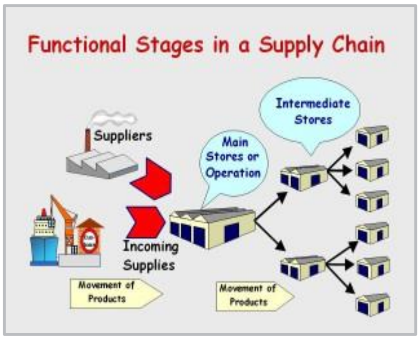
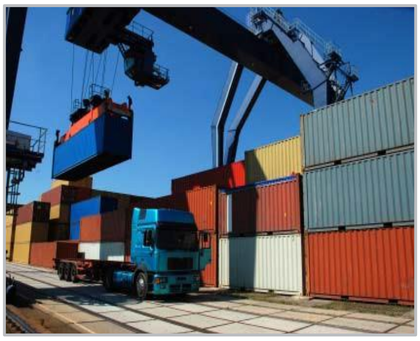
# TRUST RECEIPT FINANCING

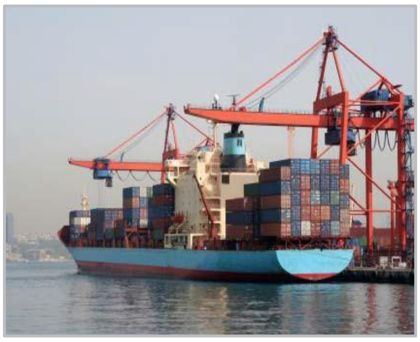
## Adoption of the UCC principles in establishing a Trust Receipt Financing

### GENERAL APPROACH





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# Definition

It may sometimes be necessary to release from warehouse, goods that have been assigned to the bank as collateral for a loan before proceeds from the sale of the goods have been obtained and applied to the obligation secured by the warehouse receipt. A manufacturer, for example, may require the goods for further processing or may need to deliver the goods to buyer before payment in full can be received. In such cases, if it has complete trust in the integrity of the borrower, the bank may authorize the borrower to take possession of the goods covered by the warehouse receipt. To affect this, the borrower signs a trust receipt in which he:

- acknowledges receipt of the goods or the title document (warehouse receipts) from the bank
- recognizes the bank's security interest in the goods he is receiving
- states that he is acting as the bank's trustee in delivering the goods to the customer
- promises to remit the proceeds from the sale of these goods to the bank in payment of the loan (or to return the goods to the bank if they are not sold)
- agrees to keep the good fully insured against all insurable risks

It is essential to recognize that the trust receipt is not a title document, but rather evidence of a security interest in the title document, which has now passed into the possession of the borrower. Releasing goods against a trust receipt entails significant potential risk to the bank, which is turning over physical possession of the goods to the trustee in anticipation that he will remit the proceeds from the sale to the bank. Once released, full control of the goods is with the borrower; the collateral securing the loan is "gone," that is, the bank no longer has possessory collateral (title documents) but instead has a perfected security interest in **non – possessory collateral**. The bank will, therefore, release goods on a trust receipt on when it has full confidence in the reliability and moral responsibility of the borrower. The signing of the trust receipt does not prevent the dishonest misuse of the goods or the proceeds.

# Perfecting a Security Interest

Trust receipt financing is covered by Article 9 of the UCC. In order for the trust receipt to represent a valid security Interest:

1. the bank must have a security interest in the goods or services that are released on trust
2. the goods or documents must be released for one of the purpose started on the trust receipt (i.e., sale of goods, transfer between warehouses, deliver for shipment in exchange for bills of lading, or to complete the manufacturing process of the goods)
3. the goods and their proceeds must be identified

A temporary perfection of the security interest is in effect up to 21 days from the signing of the trust receipt, without filling a financing statement. This is true unless the goods are sold, in which case the bank must demand and receive payment within 10 days of the sale of the sale of the goods, or the security interest lapses. If a financing statement is filed before the sale of the goods, then there is no time limit on the perfected security interest. Two examples will illustrate;

> **Example 1:** the goods are sold on day 21. Even without filling, the bank has a perfected security interest on the proceeds for 10days after the sale of the goods. In effect, the bank's perfected security interest in the goods and their proceeds will last 31 days without filing.
>
> **Example 2:** The goods are sold on day 5. Unless the bank has filed, the perfected security interest in the proceeds lapses on day 15. If payment is not received by that time, the bank must file a financing statement to maintain its perfected security interest. If the trust receipt is to be outstanding beyond 21 days, then a UCC financing statement must be filed in order to maintain the perfected security interest.

# Policing the Trust Receipt Transaction - Maintaining the Security Interest

Once the bank has a valid trust receipt and has perfected its security interest in the trust receipt, it must monitor the transaction to ensure that the security interest is maintained throughout.

Before discussing specific steps the bank may take to police the trust receipt transaction, it may be well to review the UCC rules governing security interests in trust receipts.

Under the UCC, the trust receipt represents a security interest not only in the goods (or the warehouse receipts) that has been released, but also in the proceeds from the sale of the goods. Once the trustee in the normal course of business sells the goods represented by the trust receipt, however, the buyer acquires title to the goods regardless of any security interest that the bank may have. **The bank therefore, makes sure that the proceeds from the sale of the goods are promptly turned over.**

Although the terms of the trust receipt may require the trustee to hold the collateral and any proceed from the sale of the collateral separate from his own property and ensure that the identity of the goods is not lost (through, commingling, processing, or sale), in practice such segregation of collateral is not always feasible. Component parts, for example, that are acquired under a trust receipt may lose their identity as they are processed into finished goods. The UCC, however, allow the security interest to be maintained not only in the original collateral, but also in the products and proceeds. This provision greatly facilitates trust receipt financing of goods that lose all or part of their identity.

Despite the protection provided by the UCC, prudent banking practices nevertheless require monitoring trust receipt transactions with the utmost vigilance in order to protect the bank's interests. Since the goods released to a borrower under a trust receipt are, in theory, the property of the bank, the bank should at all times apply the same principles in policing trust receipts that are applied when dealing with bank property. In monitoring trust receipt transactions, the bank should actively follow the status of the transaction through every step, from release of the goods, to delivery to the buyer, consummation of the sale, collection of the proceeds, and cancellation of the trust receipt.

A major objective of policing the trust receipt transaction is to ensure that the trustee live up to the terms of the trust receipt agreement, uses the document and goods only for the purpose stipulated, and promptly turns over to the bank the proceeds from the sale of the goods. This last point is of special significance in trust receipt financing. The bank should be careful to estimate as closely as possible the time it will take the trustee to process and or sell the goods. Trust receipt privileges should never be extended for a period longer than the amount of time necessary to complete the transaction. Suppose, for example, that trust receipt privileges were extended to commodity dealer for 60 day when only 30 day were required, and the dealer used bank funds during the additional 30 day to speculate in the commodities market. If the dealer subsequently lost the funds and had to declare bankruptcy, the bank would lose the money it had loaned. The example illustrates the importance of careful policing of the time that trusts receipt is outstanding.

In order to meet these objectives and comply with the requirements of the UCC, it is essential to arrange with the borrower a method that will enable the bank to follow the movement, in various stages of handling, of the goods and their sale. Although the UCC does not specify required actions, some precautions the bank may take, depending on the circumstances, are to require the borrower to:

1. Note on his books the trust receipt transaction, identifying the goods by lot numbers.
2. Submit period reports to the bank showing the status of lot numbers and the relative quantities involved. (In the case of fungible goods, identity can only be preserved by proper records assisted by segregated storage of trust receipt goods.)
3. Furnish the bank with details of sales so the tenor of the trust receipt transaction can be determined.
4. Identify goods to a specific trust receipt by including on the trust receipt a definite description of the goods by marks or numbers (this can sometimes be done by reference to an attached descriptive invoice or list).
5. Ensure that the proceeds of the sale of goods identified to the specific trust receipt are accounted for. The proceeds of the sale of goods released on a specific trust receipt should be applied to the specific obligation secured by goods released on that receipt.
6. Comply, promptly and strictly with trust receipt conditions, including delivery of other documents or payment of proceeds in whatever from received, including accounts receivable.
7. Cancel the trust receipt as the proceeds from the liquidation of the inventory are remitted to the bank.