ALLEN & OVERY

Lessons learned on taking security in a commodity finance transaction

Though trade finance is generally considered a safe asset class, built around self-liquidating and real economy transactions, things can sometimes go wrong – and we can learn from those occasions. In this Industry Perspective, two lawyers at Allen & Overy – partner Catherine Lang-Anderson, who leads the firm's London trade and commodity finance practice, and Brandon O'Neil, a partner in its litigation team, experienced in enforcing security and related judgments – discuss the steps banks can take to manage risk when taking security in a commodity finance transaction, what risks they should be aware of, and what to do if an enforcement situation arises.

GTR: What practical and legal factors should a lender keep in mind when taking security in a commodity finance transaction?

Lang-Anderson: First of all, lenders need to start with the basics. You can have a well-drafted legal document but you have to assess whether it works in practical terms, and that means understanding the underlying trade flow and capturing where the value lies across that flow. Typically, these deals would be cross-border, so you need to think about how you can take security in different jurisdictions. There could also be periods where goods are in transit or on the water. Practically, you need to think about whether goods are sufficiently identifiable at any given point in time, in case you do end up in an enforcement situation.

O'Neil: One consideration is that if you do have to enforce, you can probably assume there has been some breakdown in the relationship with the borrower. If that happens, you need to know where the security is, who controls it, and what your rights are to access and seize it. From a litigation perspective, I would always recommend keeping this as simple as possible, but the complexities of transaction can make that more complicated. For example, I've seen problems where there is a security agreement over perishable goods. Those won't just sit in a warehouse; they will be replaced frequently as goods are sold, so the bank should really be exercising their rights to inspection and information on a continual basis.

Lang-Anderson: Ultimately, there is a balance to be struck here. On the one hand, you have to think about the practicalities of the deal, making sure you're not disrupting a real trade flow,

Catherine Lang-Anderson
Partner
Tel +44 20 3088 2030
catherine.lang-anderson@allenovery.com

Brandon O'Neil
Partner
Tel +44 20 3088 4187
brandon.oneil@allenovery.com

but there are points you need to focus on to ensure you achieve a bankable transaction. Getting the structuring right can make a massive difference.

GTR: If an enforcement situation does arise, what is the process for realising the value of the security – and who should be involved in that process?

O'Neil: Often you will find parties want to renegotiate the deal, and you may find some kind of resolution to the problem through that route. That's usually preferable if you can do it, because nobody wants to have to go through the enforcement or litigation process. However, sometimes you might find borrowers use that possibility as a strategy to buy themselves time, dissipate security, and move assets. Lenders should think about whether the other side is acting in good faith and be prepared to take decisive action if that is in doubt.

Lang-Anderson: If the lender does go down the enforcement route, it will have to consider how practically it can enforce and have a plan on how to do this. A lender may take action directly where it is comfortable with the assets and jurisdiction or may need to engage specialist asset recovery providers for more challenging jurisdictions or scenarios. It is also important to consider how the asset can be realised – you will need to look whether there is a prescribed way of doing that – for example running an auction or private sale following specific rules.

O'Neil: It's usually going to be simpler and quicker if the lender can avoid actually taking control of the security, selling it with as minimal participation as possible, so you don't have to think about moving the goods around yourself. That's going to be especially complicated if it's perishable goods, for example, and you have to think about storage, deterioration and loss of value.

In terms of who should be involved, it's a good idea to structure the security to minimise the involvement of the borrower in an enforcement process as much as possible.
The lender doesn't want to be reliant on obtaining board resolutions or powers of attorney during a dispute; that should all be signed up front, so it's just waiting to be deployed if the lender has to enforce.

GTR: How can you ensure the security does not lose value before or during the enforcement process, and what role does inspection play in that?

Lang-Anderson: This has come more and more to the fore in recent years. Lenders have to have all the right procedures in place to understand the value of security on a regular basis. That could mean the borrower reporting on the secured assets, but more commonly it would be an independent auditor carrying out inspections and checks periodically. They might go to the facility and make sure the goods are there, that they're labelled, of the expected quality and are properly segregated from any other goods, for instance. New technologies such as shipment tracking will play an increasing role to help banks and independent auditors maintain real time information on goods and their whereabouts.

O'Neil: When times are good, this is the kind of thing that doesn't always seem too urgent, but you never know when it's going to become urgent. That means it's vitally important to keep information up to date.
Prices can fluctuate, for example; you might need to keep USD50m in value of a particular good in a warehouse, but the volume of that good required to make up USD50m will change over time. There needs to be a mechanism to assess the value of what is supposed to be kept on site.

Lang-Anderson: This also depends on what the asset actually is, particularly if it's not a physical good. If the security is the borrower's receivables, for example, inspection might involve looking at invoices, contracts and other arrangements, to make sure they have been issued in the right way. Again, you can put the best protections in place in a legal document, but if the ongoing contractual requirements are not being followed in practice it might not be worth the paper it's written on.

GTR: If the borrower is non-cooperative, is there recourse through local courts? If so, what factors should be considered there?

O'Neil: Ideally, you wouldn't need to go through the courts or arbitration. One way of avoiding that is to make sure your security is ring-fenced, so you're not in a situation where you're competing with other creditors. Going to the courts risks adding costs, delays and more potential difficulties.

If you are seeking recourse through the courts, it would be preferable if that is in a jurisdiction where there are competent, efficient courts that you trust. You don't want to be stuck in a scenario where it's excessively complicated, slow and expensive to litigate, or where the court is not used to high-value cases.

However, you may not always have that choice. For instance, if it's a share pledge, where you would take control of a company, you would probably have to enforce it in that company's jurisdiction; for share pledges specifically, those can also raise issues from a competition perspective.
It might also be that you involve other authorities, such as police or bailiffs, depending on the jurisdiction.
To understand exactly who can help you, you need to make sure you understand the local landscape.