on the Baker McKenzie InsightPlus platform). English law has not yet recognised other forms of document issued by those responsible for the transport or storage of a commodity, such as airway bills, railway bills or warehouse receipts (other than LME (London Metal Exchange) Warrants).

Security over offtaker debt

Where the borrower has entered into one or more contracts with an offtaker for the sale of the commodity, the lender will seek to obtain a legal assignment of the borrower's rights under that contract (including, crucially, the right to receive the purchase price). Much like the law of many other jurisdictions, English law requires notice to be given to the offtaker. Although a valid security interest (an equitable assignment) is created without the issuance of a notice, a significant advantage is conferred on the lender by having a notice delivered to the offtaker: this means that the offtaker can only discharge its payment obligation by paying the lender (or to its order), and can be sued directly by the lender for failing to do so. This is especially helpful in a borrower insolvency scenario, in order to avoid the proceeds of an offtake contract being paid to the borrower and caught up in the insolvency process.

However, it is not always commercially palatable for a borrower to notify its customers that its debts have been secured in favour of a lender, and/or the borrower may wish to continue collecting its debts itself for operational or regulatory reasons. In this scenario, notice need not be given to the offtaker, although the lender will reserve the right to do so if a default occurs. Prior to a notice being served on the offtaker, the lender enjoys an equitable assignment only. It will need to join the borrower to any action it may take against the offtaker (although in practice under English procedural law this is not too onerous), but crucially it cannot require the offtaker to pay to any party other than the borrower to discharge the debt.

The holder of this security interest takes performance risk and insolvency risk on the offtaker. If the offtaker refuses to pay the secured party, can it be compelled to do so in the courts of the jurisdiction in which it operates its business? Is the offtaker likely to be unable to make the payment? This could be the case if its business is too heavily reliant on its operations with the (presumably no longer operating) borrower.

Security over a bank account

The so called "triple cocktail" will be familiar to many finance practitioners, and its combination confers a robust security interest in favour of the lender over cash standing to the credit of a bank account. The lender will take:

- a charge over the deposit
- a contractual right of set-off
- a flawed asset arrangement (whereby funds are not released to the depositor until certain conditions (e.g. repayment) have been met)

Evidence of the universal recognition of the strength of this security interest is the 100% advance ratio ascribed to cash held in a blocked account in borrowing base computations, and the favourable treatment of first ranking fixed account security by the Capital Requirements Regulation.

However, clearly the value of this security interest lies in the amounts standing to the credit of the secured account. It is vital that lenders ensure, through ongoing monitoring, that revenues generated by the financed commodity flow are transferred into this account without exception - directly, in full and without delay.

CONCLUDING THOUGHTS

Obtaining the most complete security package possible, as a lender in a commodity finance transaction, whilst balancing the requirements of the borrower's business has always been a task that requires careful and detailed due diligence as a consequence of the multiple phases and jurisdictions through which a commodity may flow. However, as with many things, the fallout from COVID-19 has brought to the forefront weaknesses in arrangements that might otherwise have gone unnoticed or have been considered sufficiently low risk not to be a concern. In response prudent transaction parties may find themselves needing to revisit previously settled approaches to commodity finance security packages and perhaps adjusting where their cost benefit analysis falls.

This article was first published in the May 2021 edition of Butterworths Journal of International Banking and Financial Law

> **“Commodity finance is self-liquidating: the loan that finances a commodity transaction is repaid on completion. If the commodity “flow” cannot complete no revenue is generated to repay the loan.”**
>
> Nick Tostivin, Partner

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Navigating Between East and West: Compliance Strategies for Asia-Pac Financial Institutions

Editor Highlights

- Diverging obligations may increasingly arise with respect to Western sanctions and Chinese national security laws. These do not show any signs of relenting.
- Financial institutions may increasingly need to consider strategies to navigate these measures in a way that mitigates compliance risks for both Eastern and Western jurisdictions. Screening, due diligence and monitoring will play an important part of this at operational level, but these measures alone may not be sufficient for banks looking to retain material presence in both Chinese and Western markets.
- For Chinese and Asia-Pac financial institutions in particular, broader solutions may involve:
  - localising compliance, for example at policy and operational level, and also reflected through staffing and corporate structures;
  - diversification of currencies, platforms, correspondent relationships and customers; and
  - new approaches to advocacy with sellers and regulators when investing overseas.
- Communication and messaging on the strategies identified may be just as important as the strategies themselves. There will be nuances in how the rationale for particular steps taken should be articulated in policies, contracts, bids, reporting and broader communications when dealing with Chinese and Western audiences, as discussed further below.

Legal Background

Financial institutions face an increasingly complex legal landscape in light of diverging compliance rules in China and Western jurisdictions. Under recent sanctions, the US continues to blacklist Chinese government officials, as well as major Chinese companies across various industry sectors citing national security and other US policy concerns.[1] The US Congress has also enacted laws to restrict access to US financial markets (the Holding Foreign Companies Accountable Act) and to mandate the imposition of sanctions on banks engaging in certain "significant financial transactions" with sanctioned parties (the Hong Kong Autonomy Act). In addition, the US has reissued restrictions on investments in publicly-traded securities of certain Chinese companies.

Conversely, in parallel, China's Hong Kong Security Law, introduced last year, regulated various forms of conduct defined as collusion with foreign powers, including in relation to the imposition of foreign sanctions.[2] China also issued the Rules on Counteracting Unjustified Extra-territorial Application of Foreign Legislation and Other Measures, the Measures on Unreliable Entity List and more recently the Anti-Foreign Sanction Law, all of which could act as further countermeasures against US sanctions and export controls.

All of this poses challenges for banks attempting to comply with both US and Chinese rules, and all the more so in instances where services are being provided to targeted parties affected by the relevant sanctions provisions.

These measures should also be seen in the context of a potentially widening gap between China and the West reflected in other areas of law. Most notably, a number of Western jurisdictions have introduced (and are considering) foreign investment rules which can adversely impact Chinese buyers in certain contexts. In addition, Chinese goods exports have been affected significantly in some instances by US and EU trade remedies.

[1] Further details on these measures can be found here.

[2] Further details on these measures can be found here.

Against the backdrop of these developments, it has become more important for financial institutions to re-calibrate corporate and compliance strategies such that they are attuned to this rapidly evolving environment. The following summary sets forth a number of compliance risk mitigation strategies to consider in order to navigate a pathway through this, both in the context of domestic business and expansion overseas.

Localising Compliance

It is possible that the divergence in laws summarised above will mean that for some financial institutions - particularly certain Asia-Pac headquartered banks - a global, US driven-approach to sanctions compliance may no longer be sustainable. Rather, there may be merits in pivoting more towards Chinese-based (and possibly EU-based) compliance policies in China, and US and EU-based policies for Western parts of the bank.

As part of this, depending on the breadth of US secondary sanctions risks, Chinese banks may start to consider establishing separate corporate divisions dedicated to Chinese government businesses to enable continuity of service to those accounts likely to be exposed to US sanctions targets in future. In doing so, these divisions may be insulated from the rest of the corporate structure of the bank such that any secondary sanctions imposed on the bank may be more likely to be limited to just those entities servicing Chinese government accounts without tainting the entire institution. This is to some extent similar to the approach taken in the context of the sanctions against Russia and may help other parts of the bank maintain their relationships with Western businesses.

Diversification

There is always a degree of unpredictability as to who and what will be targeted by sanctions and counter-measures - often with little time to prepare or react. Various forms of diversification of business, systems, platforms and/or currencies may accordingly prove useful in hedging both commercial and regulatory risks.

Relationship mapping would be an important preliminary step in identifying the level of potential exposure, both in terms of the level of Chinese government business and the level of dependence on Western relationships.

Depending on the outcome of this, diversification of the APAC customer base could reduce exposure to Western sanctions (and may be premised on a non-sanctions rationale to mitigate exposure in China).

Conversely, for Asia-Pac banks, diversification of Western correspondent relationships, lenders, borrowers and currencies may avoid over-dependence on US (and possibly other Western) commercial relationships.

At the macro level, digital currencies, distributed ledgers and other new payment and settlement technologies may contribute to reducing dependence on the USD as demonstrated by the growing potential of the Cross-border Interbank Payment System (CIPs). In reducing reliance on the USD, Chinese banks may consider leveraging the ongoing efforts to digitize and internationalize the RMB.

Expansion Strategies: Optimising Structure, Geography and Advocacy

Western sanctions and foreign investment regimes are not homogenous. There are differences in political perspectives between the US, UK and EU Member States and these are reflected in differences in the laws and enforcement practices deployed by each in these areas. It may be helpful for Asia-Pac lenders and investors to calibrate expansion and investment strategy in the context of these nuances. For example, expansion in Milan and Frankfurt is likely to offer greater flexibility from a sanctions perspective than expansion in London, and this in turn is likely to offer greater flexibility than expansion in New York.

Equally, when expanding in Africa and South America, in some instances there may be a greater need from a sanctions perspective to insulate the new business from any US nexus, though less so from the EU, as the latter is less focused on applying extra-territorial jurisdiction. This may be relevant when considering currencies, correspondent banks, lenders and staffing. There may be other aspects to corporate structure to consider as well when expanding overseas. For example, from a sanctions perspective, there may be advantages in some

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instances to forming separately incorporated subsidiaries as opposed to branches in order to isolate new business from competing foreign sanctions and national security rules. This would need to be weighed up though against the commercial and regulatory downsides of the loss of a branch structure.

Separately, when investing in or acquiring Western overseas businesses, a proactive strategy towards foreign investment rules should be considered. This may include:

- Connecting with the local players and lawyers in key jurisdictions who can help the business navigate the foreign investment regimes in their jurisdictions and the timelines for any required filings;
- Engaging with regulators early on to gain valuable guidance on their interest/concerns and leveraging that knowledge to establish credibility;
- Being ready to advocate to both sellers and regulators the potential benefits to be brought to the local market in terms of jobs, finance, infrastructure and/or other investment;
- Considering non-state alternatives for sources of finance (linking in again with the diversification themes above) if and when necessary, to help reduce the adverse effects of state aid rules and foreign investment regimes.

Communicating Approach to Stakeholders

Communication and messaging on the above strategies may be just as important as the strategies themselves. As part of this, there may be nuances in how the rationale for particular steps is articulated in different jurisdictions and to different audiences.

With respect to Chinese government stakeholders, emphasis on continuity of service may be important. It may also be necessary to articulate a commercial rationale for the proposed strategies above that does not simply rely on a narrative of Western sanctions compliance. There are parallels here with the approach adopted by European companies in declining business with Iran in a manner such as to avoid exposure under the EU Blocking Statute. (The potential need for European companies to articulate a non-US sanctions rationale for terminating Iranian business has been further underlined by a recent EU-Advocate General Opinion.) [3]

Conversely, when engaging with Western regulators and Western commercial partners, more emphasis may need to be placed on compliance. This may include, for example, responses to (more and more) detailed Q&A on financial crime control frameworks, together with reassurance on steps taken to segregate sanctioned Chinese accounts from Western business. Where Western foreign investment rules are concerned, it will also likely be important to address the advocacy points regarding the local market discussed above and consider the extent of disclosure Asia-Pac investors are willing to make on issues of ownership and funding.

> **For some banks, localising compliance may be the solution to diverging obligations under US sanctions and Chinese counter-measures.**
>
> Sven Bates, Of Counsel

[3] Further details on the recent EU Advocate-General Opinion can be found here.

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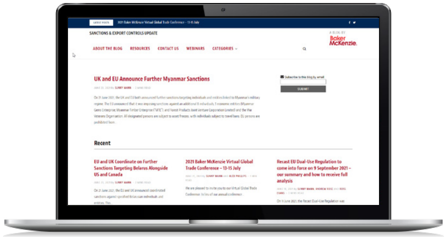
Sanctions & Export Controls Update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UK and EU Announce Further Myanmar Sanctions

On 21 June 2021, the UK and EU both announced further sanctions targeting individuals and entities linked to Myanmar's military regime. The EU announced that it was imposing sanctions against an additional 8 individuals, 3 economic entities (Myanmar Gems Enterprise, Myanmar Timber Enterprise ("MTE"), and Forest Products Joint Venture Corporation Limited) and the War Veterans Organisation. All designated persons are subject to asset freezes, with individuals subject to travel bans. EU persons are prohibited from...

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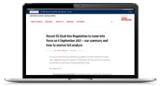
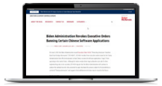
On 9 June 2021, the Recast Dual-Use Regulation was

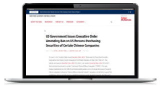
Baker McKenzie's Sanctions & Export Controls Update Blog aims to provide you with real time news and updates in respect of US and EU economic sanctions against key sanctioned countries, such as Russia and Iran. We will also keep you informed of developments in other countries, including Australia, Canada and Japan. Contributors to the blog are made up of partners and associates from our market leading International Trade Group. Here is a sample of our recent blog posts. Please click here for the full range.



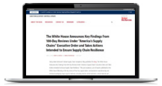
Recast EU Dual-Use Regulation to come into force on 9 September 2021 – our summary and how to receive full analysis



Biden Administration Revokes Executive Orders Banning Certain Chinese Software Applications

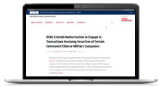


US Government Issues Executive Order Amending Ban on US Persons Purchasing Securities of Certain Chinese Companies



The White House Announces Key Findings from 100-Day Reviews Under "America's Supply Chains" Executive Order and Takes Actions Intended to Ensure Supply Chain Resilience

Between a rock and a hard place: EU Advocate-General Opinion signals strict interpretation of the EU Blocking Regulation



OFAC Extends Authorization to Engage in Transactions Involving Securities of Certain Communist Chinese Military Companies

Baker McKenzie partners with the LMA

Baker McKenzie was delighted to act again as the platinum sponsor for the LMA's Developing Markets Virtual Conference that took place in April. Bringing together experts in their fields across the EMEA developing markets, this virtual conference enabled participants to understand not just the impact of the Covid-19 pandemic, but also the underlying challenges and opportunities in these markets.

Baker McKenzie showcased areas of our expertise by chairing panel sessions on 1). The developing markets loan syndication in a post Covid world and 2). ESG and sustainable finance.

Below are some of the key takeaways from our panel chairs from the first session.

Where next for the DM loan syndication in a post Covid world?

- With the economic and political landscape still immensely uncertain, there is little doubt that 2021 will continue to be a volatile one for developing markets, irrespective of the jurisdiction.
- The impact of the pandemic on the market has been quite considerable. Nonetheless, the first half of 2021 has started more positively and there has been more liquidity, in particular from the commercial banks.
- Parties are becoming more familiar with the challenges that we are facing, but deals are being put together more selectively.
- The Libor transition continues to be challenging - ultimately ensuring that the large syndications in the developing markets are truly risk free rate deals.
- The volatility of commodity prices has had an impact on the market - the rise in the price of crude across the last 12 months has resulted in an uptick in commodity deals, so much so that economists are predicting 2021 to become a commodity super cycle in terms of pricing.
- Investment into Africa is increasing, in particular, sovereign borrowers using export credit agencies to bridge the infrastructure gap in Africa.
- We are seeing a significant rise in export credit agencies providing direct liquidity to sovereign borrowers and seeing the sovereigns and sub-sovereign borrowers taking debt on balance

sheet. A shift from project finance type structures to export credit agency backed structures - a positive shift for the loan markets.

- Environmental and social compliance continue to have a significant impact on documentation.

ABOUT THE LMA:

The LMA's key objective is improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa (EMEA). By establishing sound, widely accepted market practice, they seek to promote the syndicated loan as one of the key debt products available to borrowers across the region.

As the authoritative voice of the syndicated loan market in EMEA, the LMA works with lenders, law firms, borrowers and regulators to educate the market about the benefits of the syndicated loan product, and to remove barriers to entry for new participants.

Since the establishment of the LMA in 1996, their membership has grown steadily and currently stands at over 760 organisations covering 67 countries comprising commercial and investment banks, institutional investors, law firms, service providers and rating agencies.

They work in five main areas: documentation, market practice and guidance, loan operations, education, and dialogue with legislators and regulators.

Please See Next Page for Contributors:

> **It's very interesting to see sovereigns and sub-sovereigns taking debt on balance sheet, moving away from more project finance type structures to export credit agency backed structures**
>
> Nick Tostivin, Partner

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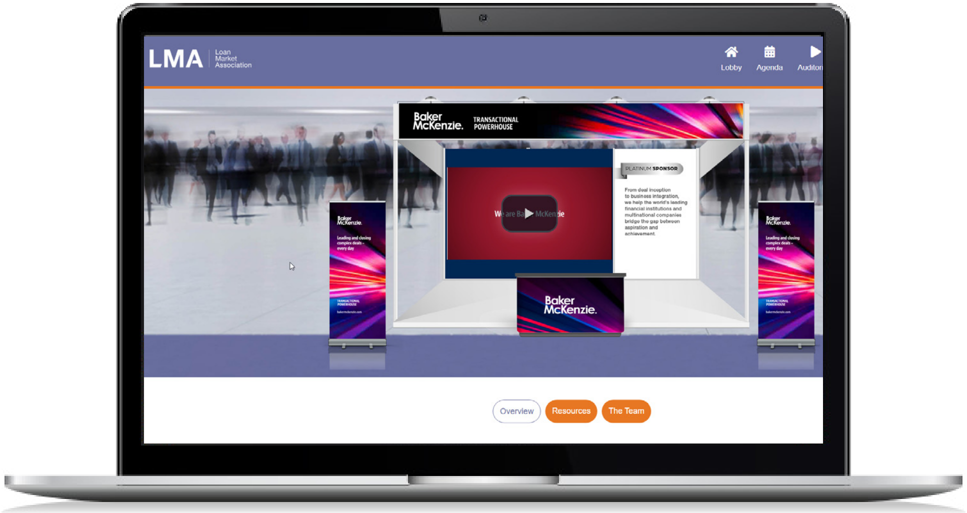
> **We are seeing more liquidity, particularly from commercial banks, but deals are being put together more selectively**

Luka Lightfoot, Partner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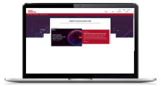
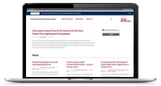


LIBOR Transition Hub

In July of 2017, Andrew Bailey, the chief executive of the UK Financial Conduct Authority (FCA), announced in a speech that after 2021 the FCA would no longer use its power to compel panel banks to submit rate information used to determine the London Interbank Offered Rate (LIBOR). Mr. Bailey encouraged the market to develop robust alternative reference rates to replace LIBOR. Baker McKenzie is pleased to provide expert guidance on LIBOR transition. Please click here to explore our LIBOR Hub.



Global Trade and Supply Chain Webinar Series

Join us for our 18th Annual Global Trade and Supply Chain Webinar Series entitled, "International Trade & Developments in a World Focused on Recovery & Renewal," which includes the latest international trade developments including updates on trade wars, trade agreement negotiations and key customs, export controls and sanctions developments. In addition to our usual topics of customs and export controls/sanctions, we have also covered foreign investment review regimes around the world. Register here for upcoming sessions.

Environment & Climate Change

Our InsightPlus platform provides the latest legal updates across practices and industries. This issue we highlight our Environment and Climate Change news. Please click here to find out more.

2021 Baker McKenzie Virtual Global Trade Conference: 13-15 July

We are pleased to invite you to our Virtual Global Trade Conference. In lieu of our annual conference in Bellevue, WA, we are excited to again provide a virtual offering available to all our clients and friends worldwide! The conference will be comprised of nine one-hour sessions over the course of three days. Please join us on **July 13, 14 and 15** for any or all sessions.

To see the full agenda and sign up to sessions, click here and use the "Register for This Session" buttons.

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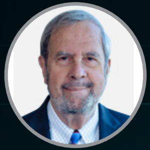

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