

Inventory Finance

Golden Rules to Mitigate Legal Risks



Report
prepared by the Legal Committee of the Banking Commission

1. Introduction to Inventory Financing

a. What is inventory financing?

In classic inventory financing, the lending bank grants loans to its borrower to finance or re-finance the purchase of commodities. The commodities are the lending bank's collateral and the source of reimbursement of the loans.

Typically, the borrower purchases the commodities through the loans granted by the lending bank. However, it also occurs that the borrower offers commodities it already owns as collateral, to raise new finance from the lending bank (this technique is also used to re-finance commodities which purchase was financed by another bank).

The financing provided by the lending bank is reimbursed through the sales proceeds of the commodities that the borrower assigns to the lending bank: the buyers pay directly to the lending bank, thus reimbursing the loans.

The commodities are usually stored in warehouses, silos, yards or tanks. Since they are the lending bank's collateral and source of reimbursement, the lending bank will insist on controlling and supervising the commodities. The lending bank may also require a perfected security right over the commodities.

Depending on its risk appetite, the lending bank may for example require that the borrower:

- ◆ abandons control over the commodities in favour of the lending bank; and/or
- ◆ only removes the commodities from the warehouse, silo, yard or tank with the lending bank's prior approval; and/or
- ◆ creates a perfected security right over the commodity in favour of the lending bank; and/or
- ◆ has the commodity regularly inspected.

b. Role of the inspection company

Inspection companies play a key role in supervising and controlling the movement of the commodities since the lending bank lacks the know-how and capacity. Typically, the lending bank, the inspection company and the borrower will enter into a collateral management agreement or a stock monitoring agreement.

Under a collateral management agreement, the inspection company takes full control over the commodity, whereas under a stock monitoring agreement it only inspects the commodity on a regular basis (between inspections, the commodities are without supervision).

The main features of these arrangements are the following:

Collateral Management Agreement:

- ◆ the inspection company takes physical possession of the commodities and stores them in warehouses, silos, yards or tanks that it rented for that purpose;
- ◆ upon receipt, the inspection company measures the commodities (quantity as well as quality) and issues a warehouse receipt in favour of the lending bank;
- ◆ the inspection company has full control over the commodities and releases them exclusively upon order of the lending bank; and
- ◆ often the CMA is entered into in combination with a pledge, or other security agreement, that gives the bank a first ranking security right over the commodities.

Stock Monitoring Agreement:

- ◆ the inspection company does not take physical possession over the commodities;
- ◆ the commodities remain under the control of the operator of the warehouses, silos, yards or tanks. It also occurs that the commodity be under the control of the borrower;
- ◆ the warehouse company issues a storage document in favour of the lending bank;
- ◆ the inspection company carries out regular inspections, where it compares the data contained in the storage document (documentary inspection) with the measurements of the commodities that are stored in the warehouses, silos, yards or tanks (physical inspection).

c. Inventory finance without involving an inspection company

Banks also disburse loans in full reliance on the storage document that the operator of the warehouse, silo, yard or tank issues. In such a scenario the storage document and the financed commodities are not checked by an inspection company.

This report only addresses the scenario where the bank involves an inspection company.



2. Terms and abbreviations

SMA	Stock Monitoring Agreement entered into between the Inspector, the Bank and the Borrower
CMA	Collateral Management Agreement entered into between the Inspector, the Bank and the Borrower
Storage Facility	Warehouse, silo, yard, tank or other installation where the goods are stored. Under SMA, the Storage Facility is operated by its regular management. Under CMA, it is operated by the Inspector.
Storage Document	Document issued by the management of the Storage Facility regarding/detailing a cargo of goods
Warehouse Receipt	Document issued by the Inspector under a CMA regarding/detailing of a cargo of goods
Inspection Report	Report issued by the Inspector under an SMA



3. Rapporteurs

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4. Legal Risks and the Golden Rules to mitigate or avoid them

	Legal Risk	Golden Rule
1	Risk of unclear identity or financial standing of the Inspector	
a	Inspector is domiciled in a country with a high legal risk	Review carefully which entity will sign the SMA or CMA. If the entity is located in a legal high risk country: demand that parent company (located in a low legal risk country) co-signs the SMA or CMA and so becomes a co-debtor.
b	The Inspector delegates the performance of the inspection to a third party	Verify that SMA or CMA restricts the delegation of the performance to entities within the Inspector's group and makes clear that the entity signing the SMA or CMA remains liable, even if the day-to-day work is performed by another of the group's entities.
c	Inspector has little or no equity	Check the Inspector's balance sheet and professional liability insurance policy. Verify the cover available under the Inspector's professional liability insurance.
2	Risk that Bank is not entitled to rely on Warehouse Receipts and Inspection Reports	
a	If the Warehouse Receipt or Inspection Report is not addressed to the Bank, the Inspector may argue that the Bank is not allowed to rely on its content	Always verify that the Warehouse Receipt or the Inspection Report is addressed to the Bank. Said documents should contain a clause incorporating the terms and conditions of the underlying CMA or SMA.
b	Inspector may argue that it was unaware that the Bank relied on the Warehouse Receipt or the Inspection Report when it financed the Borrower	Make sure that the CMA or the SMA states that the goods (a) were financed by the Bank in reliance on the Warehouse Receipts or Inspection Reports or (b) serve as collateral for the reimbursement of other financing granted by the Bank to the Borrower.
3	Risk that General Terms and Conditions "overrule" the SMA or CMA	
a	SMA or CMA contain references to general terms and conditions	The SMA or CMA should state that the Inspector's general terms and conditions do not apply.
b	Warehouse Receipts or Inspection reports contain references to general terms and conditions	Double check that the Warehouse Receipt or the Inspection Report does not refer to the general terms and conditions but rather incorporates the terms of the SMA or CMA.

	Legal Risk	Golden Rule
4	Risk that Bank's security rights are not recognised	
a	SMA or CMA are silent on Bank's security right	SMA or CMA should state that the Bank has a first ranking security right over the goods that are subject to a Warehouse Receipt or an Inspection Report (even though such reference might not create a valid security right).
b	SMA or CMA are silent on Inspector's role in the creation or perfection of the security right	CMA or SMA should state that the Inspector also holds the Goods for, and on behalf of, the Bank in view of creating and/or perfecting a security right or pledge right granted by the Borrower. Note: in many jurisdictions, separate agreements in addition to a SMA or CMA must be signed between the Bank, the Borrower and the Inspector to create a valid security right or pledge.
5	Risk that Inspector follows the Borrower's instructions and not the Bank's	Make sure that the CMA or SMA clearly states that the Inspector must follow the Bank's and not the Borrower's instructions.
6	Risk that Inspector is not paid by the Borrower and terminates the SMA or CMA (or exercises a lien over the goods)	
a	Bank is unaware of the Borrower's payment default	SMA or CMA should stipulate that the Inspector informs Bank of unpaid fees.
b	Bank cannot "fix" the Borrower's payment default and pay the Inspector	Bank should be entitled to pay on Borrower's behalf (with recourse against the Borrower) before the Inspector terminates the SMA or CMA. Alternatively the Bank may consider to guarantee payment of the Inspector's fees up to a certain amount, in exchange for a waiver of its statutory lien over the goods
7	Risk of unfit or unclearly identified Storage Facilities or that access is refused	
a	Storage Facilities may be unfit for storage	SMA and CMA should oblige Inspector to confirm that the Storage Facility is fit for the intended use. For CMA, the Inspector should carry out a survey before taking possession of the Storage Facility.
b	Unclear definition of the Storage Facilities may allow Inspector to argue that they are not subject to the CMA or SMA	SMA and CMA should specifically list each the Storage Facility. To allow for flexibility, SMA and CMA should contain a clause allowing the addition of new Storage Facilities. Alternatively, a clause should state that any Inspection Report or Warehouse Receipt issued by the Inspector is automatically subject to the SMA or CMA (this to avoid that the Inspector argues that neither the SMA nor the CMA applies but its own general terms and conditions)

	Legal Risk	Golden Rule
8	Risk of "lock out": the Inspector or the Bank are refused access to the Storage Facilities	
a	Risk under CMA that the Inspector does not have undisturbed control over the Storage Facility	<p>Inspector must, where it is not the owner, lease the Storage Facility. The Bank should receive a copy of the lease agreement and written consent by the owner that the Bank may, at any time, enter the Storage Facility to inspect the goods.</p> <p>The CMA must provide that the Inspector will add its own locks to the Storage Facility, or otherwise ensure that the Storage Facility remains secured and under the control of the Inspector.</p> <p>Where the Storage Facility is owned or leased by the Borrower, it shall – where applicable:</p> <ul style="list-style-type: none"> ◆ provide the landlord's written consent to grant a sub-lease to the Inspector; ◆ grant a sub-lease of the Storage Facility to the Inspector and obtain the landlord's written undertaking to allow complete and uninterrupted access to, and control over, the Storage Facility by the Inspector during the term of the sub-lease; ◆ not breach any of the terms and conditions of the head lease including payment of rent and other sums due; ◆ represent and warrant that all necessary consents, licences and permits have been obtained; and ◆ represent and warrant that any security interest in or over the Storage Facility does not, and will not, extend to the goods stored and secured under the CMA or SMA. <p>Note: for certain commodities, such as oil products, the Inspector will not be able to exercise sole possession since the operator of the tanks must, by law, retain full control over its installations as they are strictly regulated.</p>
b	Risk under CMA and SMA that Bank is refused access to the Storage Facility	SMA and CMA should contain a clause allowing the Bank access to the Storage Facility. Ideally, an additional agreement is signed with the owner of the Storage Facility (and/or the owner signs a statement) allowing the Inspector and the Bank unrestricted access to the Storage Facilities.

	Legal Risk	Golden Rule
9	Risk under SMA that Bank was financing non existing goods or that the same stock of goods was promised to several banks	
9.1	Documentary Risk	
a	Risk of forged Storage Documents	<p>The Inspector should collect the original of the Storage Document from the management of the Storage Facility and send it to the Bank. During each inspection, the Inspector should check the authenticity of Storage Document issued by the Storage Facility and obtain confirmation from the management of the Storage Facility that the Storage Document was signed by persons with authority.</p> <p>Alternatively, the Bank could consider accepting electronic storage documents.</p>
b	Risk that genuine Storage Document were not recorded in the books of the warehouse	The Inspector should check that the Storage Document is properly recorded in the books of the Storage Facility
c	Risk that quantity of goods on all Storage Documents issued by the warehouse exceeds the quantity recorded in warehouses' books	<p>The Inspector should obtain confirmation from the Storage Facility:</p> <ul style="list-style-type: none"> ◆ total quantity of goods stored in the Storage Facility; and ◆ total quantity of goods that are subject to a Storage Document (issued by the Storage Facility)
d	Risk that the Storage Document is unclear or does not contain sufficient data	<p>The Inspector should check that the Storage Document contains the following data:</p> <ul style="list-style-type: none"> ◆ nature, quantity and quality of goods received; ◆ date of delivery; ◆ name of party to whose order the goods are held; ◆ a number, place and date; and ◆ a signature of a person authorised to sign on behalf of the Storage Facility.
9.2	Risk of incorrect physical inspection	
a	Risk that the same stock is subject to several Storage Documents (in favour of several Banks)	<p>If the goods are segregated and clearly flagged as being held by for the Bank, the Inspector should:</p> <ul style="list-style-type: none"> ◆ determine quantity and quality of the goods in the Storage Facility; and ◆ Determine storage condition.
b	Risk that the same stock is presented to several Inspectors creating the false impression that each Bank's stock exists	<p>If goods are not segregated or not flagged to be held for one specific Bank, the Inspector should:</p> <ul style="list-style-type: none"> ◆ determine quantity and quality of all goods stored on the entire storage site (comment: this can be difficult if the storage site is very large); and ◆ determine storage condition.

	Legal Risk	Golden Rule
c	Risk of incorrect measuring	The SMA or CMA should define the measuring technique and state whether the Inspector is entitled to rely on quantity indications made by the Storage Facility or by transport documents (bills of lading, FCR or similar).
9.3	Reconciliation of Documentary and Physical Inspection; Quality of goods	
a	Risk that the results of the documentary and physical inspection do not match	The results of the documentary and of the physical inspection should be reconciled to ascertain that the Storage Facility did not issue Storage Documents for quantity of goods that exceeds the quantity that is actually stored at the Storage Facility. Inspectors are frequently reluctant to carry out such reconciliation, as they consider their mission to be limited to the ascertaining of facts only. So this reconciliation exercise must often be performed by the Bank itself.
10	Risk under CMA that Bank finances non-existing goods or that goods are released without instructions from the Bank	
a	Warehouse Receipt is not signed by proper person or is forged	Inspector must provide the Bank with a list of authorised signatories that may sign Warehouse Receipts on its behalf.
b	Bank finances against forged Warehouse Receipts	Inspector must send the original of the Warehouse Receipt to the Bank.
c	Quantity under Warehouse Receipt is incorrect	Inspector must measure the quantity as well as the quality of goods upon receipt. CMA should define measuring technique. CMA should state that Inspector is not allowed to rely on transport documents such as FCR, bills of lading, etc. (exceptions may be applicable).
d	Inspector does not take control over goods	Inspector must take goods into its custody and store the same in a segregated Storage Facility that is subject to a lease agreement.
e	Inspector does not provide uninterrupted supervision	Inspector must keep the goods under "Lock and Key" 24 hours per day and 7 days per week
f	Inspector releases goods without prior approval	Inspector must send regular reports to Bank confirming presence of goods under its custody

	Legal Risk	Golden Rule
11	Risk of unclear, ambiguous or contradictory Inspection Reports or Warehouse Receipts	
a	No agreed templates exists	The SMA and CMA should contain templates of the Inspection Reports or Warehouse Receipts
b	Minimal requirements of a Warehouse Receipt:	<p>The Warehouse Receipt should contain the following data/confirmations:</p> <ul style="list-style-type: none"> ◆ reference to the CMA; ◆ confirmation of receipt of the goods (nature, quantity, quality and indicating storage facility); ◆ reference to any Storage Document issued by the owner of the Storage Facility (if any); ◆ confirmation of the Bank's first ranking security right over the goods; and ◆ clear statement that the goods will only be released upon order of the Bank.
c	Minimal requirements of an Inspection Report:	<p>The Inspection Report should contain the following data/confirmations:</p> <ul style="list-style-type: none"> ◆ Reference to the SMA; ◆ Date of inspection, name of inspectors, names of persons met/interviewed at Storage Facility; ◆ Data of Storage Document and related goods; ◆ Results of documentary inspection (authenticity of Storage Document, accurate registration of Storage Document in books of Storage Facility, total quantity of goods stored in Storage Facility as per books and/or other storage documents, etc., see above section 8); and ◆ Results of physical inspection (nature, quantity and overall condition of goods, specification of measurement technique, measurement of goods (segregated or not), condition of Storage Facility, etc., see above section 8).
d	Risk that Warehouse Receipts and Inspection reports are unclear or do not match the terms of the CMA or SMA	Verify that the language in the template Inspection Reports and Warehouse Receipts is sufficiently clear and that their content fully corresponds to the obligations of the Inspector under the SMA or CMA
12	Risk that Storage Facility becomes unfit for storage, goods deteriorate, goods become subject to ownership dispute or attachments or seizures	<p>SMA and CMA should confirm obligation to notify the Bank in relation to:</p> <ul style="list-style-type: none"> ◆ Deterioration of Storage Facility or goods; ◆ Ownership disputes / attachments / seizures in respect of the goods; and ◆ Any other incident or circumstance that could jeopardize the Bank's interest.

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13	Risk of no, or insufficient, insurance cover of goods or of the Inspector's liability	
a	Goods and Inspector are not properly insured	<p>The SMA and CMA should contain clauses obliging the Borrower (or the Inspector, as appropriate) to purchase appropriate all risk insurance (theft, misappropriation, damage, etc.).</p> <p>The Inspector should purchase professional liability insurance (and all risk insurance over the goods, if appropriate) (it should be noted that the latter often does not cover the Inspectors' potential liability).</p> <p>The Bank should acquire bankruptcy remote rights over the insurance cover (as per the law applicable to the insurance policy).</p>
b	Bank has not right to double-check insurance cover	The SMA and CMA must oblige Inspector and Borrower to send to the Bank copies of the full insurance policies and evidence that the relevant insurance premiums are paid.
14	Risk of Limitation of Liability or short deadlines to act	
a	Limitation of liability	Check whether SMA or CMA limits the Inspector's contractual liability. Typically, Inspectors try to limit their liability to the fees paid and/or to a capped value and/or to gross negligence and wilful misconduct (this varies as per the law applicable to the SMA and CMA).
b	Time bar, etc	Remove any clause from the SMA or CMA that obliges Bank to bring legal action against Inspector within a short deadline (such clauses are counterproductive since they force the Bank to act aggressively against the Inspector). Check also for shot contractual time bars.
15	Risk of termination of the SMA or CMA by the Inspector or the Borrower	
a	Risk that Borrower terminates the SMA or CMA	Check Only the Inspector and/or the Bank can terminate the CMA or SMA. The Borrower, however, cannot terminate without the Bank's approval.
b	Risk that the Inspector terminates its mandate before a replacement was appointed	Check that if the Inspector terminates, the Bank may ask for a "grace period"/"holdover period" (i.e. 30 additional days) in order to allow the Bank to identify a new Inspector.
16	Risk that Inspector's staff is bribed or that other irregularities occur	
a	Borrower may bribe Inspector's staff	Check that Borrower and Inspector accept to abide by all local anti-bribery laws.
b	Risk that Inspector and Borrower become "too friendly"	Bank may impose requirement that the Inspector's staff be rotated on a regular basis.

	Legal Risk	Golden Rule
17	Jurisdictional Risk	
a	Defective or unfavourable jurisdiction clause	Review jurisdiction clause carefully. It must be clear and unambiguous to avoid discussions which court or arbitral tribunal is competent.
b	Jurisdictional risk	Avoid jurisdiction in a high legal risk jurisdiction.
c	Enforcement issues	Check if judgments or arbitral awards can be enforced in the country of incorporation of the Inspector or where the Inspector holds assets (or where enforcement of a judgement or award might occur).
d	Arbitration or state courts?	Consider if arbitration is not a better option than state courts (rules on evidence taking, commercial understanding of the matter, flexibility of procedure, confidentiality).
18	Risk that applicable law does not sanction a breach of the SMA or CMA	Avoid jurisdictions that are high risk, have unreliable courts or unsatisfactory case law on SMA or CMA. Choose a law that is sufficiently sophisticated to understand the mechanics of an SMA or CMA and the potential losses caused by a breach.



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The ICC Banking Commission is the world's essential rule-making body for the banking industry. With 80 years of experience and more than 600 members in +100 countries, the ICC Banking Commission has rightly gained a reputation as the most authoritative voice in the field of trade finance.

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Multiple legal challenges face financial institutions in the global economy. They essentially reflect the asymmetry between the emerging global rule of law and inconsistent laws and case law in the various jurisdictions. They result in costly legal uncertainty that hinders the availability and amount of credit. To address those challenges in a structured, expert and consistent way, The ICC Banking Commission has created a forum for senior legal counsel called the "Legal Committee of the Banking Commission."

The new Committee's Terms of Reference confer upon it authority both to identify, take up and address legal issues in connection with the Banking Commission's scope of activities as well as to address legal issues arising in the course of activity of the Commission, its task forces or working groups.

With its membership open both to senior legal officers of financial institutions and specialist outside counsel and academics members of the Banking Commission, the Legal Committee aims to offer a discussion platform to its members and make proposals for action to the Banking Commission with a view to dealing with challenges of a legal nature facing Commission members. It reports to the Executive Committee.

Issues addressed by the Legal Committee include asymmetrical jurisdiction clauses in financing agreements, the interpretation of pari-passu clauses in financing agreements in the wake of the Argentinean litigation, increased Costs clauses and the impact of Basle 3, the characterization of trade finance instruments as an "investment" eligible to the protection of investment treaties (and the arbitration mechanism that comes with them), non-national law clauses as governing law in financing agreements, UNCITRAL's work on a model law on secured transactions, the EU Capital Requirement Regulation article 194's conditions for credit mitigation arrangements and the EU Bank Recovery and Resolution Directive's requirement of bail-in recognition clauses in certain bank liabilities.

Membership is by invitation only.

Chair: Dr Georges Affaki