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COLLATERAL MANAGEMENT AND STOCK MONITORING AGREEMENTS - THE CAST IRON SOLUTION FOR LENDERS?

2020 has been a year of upheaval and no less so than in transactional commodity finance, which has witnessed a series of major frauds. The significant losses suffered have caused some lenders to exit the sector completely and others to refocus on specific clients or sectors while tightening their KYC (know your client) and KYT (know your transaction) procedures.

In this article we re-examine two important tools available to a lender to mitigate the risks associated with inventory financing: collateral management agreements (CMAs) and stock monitoring agreements (SMAs).

What are the risks:

In inventory financing, a lender provides financing to a borrower for the purchase of commodities to be stored for a period of time in a specific location, either at the place of export or destination. In some cases, lenders have taken advantage of contango markets (where the futures price of a commodity is higher than its spot price) and financed commodities in storage for long periods of time. As in all transactional commodity finance, these commodities are the lender's collateral and primary source of reimbursement. This can leave them vulnerable, particularly during periods of economic stress, because the physical distance between the lender, borrower and financed goods leaves space for misappropriation, fraud and asymmetry of information. Recent cases, such as the collapse of Hin Leong in Singapore, have seen borrowers creating fictitious inventories, manipulating inventory counts and financing the same goods with multiple banks.

Good things come in threes

A key way to mitigate the risks associated with inventory finance is to appoint an independent third party, an inspection company, to monitor and/or keep custody of the financed goods. To achieve this, the lender, borrower and company enter into an agreement in the form of either a CMA or a SMA. These agreements provide an added layer of comfort to the lender that it is actually financing the goods specified in the borrower's utilisation request and give the lender some degree of visibility over its collateral.

Collateral management agreements

A CMA is a bailment agreement and is usually made between the borrower, lender and inspector (or "collateral manager"). The borrower, as original bailor of the goods, bails the goods to the collateral manager, and the collateral manager, as bailee, acknowledges the transfer of possession of the goods to the lender ("attornment") and agrees to hold the goods on the lender's behalf in accordance with the terms of the CMA. Attornment is vital in order to ensure that the lender has good security.

The collateral manager is entrusted with physical possession and control of the financed goods and is legally responsible for storing, securing and monitoring them. It will issue a warehouse receipt to the order of the lender upon receipt of the financed goods and will only be permitted to release them on the lender's instructions.

Once the goods have been sold and the lender has been repaid by the borrower, or the inventory finance leg has been refinanced by a receivables finance leg of the transaction, the lender will authorise the collateral manager to release the inventories to the borrower or the new owner. However, in the event of a payment default, a lender can retain access to and control of the financed goods, and consider the legal options available to enforce its rights against the borrower and the collateral.

Importantly, as demonstrated by the recent case of Scipion Active Trading Fund v Vallis Group Limited , a CMA will, as a matter of English law, grant the lender as bailor a right to possession of the goods, irrespective of the validity of any security agreement in place between the borrower and lender in respect of the goods, entitling the lender to claim damages against the collateral manager in the event of breach of its obligations under the CMA. See our briefing here.

Stock monitoring agreements

A SMA is an agreement between a borrower, lender and inspection company, whereby the inspector provides monitoring services in respect of goods subject to the SMA. They are commonly used when a borrower holds the financed inventories at its own premises.

Unlike with a CMA, the inspector does not take physical possession or control of the goods and is not responsible for their receipt, storage or security, nor does it play an active role in their release. The inspector will however monitor receipt, release and despatches of stock, compare the physical stocks against the storage documents and provide the lender with stock reports to an agreed timetable.

Whilst SMAs provide less protection than CMAs, they can offer a more convenient and less expensive solution for monitoring financed goods.

Drafting tips: considerations for lenders

When entering into a CMA or SMA, lenders need to ensure that it meets their requirements for the specific transaction and will work in practice for the relevant commodity, location and logistics chain. A CMA or SMA will only be a useful risk mitigant if properly drafted; simply duplicating the terms of another CMA or SMA is unlikely to achieve the results desired.

Some important considerations for lenders include:

1. *Governing law and jurisdiction*: The governing law and jurisdiction clause should be clear and unambiguous. Care should be taken where the governing law of the inspector's standard terms and conditions is different to the governing law of the CMA or SMA. A law and jurisdiction should be selected that recognises and upholds SMAs and CMAs, such as English or Swiss law. High risk jurisdictions should be avoided where possible.
2. *Counterparties and sub-contractors*: Many inspection groups operate through locally incorporated subsidiaries (by choice or as a result of local regulatory requirements). Lenders should consider with whom they contracting and whether this entity is a local subsidiary or holding company of the group.
3. *Insurance*: The inspector appointed should be reputable and maintain adequate professional indemnity insurance (including for the contractual counterparty and all affiliates responsible "on the ground"). This should include, where possible, infidelity cover in the event of fraud or collusion involving the inspection company's own personnel.
4. *Scope of services*: The scope of services should be clearly defined to ensure that all necessary data is captured and all required services are included. In a SMA, the checks to be conducted and the frequency of stock reports should be specified. Under a CMA, the collateral manager's obligations as bailee should be set out expressly, including in relation to the receipt and release of goods, warehouse inspections and the physical security of the storage facility.
5. *Inspection company and terms of appointment*: The inspector should be obliged to follow the instructions of the lender, not the borrower, and the lender should have the option to pay the inspector's fees in the case of default by the borrower to avoid the inspector terminating the agreement or exercising a lien over the goods. Care should be taken to ensure that the inspector's standard terms do not overrule those in the CMA or SMA (including as to governing law), and any limitations on the inspector's liability should be carefully considered. It should also be considered whether staff rotations are necessary to minimise the risk of collusion and fraud on the ground.
6. *Storage of financed goods*: The goods should be segregated and marked to the order of the lender. If segregation is not possible, identification measures should be in place to ensure that the same goods are not financed by multiple banks. The original storage documentation and the records of the storage facility should be checked against physical stocks to make sure that these are authentic and match in terms of quantity and storage location. In addition, it would be usual for the borrower to insure the goods against damage or theft and name the lender as loss payee under the policy.

7. *Access*: The borrower should grant or procure the inspector access to the storage facilities to carry out the agreed services. In the case of CMAs, it will be particularly important that the collateral manager is able to demonstrate it has legally enforceable rights to access the storage facility at all times and has exclusive possession and control of the designated section of the storage facility. The lender should of course also have the right to access the storage facility and inspect the financed goods should it consider that necessary.

So, are CMAs and SMAs a cast iron solution?

In 2021, we expect that CMAs and SMAs will continue to be important tools to mitigate the risks associated with inventory financing. However, they are not a cast iron solution and although they can assist, they cannot eliminate these risks entirely. If they are used, they must be tailored to fit the specific transaction and should be used alongside other risk mitigants at a lender's disposal.

There are other options available, too: an inventory financing transaction supported by a "Holding Certificate" or analogous document issued by a reputable storage facility may provide adequate comfort without the need to resort to an independent inspection company, in particular where the inventory is to be stored for a short period of time.

However, none of these solutions obviate the need for lenders to remain alert and conduct ongoing KYC and KYT, even for clients with an impeccable track record.

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