KEY POINTS

- A bank making a contractual claim for misdelivery under bills of lading may find it difficult to show that its loss was caused by the misdelivery.
- A pledge of the goods through holding the bills of lading might put the bank in a stronger position, but is unlikely to arise in many forms of trading.
- It is essential that the bank ensures that any sale contract letter of indemnity (LOI) is addressed to it and that it is triggered.
- The use of a trust receipt may give rise to an argument that the bank did not regard the bills of lading as security.
- Assignment of proceeds of sale is vulnerable to double-financing fraud.
- A floating charge over the goods will not be effective where the goods have been sold in the ordinary course of business to a third party without notice of the crystallisation of the charge.

Feature

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Illusory security of banks in trade finance

In this article, barrister Michael Collett KC considers the types of security commonly taken by banks providing trade finance and their potential weaknesses, in light of recent case-law arising from the collapse of oil traders such as Hin Leong, Zenrock and Gulf Petrochem.

The crash in oil prices in 2020 resulting from the onset of the COVID-19 pandemic led to the spectacular collapse of oil traders such as Hin Leong, Zenrock and Gulf Petrochem. Amidst allegations of fraud including double financing, trade finance banks had to look to their security with a view to recouping their losses. The resulting case-law has put a renewed focus on the types of security commonly taken by trade finance banks and their potential weaknesses.

This article will consider six forms of security:

- bills of lading;
- pledge;
- sale contract letters of indemnity;
- trust receipts;
- assignments of proceeds of sale; and
- floating charges.

BILLS OF LADING

The terms on which banks provide trade credit finance typically include rights of the bank to become holder and pledgee of the bills of lading relating to the financed goods. If the goods are still in the possession of the carrier at the time of the borrower's default, a bank holding the bills of lading can seek to take possession of the goods and sell them for its own account. More usually, the goods have already been delivered against a delivery letter of indemnity (delivery LOI). In that case, the bank can make a claim against the carrier for damages for misdelivery, because delivery without presentation of the bills of lading is a breach of the bill of lading contract: *The Houda* [1994] 2 Lloyd's Rep. 541.

If the bank's misdelivery claim is made in contract only, it bears the usual burden of showing that the breach of contract has been an effective cause of the bank suffering loss, and proving the amount of that loss. Recent case-law in England and Singapore suggests that the bank may not always find it easy to satisfy these requirements.

The point is not a new one. In *Glyn Mills Currie & Co v East and West India Dock Co* (1882) 7 App.Cas. 591, Lord Blackburn observed that delivery to anyone other than the party producing the bill of lading was a breach, but "if the person to whom [the carrier] delivered was really entitled to the possession of the goods, no one might be entitled to recover damages from him for that breach of contract".

One recent case in which that reasoning was applied is the decision of Andrew Baker J in *Fimbank plc v Discover Investment Corporation (The Nika)* [2020] EWHC 254 (Comm). The claimant bank sought damages for the delivery of the cargo to the bank's customer without presentation of the bills of lading. On an application to determine whether a freezing injunction against the carrier should be maintained, the injunction was dismissed on the grounds that the bank was unable to show that it had a good arguable case that the carrier was liable to the bank for substantial damages for delivering the cargo in the way that it did.

The judge found that there was an arrangement between the bank and its customer whereby the customer was authorised to take delivery of the goods from the carrier without presentation of the bills of lading. On the facts of that case, the arrangement had two, possibly overlapping, consequences. First, when the carrier delivered the goods at the discharge port to the bank's customer or its agents, it was delivering to the party which was actually entitled to possession of the goods. Second, as the bank's customer had been authorised to take delivery by the bank at a time when it was the holder of the bills of lading, delivery to the customer or its agents could be treated as delivery to the holder of the bills of lading. As a result, the bank could not show that the delivery of the cargo had caused it any loss.

A bank's claim for damages for misdelivery also failed in *Unicredit Bank AG v Euronav NV* [2023] EWCA Civ 47, a case arising out of the collapse of Gulf Petrochem. The bank, Unicredit, claimed against the owners of the vessel "Sienna" for damages for delivering a cargo of oil without production of the original bill of lading. Unicredit had issued a letter of credit on behalf of Gulf, to enable it to purchase the oil from BP. In doing so, Unicredit provided financing to Gulf, which was secured by a pledge of any bills of lading and of the goods themselves. As is typical, the bank did not become the holder of the bill of lading until long after the cargo had been discharged against a delivery LOI. By this time, it appeared that Gulf had committed a fraud against the bank, and it did not repay the sums which it had borrowed from the bank.

The Court of Appeal upheld Moulder J's decision that the owners' breach in delivering the cargo without production of the bill of lading had not caused the bank any loss. The starting point for considering causation was that the breach must be an effective cause. If the bill of lading contract had been performed, the shipowner would have refused to deliver against a delivery LOI. Nevertheless, Popplewell LJ held that the enquiry did not stop at that point. It was not enough to say that performance of the bill of lading contract required the owners to keep the cargo on board the vessel until an original bill of lading was presented. It was also necessary for the bank to show that, in the event of performance by the owners, the bank would have enforced its security against the cargo so as to recoup its lending.

On the facts of the *Unicredit* case, the bank could not show that it would have enforced its security against the cargo. If the owners had refused to discharge without production of an original bill of lading, the owners would have sought and obtained express consent to do so from the current holder of the bill (which was BP) and the intended indorsee (which was the bank). At that point, delivery without production of the bill would no longer have been a breach, which meant that the actual breach caused no loss.

Similar claims by banks in the Singapore courts have also run into difficulty. In *Standard Chartered Bank (Singapore) Ltd v Maersk Tankers Singapore Pte Ltd (The Maersk Princess)* [2022] SGHC 242, the bank's claim for summary judgment against the carrier failed. The bank had financed the purchase of an oil cargo by Hin Leong. The cargo was delivered to Hin Leong without presentation of the bills of lading. The bank became the holder of the bills of lading after the cargo had been delivered.

The carrier argued that there were various features of the case which indicated that the bank never regarded the bills of lading as security for its financing of Hin Leong, with the consequence that the effective cause of its loss was not the misdelivery of the cargo to Hin Leong without presentation of the bills of lading, but rather Hin Leong's insolvency and the way the bank's financing arrangements were structured. The bank agreed to issue its letter of credit and finance the cargo after the anticipated date of delivery of the cargo and the letter of credit did not require the presentation of bills of lading. The judge found that there was a triable issue as to causation.

A bank's claim for summary judgment on a misdelivery claim was also rejected by the Singapore Court, for reasons which included a similar issue, in *Oversea-Chinese Banking Corporation Ltd v Owner and/or Demise Charterer of the vessel "STI Orchard"* [2022] SGHCR 6 (upheld on appeal in HC/RA 174/2022).

PLEDGE

In all of the cases discussed above, the claimant bank's claim was made in contract alone, and not in conversion or in bailment. In circumstances where the bank becomes holder of the bills of lading after the cargo has been discharged, claims in conversion or bailment are unlikely to be available. There would generally be no bailment relationship between the carrier and the bank, and the bank would not have sufficient interest in the cargo to enable it to claim in tort.

There is an interesting question whether a bank which becomes a pledgee of the goods (through becoming holder of the bills of lading) would face less difficulty in establishing a right to substantial damages for delivery of the cargo without presentation of the bills of lading.

As reconfirmed recently by Popplewell J in *Bassano v Toft* [2014] EWHC 377 (QB), a pledge is a common law security interest created by bailment of property as security for the payment of a debt. The pledgee has a right to possession so far as necessary to secure the debt and an implied right to sell the pledged goods on default by the pledgor, and to retain that part of the sale proceeds which is required to cover the secured obligation.

At common law a pledge could only be created by delivery of the goods. Where the goods were in the actual possession of the pledgor, the pledge could be effected by physical delivery of the goods. Where the goods were in the custody of a third party, the pledge could be effected by a constructive delivery through the transfer of a document of title such as a bill of lading: *Official Assignee of Madras v Mercantile Bank of India* [1935] AC 53 at 58-59.

The way in which the pledge is created in the letter of credit context through transfer of bills of lading was explained by HHJ Diamond QC in *The Future Express* [1992] 2 Lloyd's Rep. 79 at 93 and Lloyd LJ [1993] 2 Lloyd's Rep. 542 at 547-548. First, the bank and its customer must intend that the bank should become a pledgee of the goods on receipt of the bills of lading. Second, the seller must be able to pledge the bills of lading to the bank on the customer's behalf. To be able to do so, the seller must have the general property in the goods at the time the bills of lading are presented and accepted under the letter of credit. These principles have a number of important implications in the modern trading context.

To begin with, it can readily be anticipated that there might be a chain of back-to-back sale contracts on terms that title is to pass on shipment without any reservation of the right of disposal. In this situation, if the bank finances a purchase by a buyer in the middle of the chain, then it is not practically possible for the bank to become a pledgee of the goods. Bills of lading suitable for tender under letters of credit are issued only after the goods have been shipped. The seller of the goods who presents the bills of lading under the letter of credit will no longer have the general property in the goods at the time when the bills of lading are tendered. Consequently, it will be unable to pledge the goods to the bank on behalf the buyer (ie the bank's customer), because without the general property the seller cannot confer the special property of a pledgee upon the bank.

Further, as illustrated by the cases discussed above, the bank may only become the holder of the bills of lading after the goods have been discharged and delivered. The letter of credit may permit the seller to tender a letter of indemnity rather than bills of lading. The goods are frequently delivered

to the ultimate receiver without presentation of bills of lading, against a separate delivery LOI. If the goods are no longer in the actual possession of the carrier at the time the bank becomes holder of the bills, then the bank does not acquire the constructive possession of the goods which is essential to becoming a pledgee. It follows that the bank does not become a pledgee of the goods if it becomes holder of the bills of lading after the goods have been delivered, even if such delivery was against an LOI rather than presentation of the bills of lading: *The Future Express* [1992] 2 Lloyd's Rep. 79 at 90 (1st instance); [1993] 2 Lloyd's Rep. 542 at 550 (CA).

Consequently, in many cases the financing bank will not become pledgee of the goods through holding the bills of lading. This is potentially a disadvantage, because the measure of loss recoverable by a pledgee for wrongful delivery of the goods to a third party is the whole value of the goods, and not just the value of the pledgee's security interest in the goods: *Swire v Leach* (1865) 18 CB (NS) 479, recently reconfirmed in *Scipion Active Trading Fund v Vallis Group Ltd* [2021] EWHC 1451 (Comm).

If the bank were entitled to claim as pledgee of the goods, in principle it should not have to overcome the hurdle set by the Court of Appeal in *Unicredit Bank AG v Euronav NV* of showing that it would have enforced its security against the cargo. The pledgee's loss is not measured by reference to the value of its security interest as such. On the other hand, it might still be open to the carrier to defeat the bank's claim by showing that the bank either did consent, or would have consented, to delivery of the cargo without presentation of the bills of lading.

SALE CONTRACT LETTERS OF INDEMNITY

As already noted, letters of credit often permit the beneficiary to tender a letter of indemnity (LOI) under the letter of credit in lieu of bills of lading, if the bills of lading are not available.

These LOIs originated as documents which were to be presented under the sale contract in lieu of bills of lading. As such, it is unsurprising that originally they were addressed to the buyer. However, following the decision of the English Commercial Court in *Trafigura v Kookmin* [2005] EWHC 2350 (Comm), in which the court observed that the financing bank could not take the benefit of such an LOI addressed to the buyer, banks began to insist on being added as an addressee of the LOI. The failure to take this precaution led to the rejection of a bank's claim under an LOI in *UniCredit Bank AG v Glencore Singapore Pte Ltd* [2022] SGHC 263.

Even where the LOI is addressed to the bank, it may not provide the anticipated protection, as illustrated by the decision of the Singapore International Commercial Court in *Credit Agricole Corporate & Investment Bank v PPT Energy Trading Co Ltd* [2022] SGHC(I) 1 (the decision on the appeal in the case is awaited). The case arose out of the collapse of Zenrock. The bank had issued a letter of credit to finance a purchase by Zenrock, but subsequently suspected fraud. It obtained an injunction restraining itself from making payment under the letter of credit. The result was that payment was made much later than the due date for payment under the sale contract. The first instance judge held that in those circumstances the LOI was not triggered.

TRUST RECEIPTS

The essential purpose of a trust receipt is to enable the bank to release the bills of lading to its customer so that the customer can take delivery of the goods, all the while preserving the bank's rights as pledgee of the goods. The mechanism for achieving this aim is for the bank's customer to agree that it is receiving the bills of lading on terms that the customer will hold those documents, the goods and the proceeds of sale of the goods on trust for the bank.

The curious fact is that trust receipt loans are frequently advanced by banks financing letters of credit in circumstances where the bank is unlikely to receive the bills of lading or become the pledgee of the goods (for the reasons discussed above).

If the bank does not have the bills of lading and does not release them to its customer, then it is arguable that the consideration for the trust receipt agreement is never provided, such that it has no effect. The use of a trust receipt loan may raise a wider question about whether it was the contractual intention as between the bank and its customer that the customer should take delivery of the goods from the carrier. The use of a trust receipt contributed to the court's decision in *Oversea-Chinese Banking Corporation Ltd v Owner and/or Demise Charterer of the vessel "STI Orchard"* that it was arguable that the bank did not look to the bills of lading as security when it agreed to provide financing.

ASSIGNMENT OF PROCEEDS OF SALE

Trade finance banks often say that they finance transactions on the basis that they are "self-liquidating" – in other words, they look to the proceeds of sale to pay off the financing which has been advanced.

A number of techniques may be used in combination to give the bank security over the proceeds of sale, including requiring that the proceeds are paid into a designated account maintained with the financing bank itself, and making the customer hold the proceeds on trust for the bank.

In addition, an important security is the assignment of the proceeds of sale. However, in the context of the problems which have been seen recently with the double-financing of goods, an assignment of the proceeds of sale may not be good security.

In cases such as *Credit Agricole Corporate & Investment Bank v PPT Energy Trading Co Ltd*, double financing occurred where the bank's customer appeared twice in the sale chain as a buyer, opening letters of credit through two different banks. Each bank took an assignment of the proceeds of sale. The priority of assignments is governed by the rule in *Dearle v Hall*. In relation to such assignments, priority is governed by whoever is first to give notice to the third party whose obligations are being assigned.

In circumstances where there has been a double financing and therefore a double assignment, that can leave the bank vulnerable to the possibility that another assignee gives notice first.

Biog box

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In Singapore, this problem has been addressed by the creation of an anti-fraud registry of trade transactions which can be interrogated to detect attempts at double-financing. It has been reported that the UK's trade finance banks have joined forces to implement recommendations of the UK chapter of the ICC in its 2022 report *Shutting fraudsters out of trade*.

The assignment of proceeds of sale also presupposes that the bank is able to identify the buyer of the goods. That may be difficult in trades such as the oil trade, where the good may be delivered into storage and blended before being used to perform contracts for the blended product. In those circumstances, the bank may also be unable to make practical use of an assignment of the sale proceeds.

While the sale proceeds may be the security which the bank has most clearly in mind at the time when it agrees to finance the transaction, if its customer is dishonest its rights over the sale proceeds may prove to be illusory.

FLOATING CHARGE

Typically, deeds of charge for bank financing give the bank a floating charge over financed goods which will crystallise automatically in various circumstances, including when any other security interest is created over the goods or their proceeds. Until the charge crystallises, the chargor is permitted to deal with its assets in the ordinary course of business.

Where there is fraudulent double-financing, assuming that both financing banks have the benefit of deeds of charge on such terms, the floating charge will crystallise over the financed goods at the latest when title in the goods passes to the bank's customer.

Nevertheless, in the commodity trading context, the bank's charge may be of little benefit. This is because a party which has given a floating charge over its goods has apparent authority to enter into agreements for the sale of goods in the ordinary course of business. If the bank's customer sells the goods to a third party who does not have notice of the crystallisation of the charge, that third party will acquire good title as against the bank.

The first instance judge accepted this analysis in *Credit Agricole Corporate & Investment Bank v PPT Energy Trading Co Ltd*. Even if the floating charge is registered, and the third-party buyer is treated as having constructive notice of the charge's existence, the third party will not have notice of the crystallisation of the charge unless it knows of the double-financing. Consequently, in the double-financing context, the floating charge may also not assist the bank. ■

This article originated from a presentation made at a seminar at the EW Barker Centre for Law and Business at National University of Singapore Faculty of Law, given jointly with Arvin Lee and Mark Cheng of Wee Swee Teow LLP and Andrew Fulton KC of Twenty Essex.

Further Reading:

- Commodity finance: the complete security package (2021) 5 JIBFL 351.
- Fraud in commodity finance: identification, mitigation and resolution (2021) 8 JIBFL 563.
- Lexis+® UK: Banking & Finance: Overviews: Security and other credit enhancements in trade finance – overview.