ACEGLOBAL

ACE GLOBAL DEPOSITORY

COLLATERALIZED WORKING CAPITAL LOANS

  

INTRODUCTION

The term "asset-based lending" can be defined as any type of lending that can be secured by an asset, and is better known in the industry through the provision collateralized working capital loans. The process simply involves granting working capital loans against a borrowing company's trading assets.

Such loans can either be paid out on a short-term basis or revolved up and down based on the changing level of the borrower's collateral. These types of loans seemed to fit neatly into the floating charge / lien concept as defined for example by the Uniform Commercial Code ("UCC"), which gives a financial institution the right of a perfected security interest in constantly changing collateral.

Today however, the term "asset-based lending" has taken on a broader connotation. Lenders are now grouping all company assets – whether tangible or intangible, real or personal property – and other types of credits, such as amortizing term loans, all into the asset-based category. This may not necessarily be correct.

Asset-based lending should only be defined as the extension of credit against a company's floating assets on a collateral margin basis, with strong emphasis placed on establishing and maintaining collateral controls by the lending institution. Lending against real estate should not be considered as asset-based lending for several reasons. Firstly, real property is subject to individual territorial and country specific legislation . Secondly, real property has many different lending parameters compared to other assets. Also, there is limited need to control and monitor most immovable real property collateral compared to trading assets such as accounts receivable and inventory.

Although asset-based lending involves higher credit risks, there are many reasons why banks should begin to grant loans on the basis of the borrower's trading assets and gradually enter into this transactional field. One main reason is competition. In general, banks have traditionally been conservative and made the majority of loans based on the strong equity base of borrowing companies. They have shied away from higher-risk loans secured by floating assets. Inevitably, banks have therefore handled a lower volume of loans and maintained a smaller ratio of loans to deposits and capital. The end result was a constricted loan portfolio growth, since funds were loaned only to credit worthy and financially strong borrowers.

Since banks were reluctant to meet the needs of companies which had not yet proved their financial strength, other "alternative" institutions (such as non-banking finance institutions and funds) rushed to fill the void. As a matter of fact, the banking industry has made asset-based loans on a limited basis for years. Since the establishment of ACE Global in 1996, we have witnessed many regional and local banks began to make inroads into this market. Since then, certain banks around the world have entered the field of asset-based lending as part of a general trend toward full-service banking. These banks have recognized a very important benefit to be had from asset-based lending: not only did it help them remain competitive and maintain their market share, but asset-based loans generated significantly higher yields and spreads – fulfilling the increasing revenue pressure that today's bankers are subject to.

Over the years, although the banking industry has become increasingly involved in asset-based lending, banks have all too often neglected to adopt the proper dominion and control procedures required for these loans such as the implementation of a valid bailment in order to render constructive possession over the collateral and the ability to maintain continuous, exclusive and notorious possession over the underlying collateral against which the financing is to be provided.

While it is commonplace for bankers today to make commercial loans against balance sheet assets, many of them do not fully understand how to properly police and control the assets being collateralized . Even when they know what it takes to do the job, they may not want to incur the expenses in getting involved in the handling or monitoring such high-risk credits. Furthermore, many banks may have been lulled into complacency by merely signing a security or pledge agreements and the filing a financing statements such as under the UCC, or other registration documents under applicable statute, ensuring that notice of their interest is provided to the public at large and priority of lien is maintained through such filing and registration.

In reality, that protection may well be illusory as the signing of such documentation does not necessarily mean that the underlying collateral exists at all times throughout the financing and that appropriate controls are in place. Strictly from a credit stand-point there is good reason these days to implement prudent asset-based lending procedures and appropriate controls in order to properly secure the interest of the lending bank. If banks are to operate in the realm of high-risk lending, bankers must know how to control and police their collateral better than before to protect themselves from asset impairments.

The risk becomes greater when making loans secured by asset-based collateral such as accounts receivable and inventory because these often require only collateral margin protection based on a borrowing base formula. Then, in contrast to term loans where banks expect continuous amortization, banks adjust their debt up or down according to the expansion and contraction of such collateral.

As a result, this constantly changing trading asset collateral becomes very important to banks as a secondary source of repayment.

The foregoing discussion and this new emphasis on asset-based lending should not be interpreted to mean that banks should no longer depend on unsecured loans. Banks certainly do make unsecured loans to companies that warrant such credit – and banks would all like to have more unsecured loans in their loan portfolios. We know, however, that this facility is not abundantly available to every bank and to every customer. What needs to be emphasized is that a large majority of companies in the developing countries today are small to medium-sized enterprises. Many are in a state of continuous growth and do not have the financial strength and equity base to qualify for unsecured credit. They represent a vast lending market, and it would be shortsighted for banks to ignore it.

Lending on the basis of trading assets is an investment in the future. The good bankers will not only make loans to asset-based borrowers but will also act in the capacity of financial advisors for the duration of such transactions.

It is advised that bankers should work closely with their asset-based customers to enhance their financial condition so that someday they may qualify for unsecured loans. It is more than likely that this service on the banker's part will make a loyal and long-term customer out of the borrower – to his benefit and to bank's.

COLLATERALIZED WORKING CAPITAL LOANS - IMPLEMENTATION

The first important step to setting up a Collateralized Working Capital Loans portfolio is to get rid of obstacles which stand in the way of implementing asset-based lending programs for both the lender and the borrower.

Therefore, as a secured creditor a bank or other financial institution should use due diligence to protect its collateral interest through the best means possible. At the same time, a bank must offer its borrower a program which not only meets its need but also allows it to function properly under the asset-based lending arrangement.

While there may be more continuous paperwork involved in such financing, it should be tailored to the proper program or financial arrangement made available to the borrower. At the same time similar paperwork requested from the borrower should not hinder its operation or create any disadvantages to it. This is why a suitable arrangement for both parties is a necessity.

Remember that providing Collateralized Working Capital Loans is somewhat more time-consuming than other types of lending, because banks are normally lending on a revolving basis against a percentage of eligible collateral, which requires constant policing and monitoring though of the relevant loan documentation and the engagement of an efficient and vigilant collateral controller.

Because of the nature of the risk involved in making such loans, and the specialized nature of this type of financing, technical loan staff assistance may be needed in making decisions when contemplating entering into new load relationships with asset-based loan customers. For example, technical staff assistance should furnish guidance as to the initiation of a particular receivable and inventory lending program. This includes documentation preparation and any other necessary procedures in order to arrange for the proper financing assistance on behalf of both the customer and the bank.

Due to the volume of paperwork involved, many loan officers will not be able to properly service these credits. Also, many officers are only generalist or have another specialized lending background and may not have the ability to arrange this type of financing. Therefore, they need the support of specialized staff within their bank or institution.

Small banks do not have the luxury of support staff, and their loan officers probably need to know more about these lending procedures than anyone else. In such banks, these loans should probably be serviced by those seasoned officers who have had the most experience in specialized lending.

In medium- to large-sized banks, loan officers frequently have the support of technical staff which may be composed of personnel from Loan Review, Loan Administration or Credit Administration. In these banks the names of the line/staff departments that normally support the line commercial banking departments may be different or vary slightly, but they all do about the same thing. Often these departments have attorneys or specialists who can provide additional assistance by looking over or reviewing loan documents and agreements, or even drawing up such documents. This additional assistance may be especially helpful when dealing with intricate lending involving high-risk credits.

When possible, a specialized line/staff department should be formed to handle the servicing pertaining to such credits because of the constant volume of paperwork flow and the accuracy needed to reconcile accounts, handle disbursements, control collections and release goods. The Loan Administration Department or other similar line/staff department should handle the credit, documentation, and other agreement work. Of course, this is not to say that banks should not call upon or use outside legal counsel when drawing up or reviewing documents. Banks Loan Administration Department personnel or other in-house attorneys or specialists can often act as liaisons between the Commercial Loan Departments and external counsel. In general, support staff organization and functions will depend on the bank's own internal policies and philosophies and should be tailored to the banks needs.

Banks should remember, however, that if their own in-house attorneys draw the loan documents, there may be a legal question as to whether the cost can be passed on to the customer. If they feel they cannot pass on in-house legal costs to the borrower and lender's commitment or agreement requires the borrower to pay for it, which is often the case, lender might as well have external counsel draw the documents.

In the larger banks, a specialized department, which includes loan officers, often handles such high-risk credits. The larger the bank the more specialized the entire handling of credit becomes. In more recent years, many banks have formed or acquired subsidiaries through their holding companies to handle specialized lending. These subsidiaries may also allow some additional legal and tax advantages along with other market advantages of doing business out of the main jurisdiction.

The goal of the bank should be toward eventually qualifying the borrower for unsecured (open) credit, if asset-based lending is properly conducted. Therefore, while the asset-based collateral borrower represents a high credit risk because of his limited financial capacity or condition versus the unsecured borrower, banks should constantly strive to have their customer achieve an unsecured borrowing status. If this goal is achieved, it will mean less credit risk to the lender and less paperwork for both lender and the borrower.

Asset-based collateral must be properly assigned and banks interest must be attached to such collateral.

INVENTORY LENDING – AN OVERVIEW

Inventory loans represent an important segment of Collateralised Working Capital Loans.

Definition of Inventory

Inventory consists of any goods which are held by a person or entity for sale or to be furnished under contract(s) of service, and may be comprised of raw materials, works-in-process or finished goods categories in various stages. Therefore, all categories of inventory whether produced or bought and held or stocked for future sale or lease may represent acceptable collateral. However, while any materials, supplies, and goods used in conducing the business, and not sold or leased in the ordinary course of business, are often also taken as part of the total inventory collateral, they should not be given any loan value because they are normally not saleable.

The reason for taking these later categories of goods as collateral is because the creditor normally desires an abundance of such available collateral purpose. While the lender may not lend funds against these non saleable classes or types of inventory, a blanket lien should include them.

Purpose of Inventory Loans

Credit involving inventory financing should not be taken for granted. In considering such loans secured by inventory, as in any loan, the purpose should be a worthy one and should conform to bank's eligibility criteria and internal credit and risk policy. It should be determined that the loan is good for the borrower and that it will lead to improvement of earnings. Credit involving inventory financing should not be taken for granted.

The lending officer is cautioned at the outset that the high risk nature of inventory financing demands the utmost discretion in the extension of this type of credit. Just because the inventory loan is secured the bank it does not mean that it should continue renewals indefinitely. Loans secured by inventory should be primarily for temporary or seasonal assistance to cover specific periodic working capital needs based on cyclical demands made on the business as well as to:

- Provide funds to permit year-round production in the manufacture of seasonal product.
- Permit the company to purchase goods at an advantageous price and/or time when the inventory acquired will be used to its advantage in the normal sales cycle.
- Provide funds for an entire year's production during a short time in order to store the product for normal distribution during the year or for processing inventory over a few weeks but merchandising it over an entire year.
- Provide funds to build a substantial inventory at one time of the year which customarily is fully liquidated at another time of the year.
- Provide funds to borrowers who are experiencing a substantial growth. As a result, the credit needs of such borrower, outstrip the growth of their equity and working capital. This type of financial usually results in steady borrowers with loans that often become more permanent.

Loans in the latter instances, however, may be granted as quasi-capital in nature by establishing either a revolving credit or a non- revolving (multiple advance) credit which can be drawn to the maximum limit for working capital purposes and then, at a later date, be converted to a term payout. Otherwise lenders could arrange for split facilities, one, for revolving working capital needs and the other a term note with an amortization to pay out the permanent working capital required. These loans, in essence, would represent quasi-capital in lieu of real equity.

In order to grant the above loans, the bank as the lender, would need a clear understanding of future borrowing needs and dates when funds would be required and repaid supported by appropriate budgets and cash flow forecasts. If the lender is not completely satisfied with this information or the company's ability to achieve an acceptable level of equity, the use of inventory advances on a continuous basis in lieu of capital should generally be avoided. If the lender is already in such a relationship, or the credit has deteriorated, it shold seriously consider the use of placing the inventory under third party controls i.e. such as those of a collateral controller.

The lenders must constantly be aware of any deteriorating situation where reserves could cause a financial setback, this being another reason why lenders should control and monitor the inventory collateral closely.

Character of the borrower

In lending against inventory collateral, the character and responsibility of the borrower is as much if not more significant than in any other loan category. Because loans of this type are usually made to borrowers whose capital funds are low in relation to loans requirements, complete credit checks are necessary. The Lender must ensure that, because of the risks involved in inventory financing, the integrity and general reputation of the borrower compare as well in this of financing as with any unsecured borrower.

Most inventory loans are made to borrowers who do not have sufficient working capital or net worth to either purchase the inventory with their own money or to finance it with open (unsecured) credit extended by their banks or suppliers. One situation where this occurs is with manufacturers who must buy all of their raw materials for a full year during a period of a few weeks. Another situation is with the manufacturer who makes one-season merchandise but must run its plant all twelve months of the year to fill orders.

The organization must be well managed and the facilities adequate for this type of financing. The borrower should have good knowledge of its costs and operating expenses besides good internal controls over inventory levels.

Evaluating Inventory as collateral

Inventory must be closely scrutinized and evaluated before it can be considered as eligible collateral.

Eligible Inventory

Inventory may be considered eligible collateral if it meets the following criteria:

- The goods new, or if used, in goods saleable condition. Be cautions if goods are being sold under duress or under a distressed price situation or for purpose of liquidation where lender may become involved with a future bankrupt or defunct entity.
- The goods are owned free clear by the borrower, and are not subject to any lien or security interest whatsoever from a third party but are only subject to the priority security interest Lender hold.

Ineligible Inventory

Any inventory which is at any time eligible inventory but which subsequently fails to meet any of the foregoing requirements should forthwith cease to be eligible inventory. At this time such inventory, while still continuing as collateral, should be moved to and carried in the ineligible section of the borrowing base report until final disposition in made of it whether by sale or otherwise.

Lender may also want to conservatively eliminate any inventory for borrowing for related companies unless Lender can determine a method of eliminating all intercompany profit within the inventory. Therefore, such inventory may often be overstated in value if the inter company profit has not been eliminated.

In addition, and as in receivables from unrelated third parties because of reliance on intercompany transactions. Also, when the goods are sold from one related company to another it is hard to justify any profit increase over cost from one related company to another as, again, we often look to such closely related companies as one combined entity; this also becomes more obvious when combining or consolidating financial statements evidence eliminating entries.

Also, always remember to eliminate inventory not owned – but held by the customer on consignment, or that which has been furnished and is owned by other manufacturers, distributors, or suppliers; or inventory that is held under contracts or orders for future processing and that is not actually owned by the borrower. Occasionally, the lender may want to eliminate inventory over some stated period from purchase date, such as 180 days or less, if it subject to deterioration or over a shorter period if it represents perishable goods.

Merchandising Ability of the Borrower

Also, knowing the merchandising ability of the borrower and its sales experience cannot be overemphasized; this information can determine whether an undue quantity of inventory is being accumulated. Remember, that inventory sold is normally free and clear of Lender's lien if sold in the ordinary course of business; therefore, controls become more important for such lending.

Growers and Producers

At times Lender may face the legal question of whether growers of products of the soil other than timber, or producers of livestock or the producers of the products of livestock, who are not processors, manufactures, or wholesalers, can create inventory liens instead of only farm product and livestock liens.

INVENTORY LOANS

In view of the risk in controlling inventory collateral and often changing values, normally a larger margin of collateral to loan balance is required.

Inventory Margin Requirements

Inventory Margin is determined by the amount of reserve in the inventory collateral that exceeds the loan advance. As a general rule of thumb, banks often lend within a range of 50 percent of inventory or continuous loan position (seasonal vs permanent) and how much working capital it will need to make up the margin and meet other operating needs. Terms from suppliers should be known, too, as they will affect the ability to support the level of inventory carried and financed.

Margin requirements on inventory loans should also be subject to price stability and marketability of the product. Another factor in establishing the margin is the estimated time involved in the orderly sale of the goods. Where there are large fluctuations in market price or where the inventory is slower is moving, a larger margin than normal will necessarily be required.

In a new loan relationship where there is doubt as to setting the proper margin, it is better to loan more conservatively at the outset than to commence making higher advances against a lower collateral margin.

Maintaining the Collateral Margin

Advances on inventory should normally not exceed 50 per cent of the lower of cost or market (current replacement value) figure shown in the latest borrowing base report. The borrowing base advance for inventory should reflect a realistic dollar limit in proportion to the total approved commitment, if the commitment includes advances against receivables. Otherwise, it could conceivably be possible to over advance against inventory, if this inventory loan limit was not properly addressed in a loan agreement. This limit would be appropriate since inventory collateral normally represents a greater risk than receivables. These are only guidelines and not hard and fast rules an advance formulas since different types of inventory and the status thereof frequently are given different values and merit different collateral value consideration for loan purpose.

Collateral Value of Raw Materials, work-in-Progress, and Finished Goods

It is difficult to give much credit against work-in-process. For example, a manufacturing company that has parts assembled to different points of completion will merit less collateral value. Would the value of work-in-process inventory at 20 per cent be realistic, should the company go into bankruptcy? On the other hand, raw materials and finished goods may have much more lending value in view of greater liquidation value. Raw material such as sheet bar steel of standard specifications and rough lumber (top grade) may warrant loans as high as 80 per cent of the cost of such materials.

Items classified as raw material by many concerns actually are semi manufactured items and, as such, often have a limited market. For example, electric motors should normally have a broad market, but if they are built to particular specifications their market may be very limited. Give consideration to lending more on new and completed products of a non-perishable nature valued at the lower of cost or market (current replacement cost). Banks may also consider lending more against a firm purchase order or contract when the inventory will be purchased at a specified price and within a specified time. If banks lend to wholesalers, distributors, or retailers, it is sometimes possible to obtain a repurchase agreement or *buy-back* agreement from the borrower's major manufacturing suppliers.

Building a Reserve into the Borrowing Base

Consider building a reserve into the borrowing base to cover overages, slow moving, stale or obsolete inventory, or even on other inventory types which would not be, or be less, worthy as collateral. When inventory is subject to diminishing quickly under stress circumstances, such as in the liquidation of the company, or if it is highly perishable or subject to volatile pricing, consider the use of third party control under either a certified warehouse or field warehouse receipts arrangement. When lending against commodities always consider the use of specialist collateral controller a (third party control) arrangement which requires special handling. **Commodity financing also often involves the reliance on negotiable or non-negotiable warehouse receipts, Bills of Landing, or other title documents as collateral.**

Loans on Average Cost of Various Items

Be wary of making loans on the average cost of various items. By liquidation of the larger cost items at an average release price the loan could become considerably under margined. If prices on different items vary more than a few percentage points, it is always advisable to have the items segregated on the collateral reports submitted to the bank. Proper percentages may then be advanced, and also paid as the loan is liquidated. When loans are made on inventory at a time a historically high market price exists, the margin requirements should be greater than when a low market price exists.

Loan Repayment and Impact of Seasonal Product Sales

Repayment of inventory loans, if the credit is analyzed properly, should create no problem. Liquidation will come from inventory reduction through normal sales. The repayment program will reflect a proper knowledge of the product, its marketability and the analysis of the financial planning of the borrower.

There are of course unforeseen circumstances that may throw the program off schedule, such as sales fluctuations that will not enable the borrower to entirely clear the line. However, with proper inventory management practices, adjustments usually can be made in the ensuing operating period.

Loans secured by various products that are used or consumed seasonally, normally would not be carried over from one season to the next. In the hard goods line, loans against current models should be liquidated or least margin requirements will have to be increased to compensate for the loss in value when a new model is put on the market while the old model has not yet been sold. Take automobiles, for example. Normally in these instances the bank may lend 100 percent of the dealer's cost. However, if the dealer carries any unsold new '2010 models over into 2011 then the bank should request a curtailment (reduction) of the loan balance by ten percent, which would result in a margin based on a loan collateral level of 90 percent. If after another six months the '2010' vehicles were not sold then the bank might request another ten percent reduction in the original loan(s); this would result in an increase in the collateral margin to 125 percent of the loan balance or an 80 percent loan/collateral margin increase at any time and in whatever amount it wants.

Therefore, if the bank decided on a monthly curtailment or reduction in amounts loaned against a previous model year this could also be acceptable depending on the arrangement with the dealer.

Also, whenever banks are lending against both receivables and inventory, it is important not to forget to decrease the loan amount against inventory proportionately by the sale of that inventory, and convert that portion of inventory advance to the concurrently created receivable portion of the credit.

FINANCIAL ELIGIBILITY OF THE BORROWER

Preparation of Financial Information

Borrowers should be encouraged to prepare cash flow forecasts and operating budgets in order to show sufficient repayment potential of the loan. The customer applying for an inventory loan should be able to show why the loan is required, the benefit to be realized from it and when and how it will be retired. An analysis by the bank of sales volume should indicate whether sales will keep pace with production in the case of manufacturer, or purchasing in the case of the wholesaler or distributor. The bank should also require these financial plans and information before granting loan (s) commitments.

Turnover of inventory

Turnover of inventory should be studied to estimate how long it will take to liquidate the loan through the normal sale of inventory. The amount of loan or line of credit should be related to a study of the borrower's financial statements with particular emphasis on working capital, turnover of merchandise, and previous sales history over the past three years. Also, seasonal trends should be compared with current budgets to make sure the customer is not overambitious in sales forecasts, resulting in a situation where the credit cannot be through the normal turnover of inventory.

Analysis of Sales

Sales should be analyzed with respect to whether distribution is on a wide scale or if sold only to limited number of accounts. Wide distribution is more desirable because the borrower is not dependent upon a few outlets.

Working Capital Requirement

A study of the financial statements, particularly as to working capital, should show whether a borrower can maintain the required margin. In other words, how much working capital or equity can be tied up in inventory assigned while still allowing the borrower the capacity to carry on the business properly? For example, if it has been determined that the loan value will be 65 percent of the lower of cost of market value of inventory, the net working capital as displayed on the balance sheet must be sufficiently large enough to cover the following:

- The percent margin requirement.
- An amount that will enable the borrower to operate on a normal basis, including the ability to pay cash for releases of inventory at settlement date unless accounts receivable financing is being provided.
- An additional amount to be used as a cushion to provide additional margin if required.

CONTROLLING INVENTORY COLLATERAL

Effective controls are critical in order to establish good inventory lending practice and implementation.

Blanket Liens

Normally it is best to take a lien on all types and classes of inventory as an abundance of collateral (such as a hypothecation were possible), even when lending only on receivables; this gives better control and liquidation ability in case lender needs to resort to selling a going concerns assets. Often lender may be actually lending against inventory, based on this prior stage, to receivables which will be rolling over or converting to receivable borrowings during the normal trade (cash conversion) cycle.

Monthly Inventory Reconciliations and Schedules

If a bank is lending against inventory, it should obtain monthly inventory reconciliation schedules based on reconciliations back to the latest physical listings or observation of inventory count. It can also obtain these schedules by way of perpetual controls, with totals by categories and/or product lines, quantity, and price per unit. Inventory totals should also reflect the method of valuing or costing and pricing used goods. A reconciliation of inventory should be prepared for the latest preceding month.

These schedules should be provided by the borrower within 15 days after the end of the immediate preceding month showing as an example (a) an opening balance equal to the closing amount for the previous month (July) of $ 500,000; (b) inventory acquired during the month of August $100,000, less; (c) inventory sold and delivered during the month of $75,000, less; (d) inventory sold and held for future delivery during the month of $25,000, less; (e) inventory returned or repossessed during the month of $ 15,000, all resulting in a; (f) closing inventory as of the last day of the immediately preceding month (August) of $ 485,000.

If the lender is lending constantly (daily) against inventory, perhaps weekly reconciliation schedules should be furnished by the borrower showing the ins and outs of the collateral values. When lending constantly into inventory it would seem prudent to also obtain a physical listing of all inventory at least every six months in addition to monthly reconciliation schedules depending on the type of inventory and possible frequent fluctuations in value. Physical listings consist of o report of the actual count conducted at the end of that particular six month period reflecting any adjustments whether write-ups or write downs, in inventory values.

Monitoring of the Collateral

After having determined, in line with the above, that a borrower’s inventory is worthy collateral, the loan officer should develop a plan pertaining to the following:

- Quality, quantity and weight - collateral control requirements.
- When to check the quality, standards, production, or processing of the inventory.
- Movement of inventory whether on a daily, weekly, or monthly basis through reporting or physical inspection.

This plan must offer sufficient information to control and continually know the status of inventory at all times – including the following facts:

- Its location.
- Its grade, weigh and/or quality.
- Its value or price and how or why these may change. The price history of the item should be reviewed fully, covering both the fluctuation of the price over the past three year and current price level, historically speaking.

- Its disposition.
- How will lender know that it will be paid? Will the lender require payment before it is moved or released, and if not, how and when will it pay? Remember, the lender subject to losing lender's lien position if a receivable creditor is already in the picture; or when the automatic proceeds period expires-, or if an ordinary buyer in good faith purchases the goods. Therefore, the lender must seriously consider having a firm agreement to be paid immediately upon or immediately prior to the release of goods.

Furthermore, there is no real way to control the sale, movement, or release of inventory, unless the lender has third party control over it.

- Contingencies may prevent these plans from materializing (e.g., fire, storm, strike, vandalism, theft, misappropriation, et cetera). A lender may be protected against loss from such hazards by requiring the borrower to have adequate insurance and by naming the bank as loss payee on the endorsement.

QUALITY OF INVENTORY COLLATERAL

This issue of quality is critical in view of the lender's reliance on the value of the inventory to repay the debt, if necessary.

Checklist for Determining Inventory Quality

There are number of questions to be answered in determining whether certain inventory can be safely used as collateral for a working capital loan. These include the following:

- **If the inventory is raw material, will the borrower be paid for any part before it is used in the manufacturing process**? For example, if the lender will want to finance steel bars which go through a manufacturing process, the lender will want to know if any advance money or deposits will be furnished by the buyer. In these instances, the lender advances loan funds to be paid over to lender's bank whether before lender advances loan funds or after. Payments from buyers may offer lender the collateral margin the lender seeks. Of course lender will have to be careful if the ultimate buyer of the goods to be processed will own the inventory if it pays for the goods in their raw material state. Inventory owned by the ultimate buyer should not be carried in the borrower's inventory nor given any collateral value to lend against.

- **Has the borrower made sure that the collateral is in saleable condition at all times?**

- **How complicated is the conversion process from raw material to finished product and what is the length of time to complete?**

- **What changes will take place over time with respect to the following types of inventory:** perishable or semi perishable merchandise, seasonal merchandise, styles or fad merchandise in need of refrigeration or other special storage requirements, and merchandise (like beer or fertilizer) that undergoes chemical changes. Lender should also consider here the effect of time on the cost chemical changes. Lender should also consider here the effect of time on cost and availability of storage and the fluctuation of collateral prices in the market.

- **If the demand is limited to a particular time of the year of the year, it might be impossible to sell during the off-season.**

- **Is there a market for the collateral under a number of varying adverse circumstances?** The reason for this is that lender might be forced to liquidate the inventory when the borrower's industry is in a downturn.

- **If the inventory consists of manufactured products, what brand names will the lender consider and how does the brand under consideration, rate generally in the market?** Is the merchandise a standard type which can be used in many places? The speciality item with limited use can end up with little or no market.

- **What does the lender know about the grade or quality of the material or products (comprising the inventory) being considered?** Often the grade or quality is noted or labelled on products like lumber but, at times, the lender will have to determine this with the assistance of outside consultants or experts who deal in appraisals and evaluations of these goods.

PROTECTING INVENTORY COLLATERAL

Third Party Controls

Often it is the bank's advantage to establish third party controls in respect of overseeing the movement, in and out of storage, or release of collateral as a safety measure in assuring it is available and exists as stated. Also, this is a good way for the bank to control advances and make adjustments upwards and downwards to the borrowing base by use of warehouse receipts, according to the inventory from other goods.

Public Warehouse or Field Warehouse Controlled Inventory

Warehouses owned by third parties are generally referred to as public warehouses, and which are distinguished from privately owned storage facilities, perhaps owned by the borrower or directly or indirectly related companies.

Since the third parties at such public warehouses are holding goods for storage, they automatically have a priority lien over the goods and are not subject to the underlying terms of the financing documents. There is also no requirement for filing for public records by such third parties identifying their priority rights, and thus creating an undisclosed or bailor's lien over the goods.

The lender must make sure that the inventory under financing is properly segregated and properly identified or tagged. This would also be applicable to a field warehouse arrangement on the borrower's or a related company's premises, by sign posting, roping or fencing off such premises or in its yard.

It is also important to make sure, especially if the inventory is located on the borrower's or a related company's premises that sign posting, roping or fencing off such premises has been effectively implemented at the place where the particular inventory owned by the customer is located. In this way, the goods can be easily segregated and identified.

This procedure is necessary under a field warehouse financing arrangement when the bank is financing segregated or specially identified collateral. It should also allow for direct access to the goods by bank. By having ready access to the goods being financed, the lender can maintain an appropriate count of inventory on hand and can easily identify and inspect the goods or have it inspected and monitored by a collateral controller on site. As long as the lender makes sure that the storage charges due to the warehouse or other third party controlling the inventory are paid to date, and appropriate waivers of liens have been obtained, the lender will normally have unrestricted access to goods as there should be no third party claims in priority to them.

These procedures may make it easier to lend under a third party controlled warehouse or field warehouse arrangement whereby the borrower has either a warehouse itself or an outside service company maintains exclusive, notorious and continuous possession of the goods on behalf of the lender as bailor of the goods, and controls all movements of goods into and releases thereof from the borrower's premises or yard. The proper segregation and/or identification of the inventory may also be necessary as it could become improperly commingled with other owner's or creditors' goods.

If the inventory was mistakenly commingled in a warehouse, the lender could run into a dispute over ownership with another party using the same warehouse or storage facilities. This can become especially precarious when storing goods which are fungible. Fungible goods are evidenced by an interchangeable nature, such as grain or fuel which cannot specially be segregated or identified if held in common containers or tanks. Therefore, according to Article 7.207(2) of the UCC, for example, `Fungible goods so commingled are owned by the persons entitled thereto` The owners storing fungible goods under such a warehouse arrangement, then, are tenants in common of the commingled goods. The commingling problem may go even further, given a shortage, because each claimant of the stored fungible goods would have to share on a pro rata basis of their recorded share to the total on hand.

Full Ownership of Inventory

The lender must always verify that the customer has full legal and beneficial ownership in its inventory. Based on the nature of its business, the lender should first determine whether the borrower is holding inventory for its customer. If this is the case, goods may have been consigned to the customers for sale. Or was the customer furnished this inventory in order to complete processing under some sort of contract or order? Therefore, the borrower may be improperly showings these good as part of its inventory, represented as lender's collateral. It is difficult to determine this unless lender knows enough about the borrower's business. For instance, does it take in goods owned by the others and provide processing or is it only receiving commission to process or acquire goods?

This information along with reviews of the borrowers' financial statements and records may give lender some insight into inventory practices. One way to learn if the borrower is holding goods under consignment (owned by a third party) for future sale is to run a search at the central or local filing records because the consignor could have had the borrower execute relevant documents for public record purposes such as the UCC-1, evidencing the proper ownership of the goods. This recording may also apply if the owner of the goods has delivered them to the borrower for processing.

Accessions and Commingling

If the lender provides loan on inventory parts which could become accessions to goods in whole, such as radiators or mufflers installed in vehicles, it should always perfect lender's security interest before any installation into the whole (vehicle) in order to obtain a purchase money lien. If there is an existing lien against the larger whole, lender must perfect their security interest in any accessions before they become a part of the larger whole. If lender doesn't, lender stands to have their rights jeopardized and cut off by any third party creditor's existing security interest in the vehicle or whole, irrespective of the type of goods involved.

Also, if lender file a financing statement after the accession in goods attached to the whole, lender's lien would become invalid to any other creditor who has an interest in the whole.

Commingling involves goods which become part of a whole product or mass after a security interest has been taken in them. The interest in component parts if perfected, before they became a part of the whole, as a machine, will continue. If others also have interest in component parts which become part of the whole, each perfected party of these parts will share on a pro rata basis their respective portions which make up the whole, based on a cost of goods shared to the total cost of the completed product.

Insuring Inventory Collateral

As with any loan secured by goods, it is essential to protect inventory collateral against hazards of loss or misappropriation by mean of adequate insurance.

In General

Inventories should be protected by fire and by an extended-cover insurance in an amount equal to 100 percent of the value of the collateral. An appropriate mortgagee clause in favour of the bank should also be endorsed in policies, identifying lender bank as sole loss payee. The customer should be obligated to pay the total premium cost of these policies while the bank, being the loss payee, should receive any insurance proceeds as a result of damage or loss to the goods because of its collateral interest.

Adequacy of Coverage

Fire insurance and extended coverage, plus misappropriation and transportation insurance where applicable, should be required. The need for insurance against other risks should be considered at the discretion of the loan officer and loan committee.

(i) Originals and Certified Copies of Policies

Normally, only original policies should be held and accepted by the bank as evidence of insurance. This will prevent cancellation without the bank's knowledge. However, where this is not feasible, certified copies of the original policies should prove acceptable.

(ii) Blanket (umbrella) Policies

Frequently, customers offer blanket or umbrella policies to the bank in order to cover goods pledged as collateral to loan. Where lender collateral is only a part of the merchandise insured and where the merchandise is continually moving, it may not be possible to adhere to the provisions and coverage lenders require. In these cases, the Loan officer should use his discretion to specifically approve the acceptance of monthly confirmations from the customer that adequate insurance is being carried against all normal risks and that the policies contain acceptable loss-payable clauses recognizing the bank's interest as it may appear.

(iii) Insurance Defined as Proceeds e.g. under the UCC

Under the new definition of Revised Article 9.306 of the UCC for example, proceeds of the collateral includes any hazard insurance on these goods, which is due and payable by reason of loss or damage, except to the extent that such insurance proceeds are specifically assigned and payable to a person or party other than, say, the bank (which has a security interest in the goods). Therefore, in the case lender does not take a direct assignment in such insurance, naming the bank as loss payee, lender could still benefit by receiving any loss proceeds unless another party takes a direct assignment of the policy which should be acknowledged by the insurance company and name the bank as loss payee relative to specific insurance coverage of the goods which the bank is financing.

Acceptability of Insurance Company

The company writing the insurance should be acceptable. The Bank should researche the credit standing of the insurance company, in order to determine if it is acceptable or not.

Description of Property

The merchandise must be described accurately in the policy. Also, it should be determined if inventory insurance is restricted to certain locations whereby it will not be covered if moved to locations other than those specifically designated in the policy endorsement. The name and address of each location where the merchandise is stored or located must be indicated in the policy.

Provisional Reporting Policy

A commonly used policy, insuring inventory where the quantity and value are subject to change, is known as a *provisional reporting policy.* This type of policy is used for a definite time and maximum amount; the coverage changes in accordance with the fluctuations of the inventory value. This policy usually requires monthly reports from the borrower to the insurance company which, in turn ratifies the current coverage. Validation of this coverage should be available to the bank as the value of the merchandise and total insurance in force on any given day during the month. Reports under this type of policy must be made promptly and accurately so that the full value of the inventory is always covered.

Full Mortgage Clause Provisions

There are advantages to having policies that includes full mortgage clause provisions over policies that include only the usual loss payable clauses. The following represent full mortgage clause provisions:

- The bank's interest will not be invalidated regardless of any acts of errors, omission, breach of warranty, neglect, or non-compliance with the provisions of the policy on the part of the customer.
- In the event of non-payment of premiums, the bank is notified and given an opportunity to pay premiums to protect the asset covered.
- The policy often remains in force up to ten days after expiration. This allows the bank sufficient time to get a binder with another company in case the first company cancels its policy or is unwilling to reinstate it for some reason. Policies should expire on or after the maturity dates of the loans. In instances where a policy expires before the loan matures, evidence of renewal should be in lender's hands ten days before the expiration date of the policy. To avoid a problem resulting from the cancellation of a policy because of non-payment of its premium, payable in advance by the insured, it is advisable to require the customer to submit a receipted bill or cancelled check as evidence of payment. Where premiums are not payable in advance, the bank should be provided with a copy of the insurance company's periodic declaration of coverage.
- If title to property covered becomes vested in the bank's name or its agent, insurance coverage should continue for the benefit of the bank. At the time, however, the bank will become the insured and will have to meet the same standards as required of the former owner/insured.

Coinsurance Clause

Most policies commonly contain a coinsurance clause of 80 percent or up to 90 percent if pertaining to a blanket policy. In order to collect a partial loss in full under a policy containing such a clause, the merchandise must be insured for an amount not less than the stated percent of coinsurance to the insurance company will pay on any such losses up to this maximum percentage, adjusted for any deductible. The policy owner/insured will have to share in a proportionate amount of any partial loss. This could occur because of the goods being underinsured to the required coinsurance amount, or, in effect, for the uninsured difference.

In case where the loss is equal to or greater than the underinsured face or carried amount of the policy, the insurance company should pay the full amount of the policy. This also applies in case where the loss is equal to or greater than the amount of insurance required by the coinsurance clause (amount of insurance purchased complied with policy coinsurance requirement), as then the application of the clause should not affect the amount of recovery.

PROTECTING THE PRIORITY OF LENDER'S LIEN

There may be occasions when the lender may face the question of priority regarding its rights of lien in the inventory collateral.

Purchase Money Liens Versus Prior Blanket or other Specific Liens

Purchase money liens, if properly perfected, will take priority precedence over previous filings made by blanket lien or other specific lien creditors. (E.g. See Article 9.312(3) and 9.312(4) of the UCC.)

Definition of Purchase Money Lien

A purchase money lien interest is defined, according to Article 9.107 of the UCC for example, as an interest arising in collateral created by advancing funds to purchase specific goods. It is supposedly superior to all other prior lien filings by other creditors if funds loaned are definitely used to acquire specific goods which can be identified.

Normally, a purchase money lien is created when a seller of goods or a creditor takes a specific security interest in the goods sold to or purchased by the debtor for whom it has financed.

If the lender, at any time wishes to perfect a purchase money security interest, it will give lender a valid priority interest in inventory that the lender is financing versus another secured party (ies) that has filed a prior blanket lien financing statement on all or similar inventory items. However, lender will get priority only if the purchase money security interest is perfected at the time the debtor receives possession of the goods. Also, seller or lender must notify any other prior lien blanket creditor(s) within five years before the debtor receives possession of the collateral covered by the purchase money security interest, indicating the intent of taking a purchase money lien. This protects the lender's collateral interest in the particular goods that lender is financing.

Notifying the Other Secured Party(ies)

The lender should obtain, when possible, an acknowledgment or a waiver from any other secured party which may have an interest in the particular goods bank is financing or any other blanket lien creditors of record, which have filed a prior blanket lien. The Lender should do this in order to confirm that they have received notification before the customer receives the specific goods that the lender has financed, if the bank wants full assurance of complying with the UCC.

This notification should be accomplished by sending the other creditor(s) a notification letter. Lender should identify the purchase money collateral by item or type in the notification letter pertaining to the goods that have been financed or are committed to being financed. As a precautionary measure, lender may even want to withhold loan proceeds until they are assured that the other secured creditor has received lender's notice. However, any delay in advancing loan funds could possibly impede the borrower's position relative to the purchase of the goods.

A registered letter mailed to the prior lien holder(s) with a return receipt requested would be appropriate. However, the lender's attempt to notify, in itself, should be sufficient.
Also, on inventory, it is also important to make sure that the lender's financing statement is recorded and on file with proper central and local filing office before the debtor receives possession of the goods. Furthermore, lender must also control any sales proceeds if they do not have a priority lien on receivables ; only then will lender have a right to any identifiable cash proceeds received before or upon the delivery of the inventory to a buyer, hence, the need for immediate direct receipt of payment. Lender could consider some form of Certificate of Delivery notification arrangement with buyers whereby they would be required to pay the bank directly on delivery of the goods, or lender could have them pay before or on release of the goods under some form of draft sent for collection to another bank.

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Purchase Money Liens by Vendors

Other precautions need to be made when the borrower's financial condition is not very strong, evidenced by a marginal working capital level and rather small equity to total debt, et cetera, or it is generally facing other uncertainties.

Therefore, when lenders are extending credit under a blanket lien or the lenders want to be better assured by being in the position of purchase money lien holders, by insuring that vendors are being paid in full for purchases, the lender may want to control advances by making sure loan proceeds are disbursed directly to third party vendors. Without this assurance the lender could be facing an automatic position in inventory collateral if any respective vendor retains a purchase money lien in respect of the goods financed. This may happen because the vendor has not been fully paid, thus resulting in the double pledging of collateral. The Lender should be notified by vendors in these instances.

Double Pledging of Collateral

Double pledging is created when the borrower receives goods on which two or more creditors claim the same collateral interest. Of course, a lien by the vendor could be avoided if it were willing to ship the goods to the borrower on extended open (unsecured) credit terms such as net (due and payable) 30 days. On the other hand, if the vendor wanted to be paid in advance or C.O.D., there, again, would be no problem of an intervening open lien on the part of the supplier. Therefore, other than the supplier extending open credit to the buyer/borrower or receiving full cash payment prior to the time of delivery, a possible intervening lien by the vendor could be established.

Avoiding Liens by Vendors

In order for the bank to avoid liens by vendors, it could first approve its customer's check after advancing the needed funds into the borrower's account. It could also avoid competing liens by making the payment directly with a cashier's check in the amount of the loan proceeds. In this way the bank could hopefully be assured that the full cost had been sent, so a purchase money lien could still arise from the vendor if the bank did not advance 100 percent of the cost or purchase price; therefore, it could require its customer to put up its equity share of the purchase price. The bank would, in turn, add this equity share of the loan proceeds and then remit the full amount of the purchase price to the vendor.

Similar results could be gained by offering to honour vendor drafts accompanied by title documents to goods being purchased by the bank's borrower. This assures the vendor payment upon acceptance of the draft before delivery or release of goods. The vendor could even be offered further assurance of payment by requesting that the bank issue documentary letters of credit to it as beneficiary, relative to goods sold by the vendor and bought for the borrower's account.

Another possible way to alleviate the problem of assuring a first lien would be to set up a tri-party agreement whereby the bank would finance the accounts and another creditor or the manufacturer, wholesaler, or supplier of the inventory would finance or carry it back under a purchase money lien to their mutual customer.

Under this arrangement, when the goods are sold the bank would pay off the other party, directly with its loan proceeds, against the creation of new receivables. The other party's lien position would be for the bank to obtain a subordination regarding those specific goods and proceeds from the other party. Any one of these procedures represents a good alternative in assuring the bank a proper first lien.

Again, this type of lending should be cautiously handled because of the creation of dual lending situation. The Lender will have to be assured that it can identify its colllateral. Also, the Lender will have to exercise more caution if they are of a fungible (interchangeable) nature. Lastly Lender must watch out for the problem of commingling goods and proceeds.

Lien waivers

The Lender should obtain a waiver any time that the inventory, equipment or other goods are located or stored on property not owned or leased by the borrower, i.e. under a third party lease and/or there if there is a mortgage on the real property.

Landlord Lien Waivers

The Lender must in particular obtain a waiver from the owner/ landlord of the real property premises where the goods constituting the lender's collateral are located. All co-owners, if any, must sign the waiver. If a corporation or partnership is the owner of the promises, a resolution affidavit authorizing such a waiver is necessary, which should also authorize who may sign the waiver on behalf of the corporation or partnership. In essence, the landlord, by executing a lien waiver form, subordinates its rights for non-payment of rent to the personal property securing the bank's debt. This property is located on the landlord's premises and owned by the lessee/tenant customer of the bank. The way the bank determines its exposure on any lease is to request from the borrower any lease agreements it has, and if the goods pledged as collateral are located at such premises. If the bank has any further question as to whether its borrower is leasing premises where goods may be stored or located, it can inspect the premises and do a lien search thought a title company often referred to as obtaining an abstract. Alternatively, it is most prudent for the bank to appoint a collateral controller which would in fact be the party present on site controlling, monitoring and inspecting the goods under financing for and on behalf of the bank, and report accordingly on a periodic basis.

Generally, the purpose of the waiver is to allow the bank or its designated representative or agent, access to the property at all times, so that it may repossess and remove any collateral consisting of goods in case its borrower defaults on its loan. If the owner defaults on its payments with a mortgagee, the borrower, as tenant, should be allowed the right to remove its inventory.

The best time to obtain the landlord's cooperation on a waiver is when it is negotiating the lease with the borrower/lessee relating to the terms of the lease. However, most of the time the lease is already in force when the lender requests the waiver. In such circumstances, the lender can make such a waiver a condition precedent to disbursement or then hope for is the landlord's cooperation.

Mortgagee Lien waivers

If the landlord is willing to execute the assignment but a mortgagee holds a first lien on the premises, the lender should attempt to go one step further and obtain a Mortgagee waiver. Most of the time the first lien holder (mortgagee) will not offer a waiver because it has nothing to gain. However, lender may not have a real problem if the owner defaults on its mortgage payments. In this instance the mortgagee may not have the right to hold the tenant's goods as an offset to non-payment if the tenant can furnish evidence that it has kept its rental payments current.

If lender has a problem in this connection, the lender might request that the mortgagee give lender the opportunity of curing rights (allow lender to settle certain note amounts owed) regarding delinquent mortgage payments, in case the owner defaults; this should give lender and the borrower the right and the opportunity to remove the goods or allow the borrower to continue leasing the premises. The mortgagee may even be willing to renegotiate a private sale of the leased premises to the borrower if it decides to foreclose on the premises.

Deed of Trust Leasehold or Collateral Assignment

Lender might also take a Deed of Trust on the leasehold estate (leasehold interest in the property) or collateral assignment of the lease from borrower/tenant in order to protect the bank's interest in the real property lease itself. The Deed of Trust Leasehold or Collateral Assignment is good in case the borrower defaults on the bank's debt and the bank wants to move in another party who could assume the debt, including the ownership of the goods. The other party is thus allowed the opportunity to acquire an appropriate ready-made business and a location from which to operate. This could prove very beneficial with certain specialty retail or distribution businesses.

(Liquidation prices would probably be very low pertaining to such items, besides the cost of removal, detachment, movement or even storage). Also, the bank would probably be responsible to the owners for many damages done to the real property while removing these items.

In any case, it could be very beneficial to obtain the owner's/landlord's permission in order for the bank to take over the lease and, in turn, sublease the premises at its option through any foreclosure under the collateral assignment or deed of trust leasehold lien. This is especially beneficial if there is a clause in the lease that prohibits assignments or subleasing by tenants.

Waiver form including lease reassignment

The landlord lien waiver form used by bank could build in protective language for added benefit regarding curing rights and the reassignment of the lease. If a landlord balks at a lease reassignment clause while allowing a waver to goods collateral, lender may delete those applicable sections. A separate lease reassignment form for this purpose, however, could be used. While still protecting the collateral, any deletion or non-existence of reassignment would eliminate the flexibility and the ease of allowing another party to move in and continue to operate the business at the same location. Therefore, when possible lender's form should serve as a combination of Landlord's Lien Waiver and an Assignment of Lease with subletting and curing rights. This form should also be recorded in the local deed records where the property is located in order to offer the lender full protection in enforcing the rights against other lien creditors or future buyers of the premises. This recording may prove especially help full if lender has taken fixtures as collateral.

These waivers forms may be recorded separately or in conjunction with taking a Deed of Trust Lien of the leasehold interest of the lessee customer or when taking a collateral assignment of lessee's interest in the lease. In either case, it is important that lender get the lessor's permission for the bank to take over the lease at its option through any foreclosure under the collateral assignment or Deed of Trust leasehold lien. Lender needs this permission especially if there is a clause in the lease that prohibits assignments or subleasing or does not state that the landlord will not unreasonably withhold any assignment or subleasing by its tenant. Therefore, the bank must make sure that the waiver agreement form includes a clause pertaining to the landlord's acceptance of the bank as lessee under the lease, in case the bank elects to foreclose either under its Deed of trust leasehold lien or its collateral assignment of the lease.

The form should also attempt to build in a clause whereby the lessor/owner would not hold the bank responsible or liable for the payment of the rent as specified in the subject lease, or in any way be obligated both under the terms and conditions of lease and/or the rights and remedies provides there under including any provisions and covenants of the lease, unless the bank expressly agrees to such responsibility or liabilities. It should also be agreed that if the bank sublets the premises to another tenant pursuant to the agreement, the tenant would automatically be accepted by the owner/landlord as its tenant.

Where the bank engages a collateral controller on site in respect of the financed goods, the collateral controller would step into the shoes of the bank and negotiate in its best interests.

CONSIGNED INVENTORY

This type of inventory consists of goods owned by the borrower and held for process or sale at a third party's premises or of goods owned by the third party held at the borrower's premises.

Borrower's Consigned Goods

Lender may be faced with a situation where the borrower is consigning its inventory to a consignee that may not have its own inventory financed by other creditors.

Compliance with basic principles

In order for the inventory collateral to be protected, the lender as pledgor or its designated collateral controller, must make sure the borrower/consignor has the consignee/seller do one of these three things:

- Have a sign conspicuously posted on its premises where the particular inventory should be located and segregated, in order to show the seller's/consignee's creditors that such goods are not owned by the seller but that he or she is only selling them for the owner. This will protect the bank by not having another creditor claim an interest in these goods.

- Reveal in writing to its creditors that it is substantially engaged in the selling of consigned goods (goods it does not own but is selling on behalf of others) and is unable to offer a lien on these goods. This will protect the bank because the consignee's creditors should not enter the picture by lending funds against inventory that the consignee does not really own.

- The third way, which offers the optimum means of protection, is to file the like of a UCC-1 financing statement where possible under relevant local jurisdiction where the inventory is to be located giving a description by item and type of the goods financed. The borrower/consignor should be shown as the secured party, the consignee as the debtor and the bank as the assignee. Lender should make sure this financing statement is properly on file in order to protect lender against other possible inventory lien conflicts especially with creditors of the consignee. This will protect the bank by having its customer show, for public record purposes, that it has assigned the goods to the bank and that the consignee does not have an interest in them thus preventing any creditor of the consignee from taking a collateral interest in such inventory.

Consignee Collateral Creditors

If the lender becomes aware that the consignee has inventory creditors of its own, after running a search of the public central or central and local filing records, the customer (or the bank as a assignee) should, in turn, conform to the same rules with its customers as the lender would on a purchase money lien with its customer (as previously discussed in section 8). This practice is necessary because the consignee's inventory may be financed by another creditor(s), who may possibly have a blanket lien or purchase money lien(s), on file in the consignee's name as debtor. Therefore, lender should make sure the customer furnishes proper notice to other creditors dealing with the consignee before it receives possession of those goods. Also, this financing statement pertaining to consigned goods owned by the borrower should be on file before the consignee receives possession.

Protecting Consigned Inventory Collateral against Other Purchase Money Liens

Now, what if other suppliers subsequently sell to the consignee under a purchase money lien or creditors finance its inventory, after the borrower/consignor's lien is of record showing the bank as assignee, and take back purchase money liens on similar goods lender are financing?

The borrower or lender should be put on notice by these suppliers or creditors. Lender will then have to make sure that the goods representing the collateral are clearly marked or identified so they will not become mixed or commingled in with other suppliers or creditors goods. If this commingling occurs, it could later lead to a dispute and conflict over collateral interests.

If the lender feels there are too many purchase money lien vendors or creditors involved; or if lender has a problem with identifying the goods represented to be the collateral ; or if the value or quantity is too large in relation to competing suppliers or creditors' lien on similar goods, lender may determine that the risk of knowing, controlling, and monitoring the collateral is too great. In these instances, lender may prefer to cancel the line or at least that portion made available for consigned goods, unless under third party control.

Of course, a great deal depends on the amount of consigned inventory lender are financing. The more inventory lender is financing that is held by a third party consignee to the total amount of inventory collateral from the borrower, the greater the risk. This risk may also be higher pertaining to consigned inventory in these instances, especially if lender is not using a third party to control the release of the goods. Or, the risk may be too high considering a buyer in good faith takes goods sold in the ordinary course of business free and clear of the lender's and the borrower's interest. Therefore, should the consigned inventory collateral be sold in the ordinary course of business, without complete control over the payment for these goods, lender's only recourse will be against the consignee upon whom it will have to trust to remit the proceeds of sale.

NEGOTIABLE AND NON NEGOTIABLE TITLE AND POSSESSORY DOCUMENTS

Warehouse Receipts, Order or Straight Bills of Lading, Other Negotiable and Non-negotiable documents of title, Including Warehouse, And Bailee or Dock Receipts

Definition of title documents

The items listed above comprise documents of title (to the extent permissible) that allow the person in possession to receive, hold, and dispose of them in the normal course of business, including the control and disposition of the underlying goods.

These documents are issued by or to a bailee and cover goods in its possession that are fungible or able to be identified. **The warehouse receipt,** however, does not represent ownership of the merchandise. It offers the bank proof of intake of the goods by the collateral controller or the third party warehouse, and the control over the movement of the merchandise. The bank must maintain control over the goods until they are released through the use and implemention of such receipts.

If the borrower defaults on its loan, the bank may have difficulty taking possession of the goods without proceeding through legal channels. If prior lines exist on the goods or clear title does not exist, the bank can face exposure even though it has possession of a warehouse receipt and this constructive possession of the underlying collateral under and pursuant to the legal principle of bailment.

Categories of Documents

These above documents are also considered **commodity paper**, which falls into two categories, negotiable or non-negotiable. Documents of title include order bills of loading, considered non-negotiable, and bailee or dock receipts and warrants, warehouse receipts, and general orders for the delivery of goods. Warehouse or dock receipts or general orders for the delivery of goods may fall into either the negotiable or non-negotiable categories. Documents of title include any other documents that, in the ordinary course of business, enable the holder to receive and dispose of the documents and underlying goods as it pleases. To be considered official, such a document must be issued by or be addressed to a bailee covering the goods. The goods in question should be identified specifically in the documents or be identified as a fungible part of an identifiable mass. For this document to be considered a registered receipt, it must be in deliverable form in accordance with exchange regulations, and it must be issued in negotiable form. It can be accepted without question by a buyer.

Warehouse Receipts

Ordinarily, underlying inventory is controlled by such documents (warehouse receipts). This receipt should be issued in consecutive numbers, for goods that are frequently stored in a warehouse. It acknowledges receipt of the goods and agrees to their safe custody and delivery upon surrender of the receipt properly endorsed. Often, such receipts are referred to as “public” warehouse receipts because they are issued by independent third-party controlled (public) warehouses. This means such facilities are bonded and available to the public, as opposed to privates’ warehouses which may be owned and used only by the borrower or a related company for their own products.

The warehousemen operating public facilities are considered independent bailees for hire. They perform the necessary functions of receiving, storing, and delivering goods in accordance with instructions from the owner, or the bank, in case the goods represent the bank’s collateral. The warehouseman has a prior lien over the goods for unpaid charges. The warehouse receipts indicate storage and handling charges on its face, commonly excluding non-negotiable receipts issued by field warehousemen.

Always verify unpaid and due storage charges outstanding on merchandise prior to issuance of the warehouse receipt. Also, continue to verify **unpaid warehouse charges** while holding receipts, as this can affect **the bank's margin of perfection**.

In some instances, lender may be able to arrange to have copies of storage bills sent to the bank, making it possible to monitor payments and enforce payment. Consider obtaining warehouse invoice copies to assure that such charges are being paid. Public warehouses should be bonded. This offers greater assurance or protection of the goods to clients.

Public Warehouses

Public warehouses must be licensed under a Uniform Warehouse Receipts Act for example as applicable in the United States and which requires the posting of a bond. They must meet specific minimum security standards and other legal requirements to qualify for bonding. Bonded warehouses are certified by the regulators, and goods are protected by guaranty from the regulators. The regulators assure that all taxed and duties are properly paid on stored goods.

United States Warehouse Act (Example)

In United States the uniform warehouse Act requires proper uniformity and controls regarding the storage of agricultural products. It also allows farmers and other dealers in commodities the distinct advantage of arranging credits, since a bonded warehouse offers lenders more collateral protection. Federally bonded warehouses must also meet specified Department of Agriculture regulations. The federal act requires warehouses to be inspected regularly relative to storage facilities and records. It prohibits certain other acts by the warehouse, while enforcing penalties for regulatory violations.

Loans on Warehouse Receipts

Loans against warehouse receipts are generally made on staples or standard commodity products that can easily and readily be marketed. The typical warehouse receipt loan is for a percentage of the estimated value of the goods used as collateral. Loans on warehouse receipts, therefore, may be made on commodities in either a raw or finished state relative to merchandise stored in public or field warehouses. Borrowers often consist of processors or distributors of goods, including manufacturing of seasonal products.

Dealing with Warehouses

The bank should take necessary precautions when dealing with a new warehouse or Collateral Control company, because it may have to rely on the warehouse to deliver the goods to it or to the holder of the receipt in case of default by the borrower. Scrutinize the standard warehouse receipts form to determine its acceptability and that it meets the requirements of the applicable law. The warehouse should also be investigated for reputation, management responsibility, and financial condition. The bank should also request financial statements on the warehouse to determine its financial responsibility and standing. Also check with other banks and lenders who have used this warehouse or Collateral Control Company.

Warehouse or Collateral Control Insurance Policies

Insurance policies carried by the warehouse owner and Collateral Control Company should be reviewed by the bank. A bank should make sure that the Warehouseman carries sufficient legal liability insurance with limits no less than USD 25 million and that the Collateral Control Company's carries professional liability insurance which incorporates insurance for fraud by employees. These insurances will protect the bank against any losses caused by forged receipts and coverage relating to the value of the goods stored as well as negligence caused by the warehouseman or collateral manager in providing their services. Limitations and exclusions should be reviewed as these can have an affect on the recoverable amount. Also, cargo losses should be covered fully for the entire contents of the warehouse which assuming this liability.

To summarize, the warehouse or Collateral Control Company should maintain coverage **for legal liability**, **fidelity coverage**, third party **public liability** and **property damage**. **Legal liability protects** against losses for non compliance of the warehouse with its legal responsibilities, while **fidelity coverage** insures losses caused by acts of dishonesty or fraud by warehouse employees and even intentional alterations of warehouse receipts.

The public liability and property damage policy covers liability for body injury or death to warehouse or Collateral management personnel as a result of warehouse receipt activity. In addition, it includes protection against liability involving personal or real property damage that normally excludes the merchandise in the warehouse.

But obviously, the type of insurance that is necessary depends on the goods being stored.

Warehouse Receipt Collateral

The pledge of warehouse receipts offers the bank a security interest in the underlying goods so stated in the receipts, subject to any other valid existing liens. Therefore, the bank should assure itself that **the merchandise has been fully paid** for, there are no outstanding liens exist against the commodities, and that the goods have not been received on consignment. This should be reflected on the receipt or in some form of receiving record, **by wording to the effect that the depositor has good rights to the merchandise. It should be confirmed by the signature on the receipt.**

While the receipt may accurately disclose the quantity of goods (**number of bags**), it is not a guaranty of quality (grade), weight, or title. Furthermore, a warehouse receipt does not necessarily protect the lender against loss or damage of the commodities nor does it warrant that the contents of boxes or containers match the description on the face receipts. If a receipt reads “said to be or contain,” this excludes liability to the warehouse or Collateral Control Company and to warehouse receipt holders for the non-existence or the improper description of the merchandise. However, if such wording is not indicated on receipts, the warehouse remains liable.

All goods assigned as collateral moving in and out of the warehouses should be accounted for with such receipts, thus furnishing the lender an exact accounting at all times. Release of goods should be based on strict adherence to instructions provided to the warehouse or Collateral Control Company by the bank.

This is followed up with a “confirmation of delivery” from the next day by the warehouse or Collateral Control Company of the goods released the previous day. The bank should also receive a remittance of the goods released and evidence of an invoice for the sale of the goods.

Collateral Transition

Lender’s lien should continue into accounts receivable as goods are sold. This means that the loan facility should be arranged for an inventory portion on the line while lender is holding warehouse receipts, which are converted to the receivables portion of the line once merchandise is sold. If there is much activity in the credit, the bank should consider using a cash collateral account for depositing proceeds. These proceeds can be debited on specified days throughout the week or month and applied to debt intermittently rather than immediately crediting them to debt as they are received.

Therefore, warehouse receipts collateral consists of documents issued by the warehouseman or Collateral Control Company and addressed to a bailee or receipt holder regarding the goods in the warehouseman’s possession, which can be specifically identified or represent fungible portions of a larger identified mass.

Dealing in Negotiable and Non negotiable Warehouse Receipts

Warehouse receipts are often issued in negotiable form, in that the face of the certificate indicates that the goods will be delivered to the bearer or to the order of some person or entity. If there is no such indication, the receipt is non-negotiable; it should be issued in the name of the bank to which the goods must be delivered, if required. The bank has to endorse non-negotiable receipts in order to transfer them, besides notifying the warehouse or Collateral Control Company. Practically speaking, this normally does not happen; the bank or its authorized designee usually has goods released by providing written instructions to the warehouse or collateral Management Company. Negotiable warehouse receipts should be endorsed to the bank and held until presented to the warehouse company in order to obtain the release of the goods**. However, many banks prefer dealing with non-negotiable warehouse receipts.**

Receipts Requirements

The receipt should meet the minimum following requirements:

- Location and any lot number where goods are stored.
- Date of receipt issuance
- Whether goods will be delivered to bearer or a specific person or their order; or a statement that the goods are being held for the bank if the lender is dealing with a nonnegotiable receipt.
- Storage and handling charge rates.
- Complete description of the goods or the packages containing them, including code numbers and units of measure, such as cartons, pounds, and case length.
- Proper signatures of the warehouseman or his authorized representatives evidenced by their specimen signatures on file and any ownership the warehouse has in the goods.
- A description of any loans, liabilities, or existing charges whereby the warehouseman claims a security interest or bailee's lien against the goods.

Verification of Signatures

Receipts should not be accepted if they have any erasures or other corrections. Verifications of warehouse representative signatures on the face of receipts are very important. Thus, the need for the specimen of the warehouse representative's signature must be on hand and checked out by the bank against each executed receipt.

Releases

The bank, in turn, must furnish the warehouse or collateral management Company approved specimen signatures of the bank loan officer authorized to execute releases of goods. The bank may approve blanket release authorizations relative to delivery. This can involve the release of merchandise up to a specified level or amount over a specified period of time. The bank should still confirm the approval of delivery of merchandise. The release of goods should be made with the understanding that the risk is high. **Trust receipts** can be used, although the banks may in reality be in an unsecured position with them.

Warehouse Ownership in Goods

In some instances, the warehouse may have an ownership in the goods, whether by itself or in common with others. Then the lender needs to obtain proof of ownership. Also, if others have an ownership in the goods, have them consent to the assignment of the goods.

Storage

The storage of commodities is undertaken in two forms. One is the stack and lot number, which can readily identify exact same goods that are deposited and then withdrawn.

The other involves fungible goods that are commingled and represent interchangeable merchandise. Units of the same commodities are usually stored in common containers or tanks and are treated equivalently. Therefore, withdrawals are normally made based on the same grade, and depositors are treated alike as tenants in common. Substitution of merchandise should not be allowed. And if goods need to be replaced, then new receipts need to be issued and executed.

Documentation Factors

Negotiable documents of title, such as negotiable warehouse receipts, should be endorsed in blank and remain in the bank's possession at all times while loans are outstanding. Check endorsements in order to determine that they have been executed by the pledgor/owner and that those executing them had proper authorization besides verifying their signatures.

The bank should obtain confirmation letters from the warehouse or Collateral Control Company that receipts are, in fact, outstanding. If the credit is participated from another bank, obtain photocopies of receipts for lender's files.

Remember, the warehouse or Collateral Management Company has a secret or bailee's lien on the goods in storage, including handling charges or for any advances it may have made for the goods. So make sure all warehouse charges are paid. Obtain warehouse billing statements that support claims for advances or other liabilities on which it may claim a lien on goods; this should also be reflected in receipts.

A verification letter with an accompanying schedule should be sent by the bank to the warehouse before release of the goods requesting verification of receipts presented by the borrower to the condition of the goods is acceptable or have bank personnel inspect the goods by opening containers or boxes. Make sure, if goods are liquid or are maintained in cold storage, that the warehouse offers appropriate facilities. Cold storage warehouses must be capable of storing perishable goods under controlled temperature levels.

The bank must also make sure that the warehouse carries adequate hazard insurance covering the value of any goods held, naming the bank "loss payee as its interests may appear."

Field Warehousing and Storage Services

If public warehouse facilities are not used, a Collateral Control Company may provide a necessary control over the premises and the goods within the private warehouse premises or yards through what is defined as a **"field"** warehouse service. This can be done by roping or fencing off collateral goods to segregate those being financed and also by controlling their releases.

Field warehousing is used more than public warehousing by bankers specially since 90 per cent of the borrower own or control the premises in which the goods are warehoused. Services offered by the Collateral Controllers would and should include ensuring the segregation, inspection, accounting, release, monitoring, reporting and the general protection of the goods. Ordinarily, a Collateral Control Company providing field warehousing service leases a part of the borrower's or owner's premises and maintains the assigned goods under its control.

Segregation and Separation of Goods

The establishment of a field warehouse invariably involves the concept of bailment, in legal terms; field warehousing may be defined as the establishment of a valid bailment upon the premises of the depositor by a Collateral management Company, thereby creating a change of possession and an effective pledge.

COLLATERAL CONTROL OPERATIONS -

Legal Appraisal of Field Warehousing operations:

Generally, Field Warehousing is essentially a method whereby a borrower's trading assets are used as security at the borrower's own premises for a loan or financing. It is a security instrument which enables the borrower, to deliver to the Bank legally valid documents of title and to grant a possessory pledge over goods stored in the borrower's own plant, mill, refinery or warehouse via the legal principle of Bailment.

"Bailment" means the transfer of the possession of Goods by the owner (bailor) to another (the bailee) which shall thereafter maintain notorious, continuous and exclusive possession of all the Goods, for particular purposes such as hiring, financing, pledge of goods, and the delivery of Goods for carriage, safe custody or repair.

Notorious possession is evidenced by numerous conspicuous signs placed by the Collateral Controller at the storage premises.; Continuous and exclusive possession is assured by the fact that the Collateral Controller has one of its employees or agents or representatives on duty at all times when the premises are unlocked and that anyone permitted to enter the premises does so only at the will of the Collateral Controller or with its consent.

The foregoing steps accomplish an effective change in the possession of the goods and premises. Thereafter, warehouse receipts may be issued at the borrower's premises in respect of Goods stored therein just as though they were in any public warehouse and the constructive possession of the Goods is maintained by the Collateral Controller for and on behalf of the bank throughout the duration of the financing and till the goods are released.

The Collateral Controller as the independent issuer of the field warehouse receipts creates a legally independent warehouse within the borrower's premises by leasing the storage area, posting prominent signs giving public notice that the controlled area is operated by the collateral control Company. Controlling movements in and outfield of the warehouses Installation of locks (double lock kept by e.g. by ACE Global and the borrower) and seals, management by the Collateral Control Company staff, in order to issue legally valid warehouse documents.

The principal competitor of a Collateral Control Company providing Field warehousing Services as a method whereby a corporate customer can give security over stocks and similar assets to a lender is the floating charge. However, not only does the floating charge have many disadvantages, but Field Warehousing services has certain positive advantages in those areas where the floating charges is weakest. Thus, Field Warehousing enables the bank immediately to perfect its security. The floating charge, on the other hand, only "crystallizes" (that is, becomes fixed) if the customer goes into liquidation or makes default in payment of principal or interest or some other breach of the terms of the debenture occurs, and the bank thereupon takes some positive step to enforce the floating charge. Until such time as the floating charge crystallizes (which will, of course, often occur only when the customer is in extremis) it will be superseded in order of priority by any subsequent fixed charge unless the floating charge prohibits this and the fixed charge has notice of the prohibition.

Field warehousing services provides the bank with both the organization and expertise to control its security: It has the guarantee of the Collateral Controller that if and when security is needed it will be there intact and available to be realized. The existence of a floating charge, on the other hand, gives no such guarantee and until it crystallizes will not prevent the customer disposing of all or any of the assets charged. The customer may therefore, unknown to the bank; realize his stocks and other current assets in order to meet pressing unsecured creditors, with the result that when the bank appoints a receiver the value of the remaining assets secured by the floating charge is totally inadequate.

The bank's security under field warehousing services has priority over other creditors except the Collateral control's lien for its charges and the claims of a landlord levying a distress for a rent. These risks may however be mitigated by the bank guaranteeing the collateral Controller fees and landlord rent whereas the landlord will sign a waiver of lien. The floating charge, on the other hand, is subject to priority by a variety of creditors both preferential and others. Preferential debts include not only wages and salaries and national insurance contributions but one year's taxes payable to the Inland Revenue (who are in practice often the largest creditor of all).

Other creditors which take priority over the floating charge are the landlord levying for distress, secured creditors in respect of their specific charges (as mentioned above) and judgment creditors who execute before the floating charge crystallizes.

A security perfected under Field Warehousing provided that it is not a fraudulent preference is unaffected by a subsequent liquidation however soon it may follow.

A Floating Charge can only be granted by a corporate customer. A floating charge has to be registered which may affect the customer's credit rating and may give information to third parties which the customer would not wish to be disclosed.

Companies are frequently subject to restrictions in loan agreements or debenture trust deeds which prevent those giving charges. In some cases this prohibition may not extend to pledges, depending on the terms of the particular restriction.

The Collateral Controller providing field warehousing services often posts signs on the premises, evidencing its control to all parties who enter the area. This is frequently accomplished by having a custodian oversee the storage of goods; the custodian releases goods to the borrower upon approval or order of the bank. The custodian is often an employee of the Collateral Control Company

Separation or the segregation of goods by a warehouseman creates a change not only in possession and control but also in title ownership. Therefore, besides creating the role of a lessor and warehouseman, respectively, lender can also gain the benefit of having a bailor/bailee arrangement from a legal and collateral protection standpoint.

The field warehouseman should maintain a record of all the goods moving in and out of the warehouse under its control. The Collateral Control Company providing field warehousing services should also arrange to have its auditors come in on a regular basis to check and verify merchandise. Lender should arrange to obtain copies of these audits or at least evidence that they have been completed properly.

In order to separate or segregate the inventory under its control in the case of a lease, the warehouseman leases a designated area of the warehouse premises. Control is handled by posting signs, roping, fencing, and the use of locks and barricades, when necessary, to maintain goods properly under trust.

Collateral Control Employees

Typically, Collateral Controller providing field warehouse services employ one or more persons at the borrower's or owner's warehouse in order to receive and release the goods. The Collateral Control Company uses its own personnel to control the inventory. The Collateral Control Company employees are responsible for issuing new warehouse receipts for goods as they move into the warehouse. Before goods move out, more requirements have to be met by the Collateral Control party, such as:

- Obtaining an acknowledged release order for delivery from the bank.
- Receipt of payment in cash or the equivalent based on an amount that meets the price release schedule authorized by the bank or under some sort of blanket agreement for release, as arranged between the bank and the collateral Control Company.

Periodic Inspections

Once the field warehouse arrangement is underway, the Collateral Control Company employees undertakes periodic inspections of the goods and provides the bank with written reports evidencing types and quantities of goods on hand, together with other requested information. It is necessary for the bank to determine the quality and condition of the goods for itself, even though the Collateral Control Company acts as a custodian relative to reasonable care and quantity of goods available.

While the warehouse or Collateral Control Company is concerned with quantities on hand, it will not be responsible for quality and weight, nor will it be accountable for the contents of the goods stored. Warehouse or Collateral management companies protect themselves in this respect by writing "said to contain" into warehouse receipts.

Therefore, the bank should arrange to inspect the goods directly to determine that they meet quality standards and weight, even though this may prove difficult. Undertake the inspection on a random or spot-check basis by withdrawing samples or obtaining the services of a collateral control company that issues the bank inspection certificates in conjunction with warehouse receipts. More frequent inspections should be made of perishable goods. The bank's inspectors should report any deviations from the norm and also report any unusual problems.

These inspections should include the following:

- Inspection of receipts is performed to make sure they are properly signed by warehouse representatives; verify the signatures of all warehouse personnel authorized to sign warehouse receipts.
- Inspection of the goods for deterioration, including their count. Confirm they agree with receipts based on quality and quantity.
- Inspection of the premises to make sure the goods are properly maintained; if in field warehouse, they need to be marked so they can be easily identified as lender's collateral.
- Signs, posts, or roping off of the area where the bank's collateral is maintained is necessary unless the goods are maintained in common tanks and are of a fungible nature.
- Inspection of all documents and releases determines what is on hand and what has been shipped. Releases should be posted properly on registers or to the warehouse receipts themselves. This information may include items released and dates, along with the remaining items on hand.
- The accounting should include goods deposited that reflect description, cases or boxes, numbers, and release prices when applicable.
- Inspections should be made of insurance policies to make sure coverage is sufficient and that all guaranties or warranties are in force. Also, make sure coverage is properly extended to all locations where goods might be located.
- Examiners must review past warehouse charges and make sure they are all current and not delinquent. Any past due amounts should be subtracted from the collateral value.

Proper Bailment Capacity

The bank should assure itself that, if a Collateral Controller is being used to provide field warehouse service, it acts in a proper bailment capacity and has properly leased a portion of the warehouse premises evidenced by agreement. Warehouse receipts should reveal the legal capacity under which the field warehouse company is responsible for the storage of goods. When dealing with field warehouse services, lender is at greater risk, because such arrangements are more vulnerable to frauds. In addition, conflicts of interest can arise because bonded employees are often staff members employed by the owner.

Subsidiary Warehousing

Borrowers also set up their own warehouses and obtain the necessary licenses to operate them. In such cases, the borrower storing only its own goods does not qualify as an operating warehouse "for hire" such as a public warehouse. This type of arrangement, when the borrower or related party owns the warehouse, is considered *subsidiary warehousing*. Obviously, receipts issued by such warehouses do not offer the bank third-party protection or control against other possible interests. Therefore, the collateral position is somewhat weakened because of no control by independent third parties on an arm's length basis.

Controlling and Maintaining Goods by Warehouse Receipts

Control of goods by a third-party warehouseman is arranged by issuing warehouse receipts, which represent the contracts between the collateral control company responsible for the storage, control, and maintenance of the goods, and the borrower (who is the bank's customer) who must pay for this third-party warehouse service. The receipts issued by the warehouse company become a "document of title." The bank must use its own due diligent efforts to determine that the borrower has good ownership in the collateral to be pledged and that there are no prior or existing liens – even though the field warehouse issues a title document.

Warehouse Responsibility

The warehouse company is not responsible for the title or true ownership of goods stored in its possession. The bank can accomplish title verification by examining the borrower's books and records along with public records for other collateral filings and/or recordings. Furthermore, the warehouse company does not obligate itself to be responsible for the quality and condition of the goods as received beyond maintaining proper security while the goods are on its premises. This also applies to shrinkages, shortages, and deterioration while in the warehouse. However, the warehouse may have deterioration responsibilities in some instances, e.g., when a refrigerated warehouse is used for the cold storage of meat. In this connection, if the warehouse were negligent or if it did not maintain the proper temperatures and the meat deteriorated, it would be responsible and liable. The warehouse also does not accept any responsibilities for the values of goods as stated on receipts. While generally it does not take responsibility for weights and volumes regarding goods, in some instances the warehouse may take responsibility for – the release and delivery of goods based on weights and volumes as in the case of fungible goods that are interchangeable in nature and cannot be separated, segregated, or distinguished one from the other. This is more prevalent with public warehouses, where different grades of commodities, such as grains, are stored or with petroleum products maintained in common tanks. The parties storing goods under these arrangements execute agreements with the warehouse that their goods are being maintained in common with other owners' goods often based on grade and that the warehouse is responsible for the goods based on given weights and volumes.

Beyond the storage of fungible goods, warehouse companies normally only take responsibility for releasing and delivering the same number of units originally stored, with no reference to volume and weight responsibilities. Warehousemen generally will not take responsibility for casualty losses of goods on their premises. In instances where the warehouse company assumes liability for casualty losses in conjunction with accepted receipts, it should not be in excess of the amount stated on the receipt. This does not exempt the warehouseman from responsibility for the proper care of the goods while in its possession although the contingency may be limited to some dollar limit of storage charges or goods value with reference in receipts.

The warehouse company verifies that the goods delivered and stored comply with the description on the receipt. However, it is not responsible if the contents are not as actually stated on receipts and described on the outer coverings of the goods.

Negotiable Warehouse Receipts

Negotiable warehouse receipts are used with fungible commodities, such as grain, dried feed, and certain oils. Dock and gin receipts pertaining to cotton bales may also involve negotiable warehouse receipts. These receipts should be issued in the name of a party other than the bank. They should be endorsed in blank by the debtor and any predecessor title holder to the bank's order to make them negotiable instruments and offer the bank a holder in due course status. This imparts to the bank full enforcement rights regarding payment of the pledged document. The underlying goods may only be released in full or in partial amounts to a specified party of its order or to the bearer. If receipts are endorsed by parties unknown to the bank, require that the signatures be guaranteed by another bank or other acceptable parties. If in bearer form, surrendering the receipt transfers title. The physical receipt must be presented to the warehouse for the release of goods specified therein. If a partial release, the receipt needs to be presented to the warehouse for endorsement for the goods being released. If the receipt is lost, misplaced, or destroyed, it can only be replaced after an appropriate bond is posted.

Use insured registered mail when sending receipts. This procedure acts as further protection to the bank in realizing return on its collateral if the borrower enters bankruptcy or if a judgment creditor attempts to levy on the goods. A negotiable warehouse receipt is, therefore, held and controlled by the bank. The ownership or collateral interest in the goods may then be transferred and endorsed over to other parties without disturbing the responsibility of the field warehouseman to the warehouse owner or borrower. If it is necessary for the bank to endorse a negotiable warehouse receipt, it should be executed without recourse. The endorsement should also be made without any warranties pertaining to the quality, title, and condition of the commodities as evidenced by the receipts. Remember, negotiable receipts should be payable to the order of a specified party or be in bearer form. Negotiable documents are so identified on their face; always take physical possession of these documents.

Document Handling

The negotiable warehouse receipt is used more prevalently when the ownership or collateral interest in the goods tends to change hands frequently without their actual physical movement. This creates the need for careful handling of these documents, especially in view of their negotiability. In case such a receipt is destroyed, lost, or stolen, only a court order requiring a bond posting will allow the release of goods. If receipts have to be mailed, make sure they are insured and sent with proper instructions by registered mail, return receipt requested. By having warehouse receipts, the bank is assured of third-party control and verification of collateral values based on the description of the receipts; release of the goods is allowed only to bearer parties holding receipts evidencing the party so named in the receipt, or depending on whether the receipt is negotiable or non-negotiable. Any removals of goods when using such receipts should first be approved by the bank as lender.

The handling of negotiable receipts may prove cumbersome for the bank because of frequent releases. Therefore, the servicing officer or some agent should physically present receipts to the warehouse for release of goods. If this cannot be done, lender may consider allowing the borrower to present the receipts under a trust receipt. It is imperative for the bank to follow up on the payment being made in full for the underlying goods and to make sure the warehouse receipts are returned within 21 days of their release as allowed under the UCC.

Non-negotiable Warehouse Receipts

Non-negotiable warehouse receipts state that the delivery of the commodities will be to the other of the bearer or some specified party. They are commonly used by banks when financing a borrower's inventory and they should be registered and issued for the account of the bank. Non-negotiable receipts provide that the goods be released pursuant to written instructions of the bank, which is named in the receipt. If the receipts are issued in any other name, they must be reissued in the bank's name in order for the bank to perfect its security interest before making advances. These receipts specify to whom the merchandise is to be delivered, stipulating that they cannot be negotiated to others. The receipts should be marked clearly on their face that they are "non-negotiable" or "not negotiable." Such receipts are generally issued in the bank's name and should be written to be held for the benefit of the bank.

The bank should only take such receipts as collateral if it is so named in them as the party having the sole right to possession of the goods. The receipts should be registered in the bank's name in order for it to control delivery and releases of goods. The receipts should always reveal from whom goods have been received. Title to non-negotiable receipts is not negotiated but is transferred by assignment. Unless the bank assigns the receipts to a third party, non-negotiable receipts of themselves have no value.

Nonnegotiable receipts are more convenient for the depositor or holder to deal with than negotiable receipts because they do not have to be surrendered to the warehouseman before the merchandise is delivered. At times, warehouse companies may issue non-negotiable warehouse receipts against the surrender of negotiable warehouse receipts.

The bank as pledge may allow releases of the goods by its written order. Usually, the bank pre-arranges with the warehouse to allow goods to be withdrawn on a blanket release basis up to a certain dollar limit. Such pre-arranged releases usually stipulate that payment must be made within a certain short time before further releases will be allowed. Release schedules under a blanket arrangement allow the borrower more flexibility by not creating delivery delays.

Loan Arrangements

Loans are often granted from a range of 50 percent to as high as 90 percent of cost or the selling price, depending on the commodity. Other factors that may have a bearing on advances are market demand, price stability, seasonal implications, if any, grade of merchandise, and effects of obsolescence or deterioration. Margins assure that the borrower has some equity in the transaction. Lender margin of collateral to advances depends on the nature and marketability of the merchandise, price fluctuations, hazards, costs and expenses, and seasonal effects on values.

If Banks lend constantly to a borrower under a demand or revolving credit arrangement, bank need to monitor the borrowing base closely for collateral margins in order to buffer price declines. Lender must also watch for dissipation in the quality of goods and possible liquidation expenses. Also, consider the state – raw or finished – and how it could affect liquidation values and ability to sell the goods. Consider the value of a repurchase from sellers or others.

Closely check the amount of goods out on release that have not been paid for and compare it to the amount of inventory equity cushion and against the borrowing base. This prevents lender from overextending unsecured credit to the borrower.

The frequency of borrowing base reports or independent margin checks not only depends on the customer's borrowing and collection pattern but also on the particular type of commodity, market conditions, and price fluctuations. Therefore, release limits may be adjusted up and down in conjunction with borrowing base levels.

Other factors should be considered relative to maintaining an adequate collateral margin, such as monitoring price increases and declines of goods and deteriorations. Thus further adjustments to the borrowing base may be necessary. The advance formula may also be impacted by the stage of the goods. Consider obtaining repurchase agreements from suppliers when they are available. This might have a bearing on how much lender is willing to advance.

Computer or manual records should be maintained on commodities. These records, to be sufficient, must include loan balances, dates, quantities, collateral types, and values and payment histories. The bank should use a "release order" form that describes quantity, including the description of the commodities and any special conditions for their release.

When non-negotiable receipts are issued, specific instructions must be furnished to the warehouse regarding the release of the goods covered by such receipts. Make sure the warehouse is furnished specified signatures of bank officers authorized to execute releases of goods. Make sure the bank receives the original invoices from the purchase of the goods. The bank may allow payments to third parties against the delivery of documents, including the warehouse receipts, bills of lading, or to pay drafts with bills of lading or warehouse receipts attached.

NECESSARY DOCUMENTATION

Notes

Short-term, demand, or revolving notes should be used.

Bills of Lading

Basically there are two types of bills of lading:

(a) Order Bills of Lading. This is a negotiable title document that is issued by and acts as a receipt from the carrier or shipper of the goods. It also represents collateral, since it serves as a contract to deliver such goods and a title document for the party for whom it is drawn. This title document may be transferred to another party by delivery and endorsement and is usually made out to the order of the creditor or the shipper. The creditor or shipper can, in turn, transfer ownership of the merchandise to the buyer by endorsement upon payment in full.

(b) Straight Bills of Lading. This document is non-negotiable and should not in and of itself act as collateral for a loan. It is also issued by a carrier or shipper to the buyer, who acts as a consignee. The buyer is allowed to obtain possession of the goods without surrendering the bill of lading since, under this type of arrangement, the buyer usually does not have to pay for the goods upon release (it has already established credit with the seller). The term *straight* comes from the fact that there is no third-party involvement, such as by a bank in the release of such goods.

Warehouse Receipts

The warehouse receipt itself should reflect specific descriptive information, including the location of the warehouse where goods are maintained, receipt dates, and numbers. The receipt should also identify to whom the merchandise will be delivered, whether to a specific party or to its order, or to bearer. Other information that should be provided includes verification of proper execution by approved warehousemen, storage charges, and descriptions of the merchandise.

Pledge and/or Security Agreements

Lender needs to control the storage of goods. Some banks use a separate pledge agreement to describe the documents, whether negotiable or nonnegotiable. The pledge agreements reflect the agreement by the borrower or owner with the bank; they may provide a description of any documents, the documents' serial numbers, who issued them, and any involved warehouse receipts of bills of lading so issued or in connection therewith. This agreement may include a description of the underlying arrangement that gave rise to the issuance of the documents via warehouse location and/or transportation of goods. Other banks may also use a separate security agreement for the underlying goods inventory behind the documents that describe the inventory by item and type, including any applicable purchase money lien rights.

This agreement may also be used to indicate taking of warehouse receipts, including warehouse receipt numbers. It could reveal the name of the storage agency, and to whom the warehouse receipt is being issued, whether it is in the name of the borrower or bank. The writer prefers to use a combined form for the pledge of documents and security agreement interest in the underlying goods inventory. A security agreement must be executed covering nonnegotiable warehouse receipts and underlying goods, including products and proceeds. Relative to negotiable receipts, even though possession controls, lender should obtain a security agreement to further protect the bank's lien interests in and to all the borrower's inventory and documents.

Financing Statements

Filing of a statement, either in a central jurisdiction or in central and local jurisdictions for dual filing states, should be undertaken as a normal procedure for all types of documents of title, and especially for nonnegotiable warehouse receipts. While filing may not be necessary if the warehouse receipt is negotiable and remains in the bank's possession, it is still a goods habit to file a financing statement as a catchall regarding a blanket lien interest in existing documents not held in lender's possession. This offers protection in case of lien challenges or relative to proper possession of goods by warehousemen.

Regarding non-negotiable documents, other ways to control and protect the bank's interest, besides filing, may be by giving the warehouse bailee notice of the bank's security interest in the documents besides having them issued in the bank's name. Also, conduct proper searches by use UCC-11s or through private search sources. Negotiable receipts should remain in the possession of the bank. Some banks prefer to file financing statements as a precautionary measure against a claim a trustee in bankruptcy might make on the goods. This is also protection to the bank's perfected interest in the underlying merchandise that is stored or transported.

Trust Receipt

If lender does not have possession of documents or have a filing of record, lender can still perfect lender's interest in negotiable documents for a period usually of 21 days without filing, possession, or control. This is done by use of a trust receipt.

However, this is considered virtually an unsecured interest even when taking a trust receipt with proper notice to the party issuing or holding documents. Therefore, the bank only retains a good collateral interest when it receives or maintains title to the goods, the documents, or the documents reflected in the trust receipt from someone other than the borrower.

The borrower should acknowledge the trust receipt, which is usually a standard bank form that acts as a release of the goods to the borrower or its designee. The form should address the specific purpose for the releasing of goods, including storing, loading, unloading, sale exchange, shipment, fabrication, processing, or conditioning. The receipt should also require the borrower to account for any sales proceeds or for the return of the goods and/or the warehouse receipt.

Checking Warehouse Receipts

Receipts, whether negotiable or nonnegotiable, should be complete in every respect as they pertain to warehouse locations, numbers, dates, goods descriptions, and signatures. Always check and make sure nonnegotiable receipts are issued in the bank's name.

Periodic Reports

Monthly, the warehouse will furnish the bank with either an electronic or manually-written report on the status of the goods held as collateral, reflecting all the additions and releases, that should reconcile to bank records. Differences must be rectified with the warehouse.

Invoices

In some cases, when lenders are unsure of the real value of the underlying merchandise, request a copy of invoices of purchase along with warehouse receipts. The invoice terms and other details normally evidence ownership title to the goods.

Notification Letter

Any time a negotiable warehouse receipt is issued and accepted as collateral by a bank, the bank should notify the warehouse company that the bank holds the company's receipt and is requesting that the warehouse subordinate any rights of the offset for unpaid charges to the bank's collateral interest. Attempt to have the warehouse or bailee acknowledge the bank's interest in the warehouse receipt and underlying goods. This protects the lender from another party withdrawing the goods from storage without lender approval. In this connection, check the reputation of the warehouse, and inspect the goods to determine that they are being cared for properly.

Collateral Receipts

These receipts should only be issued for negotiable warehouse receipts. Details specified in receipts should include names, receipt numbers, and dates, along with a description of the collateral.

Hazard Insurance

The warehouseman or bailee will not maintain insurance on the loss of goods concerning warehouse receipts, except for negligence. Therefore, obtain appropriate insurance based on the type or merchandise lender is warehousing. In addition, the warehouse will not take responsibility for fire losses and similar type coverage unless so stated on the face of the warehouse receipt. Therefore, always obtain fire and lightning insurance, including extended coverage – which should include windstorm and explosions. Additional special types of insurance may be required depending on the goods warehoused.

If values of commodities fluctuate very much, the borrower may use provisional reporting-type policies. If a provisional reporting policy is in force, make sure to receive and closely scrutinize and examine this policy and monthly reports. Lender must confirm and verify that the goods are being accurately reported. Therefore, these policies, which are usually provided in monthly reporting form, must be reviewed consistently for changing values and limits of liability at each different location where inventory may be stored. Also, make sure the goods are fully insured for replacement value at the different interval dates. Hold the original or a certified copy of the insurance policy covering the goods naming the bank as an insured "loss payee as its interests may appear," along with a loss payable endorsement. The warehouse company should hold a duplicate copy of this policy. Policies should include full mortgage clause provisions. The bank should hold the original policy or a certified copy. One of the advantages of having full mortgage provisions is that the bank will be notified prior to any cancellation of the policy. Require additional insurance when necessary pertaining to other types of risks. Insurance maturity ticklers should be set up by the collateral department.

Blanket and Specific Release Letters

This letter of instructions is issued by the bank to the public or field warehouseman regarding dollar withdrawing limits on goods besides indicating when the accounting for payment of released goods is required. It should reflect the location and address of the warehouse, allowed release order, delivery dates, necessary signature information and method of valuing goods. Such releases are often used for revolving credits.

Specific releases of merchandise may be allowed regarding negotiable warehouse receipts upon presentation by the bank or its agent or upon request by the borrower which should simultaneously reduce its debt accordingly. If all goods are to be delivered, the receipt will have to be surrendered to the warehouse, but for partial deliveries it should be endorsed each time. Movement of goods should be recorded on respective receipts.

This letter should be sent to the public or field warehouse and a copy should be returned acknowledged. The letter should reserve all the bank's rights and remedies to the goods and not create any waivers thereto until the goods are delivered from the warehouse to the party to whom they are being sold and transferred.

Signature Cards

Lender needs signature cards executed by the party acting as the warehouse manager. If lender is under a field warehouse arrangement, lender needs to confirm the signature of the employee acting on behalf of the field warehouse company and the signature of someone from the field warehouse authorized to undertake the responsibility of a bailor.

In addition, a signature card executed by the servicing loan officer and other authorized bank personnel should be furnished the warehouse company. This card should specify blanket release details and other information on payment and handling requirements.

Collateral Control Certificates and Supplemental Collateral Margin Reports

A Collateral control certificate should be furnished as frequently as needed, whether weekly, when advances are made, or at the time new or renewal notes are taken. Also, supplemental collateral margin reports should be submitted constantly as new collateral goods move. These reports should reflect specific storage dates and when goods move out. Margin reports should be continually reconciled to borrowing base certificates in order to monitor and control acceptable loan to collateral levels.

Draft Collections

Often the seller's bank sends sight drafts with receipts and other documents attached or enclosed to the buyer's bank for collection. If the lender is the buyer's bank, lender may be willing to release the documents for inspection for a very short time, usually requiring them to be returned the same day against payment or refusal. The collecting bank often requires its customer to execute an agreement in this regard.

It should include hold harmless language and indemnification protection regarding loss of documents. Therefore, the only way to minimize the bank's potential liability if the released documents are not returned is to create an indemnification arrangement with its customer so that the customer will make good any losses incurred by the bank due to its release of the documents prior to payment. The bank should draw up a letter regarding such an agreement to be acknowledged by its borrower. This should be followed up by having the borrower execute a receipt for each group of documents removed for inspection. It is best if the receipt lists the pertinent documents in the most identifiable manner possible. Such a receipt could be in the form of a trust receipt, except that the term, *trust receipt*, usually refers to a receipt provided to the bank for the release of documents in which the bank itself holds a security interest. The bank does not really hold a security interest in the subject documents even though it does have a strong responsibility in acting as the collection agent for the buyer.

Therefore, use of the term, *receipt*, should be sufficient for the document. Be cautious, because this arrangement does not reduce the bank's responsibility. The bank should make sure that the party with whom the arrangement is joined is strong enough financially to cover any losses that may be incurred.

Delivery Forms

Lender should receive delivery forms or other evidence of delivery, such as receipts confirming that goods have been properly delivered. In this connection, pertaining to the release of goods, check for the completeness of forms relative to release prices and payments. Also check signatures, as any forged signatures should be covered under the bank's fidelity policy. Appropriate copies of delivery receipts should be furnished the warehouse company and any third-party field warehouse company or personnel.

Inspection Reports

Have bank staff review storage records and prepare monthly inspection reports. These inspections may provide statistical and factual data on the collateral. They may include:

- Spot checking and matching of commodities involving containers, cartons, boxes, or other items against warehouse receipts.
- Checking out warehouse liens for unpaid storage charges or for past due amounts owed for storage.
- Inspecting warehouse facilities relative to storage and general appropriateness, including signs, security systems, and management and control of premises.
- Verifying insurance coverage on commodities and making sure the proper type of insurance and enough of it is in force.
- Verification of proper segregation and marking of goods by use of stock cards or otherwise evidencing in whose account or name the goods are being held.

Note: All loan officers should be alert to unpaid warehouse charges because they can represent a "secret" lien prior to the lender's first lien position. The warehouse company, in essence, is conferred a bailor's lien right for unpaid storage charges, which is not subject to the UCC.

The term, *secret*, is used because no filing requirements are necessary for the warehouse company or third-party field warehouse service to obtain such a lien. It is suggested lender obtains a copy of paid monthly billings for this service from the warehouse company or from the collateral controller.

Note:

The foregoing discussion is aimed to serve as a basic opening discussion on exploring asset based lending and making the implementation of Collateralised Working Capital Loans successful through the application of effective collateral control mechanisms.

As follow up reading to this, it is important for interested parties to review our Trading Assets Guide, Bankers Guide to Secure Lending, Field Warehouse Implementation and Trust Receipt Financing Guides.

We at ACE GLOBAL are making continuing efforts to improve our knowledge base and share our experiences in this field. We shall therefore continue to develop more informative discussion papers in order to benefit our clients and stakeholders in an ever evolving and dynamic trade and commodity financing market.