KEY POINTS

- 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.
- 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.

Authors Nick Tostivin and James Clarke

Commodity finance: the complete security package

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:

- 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.
- 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.
- 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 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

Biog box
Nick Tostivin is a partner and leads the Baker McKenzie London Banking team, focusing on cross-border syndicated lending transactions including in relation to emerging markets, governmental authorities, trade finance (including ECA-backed export finance) and financial restructuring. Email: nick.tostivin@bakermckenzie.com

prudent lender will also take security over that asset in that location, ie 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 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); and
- 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 of 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; and
- 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).

Biog box
James Clarke is a senior associate in the Baker McKenzie London Banking team with particular expertise in trade and commodity finance, including in full and limited recourse receivables financing, warehouse financing, supply chain financing, risk distribution, pre-export finance facilities and borrowing base facilities.
Email: james.clarke@bakermckenzie.com

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 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 has 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 (eg 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. ■

Further Reading:

- Commodity finance (2017) 2 JIBFL 89.
- Commodity finance: is there a role for repurchase transactions? (2012) 11 JIBFL 695.
- LexisPSL: Banking & Finance: Practice Note: Structured commodity finance: key issues for financing commodities.