ARTICLES

LETTERS OF INDEMNITY AND BANKS' COLLATERAL SECURITY

by Peter SPROSTON*

This article seeks to discuss some of the significant issues relating to a bank's collateral security regarding traded commodities and bills of lading (BLs) as frequently used under letters of credit (LCs) in trade finance transactions.

Within this context, which criteria might a financing banker apply to determine whether a client's proposed transaction provides satisfactory security? What inherent qualities should the collateral have?[1]

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1. The assumption hereafter is that a client maintains an account and Facility Letter with his financing bank.

The commodity being financed must be tangible, identifiable[2] and extant,[3] i.e. the bank must be certain the goods actually exist and that the seller has the legal capacity to pledge them to the bank.[4] The bank should be able to establish and verify the current market value of the goods independently. A BL[5] has several functions[6] of which perhaps the most important is as a document of title[7] to the goods as this, if the BL is issued or endorsed to the bank, generally ensures that property is passed to the bank[8] and gives rights of disposal over the goods should this prove necessary.

Let us consider the purpose, under LC secured transactions, of issuing or endorsing BLs to the order of the buyer's /applicant's bank. Under the Carriage of Goods Act 1992, the holder of a title document, e.g. a BL, is entitled to take delivery of the goods from the carrier. Therefore, once the consignor, seller, or seller's bank has endorsed the BLs as noted above, and presented them with the LC's original documents to the LC issuing bank, this might have consequences regarding property in the goods.

If at that time the presenting bank has already paid for the goods, then both it and the seller retain certain rights over the subsequent delivery of the goods.[9] If not, both would have initially a claim upon the issuing bank for payment of compliant documents presented under the LC, absent which then ultimately, of course, upon the buyer.

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2. Especially important for bulk cargoes and goods held in storage in the bank's name

3. The shipped on board BL will usually suffice for goods in transit but care is needed for goods held in storage; issues around Holding Certificates, Warehouse Receipts etc. are outside the ambit of this short article.

4. The seller must have legal title at the time of presenting documents to the bank (e.g. in availment of an LC) but, if title has already passed to buyer before then, title cannot be passed to the bank as pledgee. Per *The Future Express,* Lloyd L.J. held that: "the bank's security depends, not on the contract between the buyer and his bank, but on the ability of the seller to pledge the documents of title on his behalf, or with his consent. Otherwise the confirming bank would be unsecured in the perhaps unlikely event of the issuing bank becoming insolvent."

5. A bank usually calls for a full set, clean, shipped on board ocean BLs, a distinction being drawn between shipped and received BLs; only the former providing conclusive evidence that the goods went on board.

6. As per the Carriage of Goods by Sea Act 1992 (COGSA), a bill of lading has the characteristics of a receipt for the goods, confirmation of carriage thereof and, if applicable, a document of title thereto.

7. The bank will usually want a full set of original, shipped on board ocean bills of lading issued or endorsed to the order of the bank.

8. For simplicity's sake this procedure only is noted. In general, the person in whom property is vested is the one entitled to possession. Hence the importance of a (perfected) pledge by the pledgor to his bank requires that property in the goods is retained by the seller, i.e. the bank's client, at least until such time as property is deemed to pass to the bank.

9. s 19(3) of the Sale of Goods Act 1979 grants seller rights of retention absent return of an unpaid BoE / BL. This might be of importance if the issuing bank rejects documents and the presenting bank made payment 'under reserve' to the seller.

The current market value of the goods is generally more important than the original sales value because if the buyer defaults the bank[10] will have to sell the goods at the prevailing market price which might have fallen since inception of the transaction. Indeed, this might be the cause of a buyer's default who 'covers in' at a lower price and then seeks to avoid payment to the seller. Usually the bank will take a haircut[11] and only finance circa 80–95% of the initial goods value as a price buffer as also to ensure their client 'has some skin in the game'.

Having touched briefly on a few matters concerning property in the goods and disposal or redelivery rights over same, we can now consider how use of an LOI relating to the delivery of goods without presentation of an original BL to the carrier might affect the collateral value of goods being financed by a bank.

What if the vessel arrives at the discharge port before documents become available to the buyer or issuing bank upon completion of the LC-related handling process? The following options then present themselves:

The vessel can wait until an original BL can be presented to obtain delivery of the goods, but this will incur demurrage[12] which, depending on the size of the vessel and the port in question, could be a significant financial charge. Alternatively, the master might agree to deliver the goods without delay to the person named in the Letter of Indemnity (LOI). This procedure is quite common and indeed, in the oil business, is the standard modus operandi. An LOI is generally issued in two parts: one from the seller (as charterer or consignor) to the carrier/master (that may sometimes be countersigned by his bank), permitting delivery of goods without presentation of an original BL, and another from the buyer/receiver to the seller to indemnify same for allowing delivery of goods without a BL.

What then are the potential consequences of delivering goods against an LOI rather than an original BL for the parties concerned and affected? The carrier will have incurred a potential liability by failing to adhere to the terms of their P&I[13] cover[14] and might find the LOI under which it

10. Depending upon which bank is deemed to have obtained property in the goods this could be the seller's or indeed the buyer's bank. Assuming the latter is the LC issuing bank it must have effected prior payment of the LC otherwise all original documents would need to be returned to the seller via his presenting bank.

11. The financing shortfall has to be financed with the seller's own cash or acceptable collateral.

12. Detention of a ship, freight car, or other cargo conveyance during loading or unloading beyond the scheduled time of departure and the compensation paid for such detention.

13. Protection and Indemnity insurance., for details see: Letters of Indemnity a guide to good practice by Stephen Mills & NEP&I.

14. "All P&I clubs expressly state that no claim can be made where the carrier has incurred liability (a) for discharging the cargo without production of a bill of lading," Letters of Indemnity a guide to good practice by Stephen Mills & NEP&I.

acted cannot be enforced against the issuing party[15] for failing to deliver goods against an original BL.

Banks relying primarily upon the purported collateral value of, and title to, goods being financed might consider the following situation:

> Vessel transit's duration shorter than the time required for receipt, handling and forwarding of documents under the LC securing the transaction.

When seller and buyer agree to transfer title and possession in the goods before the financing bank(s) obtains the BL, it appears that the bank(s) (as holder(s) of the BL) cannot subsequently sue the carrier for wrongful delivery as the bank(s) has/have no title to sue.[16] According to Aikens:[17] *"An action for wrongful interference with goods can be brought if and only if the claimant has at the time of the wrongful interference with goods, either actual possession or the immediate right to possession of the goods concerned.*[18] *In* The Future Express,[19] *… presentation of the bills of lading, made out to order of the buyer's bank (the claimant), was delayed until long after the goods had been discharged under a letter of indemnity provided by the sellers to the carrier and they had been delivered (but not to the bank's order). The claimant paid the seller on eventual presentation of documents and sued the carrier for delivery other than against the bill of lading. The action failed, the court concluding that although it was the original intention of the parties that the claimant should become a pledgee of the goods, which would have given it possessory title sufficient to sue, it never did so; nor did it acquire any other security rights in the goods, and thus had no title to sue. This illustrates a potential limitation on a bank's security rights given the increased prevalence of discharge against letters of indemnity prior to negotiation of documents."*

In this situation the bank(s) were presumably unaware of the seller and buyer's intention to use an LOI to deliver the goods and circumvent the bank(s). What might the case be if banks agree to presentation of an LOI under the LC? As noted above, this is common in the oil trade, but what of other commodities?

The nature of the goods is one factor, e.g. whether bulk, ascertained or undivided, if the vessel has been identified, final allocation of goods by seller to buyer(s), the parties' intentions regarding passing of property[20] as this is not automatic upon simply endorsing and delivering the BL.[21]

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15. *Kuwait Petroleum Corp v I. & D. Oil Carriers Ltd. (The Houda) (1994) CA, 2 Lloyd's Rep. 541,* Brown Jenkinson v Percy Dalton [1957] 2 Lloyd's Rep 1, however (The "Jag Ravi") [2011] EWHC 1372 (Comm) demonstrates that owners can indeed rely upon an LOI under certain circumstances.

16. Goodacre, J. Kenneth, Marine Insurance Claim, 3rd ed. 1996 (Witherby & Co. Ltd., London) at pages 1043-1044 referring to *The Future Express*, (1993) 2 Lloyd's Rep. 542.

17. Sir Richard Aikens et al, *Bills of Lading*, Lloyds Shipping Law Library (Informa, London 2006), 9.85 ff at pg 202.

18. *Clerk & Lindsell* (19th edn.), para. 17-40.

19. (1992) 2 Lloyd's Rep. 79, affd. (1993) 2 Lloyd's Rep. 542.

20. s. 17(1) of Sale of Goods Act 1979 refers regarding this last point.

21. (1884) 10 App. Cas. 74.

According to Todd,[22] in *Kum v. Wah Tat Bank Ltd*.[23] Lord Devlin said: "this is not property in the ordinary sense; the pledgee [i.e. the financing bank] has not even temporarily the use and enjoyment of the goods but simply the right to retain them until the pledge is honoured and, if it is not, to sell them and reimburse himself out of the proceeds."

The foregoing is predicated upon the financing bank becoming pledgee over the goods and holder of the BL. If, however, goods are per agreement *ab initio* to be delivered against an LOI, the original BL serves no useful purpose and can hardly be construed by the banks as a title document. Banks may well agree to this premised upon their faith in the client to honour their obligations. The 'collateral security' is thus provided by a client's financial standing alone. It may however be the case that the seller, depending upon the contractual terms agreed with the buyer, will retain title to the goods until the buyer has paid the sum. Ergo, should the bank(s) refuse to pay against non-compliant documents under the LC, the seller may still retain constructive, if not possessory, title in the goods. This would be implicit in the seller retaining the original BL, especially if issued to order of the buyer, until paid for the goods thus delaying property transfer.[24]

To what extent might that benefit the seller's financing bank? By retaining title and/or by his actions,[25] the seller may have made the bank pledgee of the goods. In that case the seller, provided he had been paid by his financing bank, upon obtaining disposal rights over the goods, could be deemed to do so as agent of the bank. Hence sales proceeds (and any shortfall due) would be held in trust by the seller for his bank. This is indeed the purpose of a bank taking a Trust Receipt from its client to perfect the pledge and define on what grounds goods are released and proceeds of sale are to be disbursed.

It is probably clear from the above that LOIs[26] can represent a minefield for the banks involved in financing the flow of trade goods. E-BLs permitting digital endorsements and delivery of goods would be a massive enhancement of such trade flows but their general acceptance to date has not been very common, being limited to bilateral movements of goods between trusted parties. Until such systemic change can be implemented it behoves parties handling BLs to be aware of the issues surrounding the use of LOIs, both disclosed and undisclosed, and the potential risks they can pose to banks' perceived collateral security. ■

22. Paul Todd, *Bills of Lading and Bankers' Documentary Credits* (4th ed. Informa, London 2007) at para. 6.20 pp 155.

23. Kum v. Wah Tat Bank Ltd., (1971) 1 Lloyd's Rep. 439.

24. Lickbarrow v. Mason, (1794) 5 Term Rep. 683. see also s. 19(2) of the Sales of Goods Act 1979.

25. At common law, the pledge is made by the legal owner of the goods delivering them, or the documents representing them to the pledgee, with the intention that he should become pledgee. Todd, *Bills of Lading …* at para. 6.22 pp 155.

26. It must be noted that LOIs can be issued for myriad purposes, most legal, some not, see NEP&I Letters of Indemnity.