

WAREHOUSE RECEIPT FINANCING

Adoption of the UCC principles in establishing a
Warehouse Receipt Financing

GENERAL APPROACH



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Description

Warehouse receipt financing is a form of secured lending in which the bank advances funds against inventory goods that are being stored in a warehouse and that have been assigned to the bank through warehouse receipts. Warehouse Receipts should be treated as a document of title, give the bank title to the goods until they have been sold and the proceeds collected.

Procedure

The borrower usually arranges for the storage of goods in an independently controlled warehouse, which will issue warehouse receipts for the merchandise deposited. The warehouse receipt is an acknowledgment by a warehouseman to the effect that certain goods have been received for storage and will be delivered on demand in accordance with the terms of the receipt. The warehouse receipt is, by definition, a title document, and possession of it is evidence of ownership of the goods represented. A warehouse receipt issued to the bank serves as **possessory collateral**.

Upon receipt of the warehouse receipt, the bank advances to the borrower a specified percentage of the value of the goods represented by the receipt. (The lending margin is determined based on the bank's evaluation of the borrower. Please refer to the section "Borrowing Base" for further discussion of considerations in setting margins on inventory.) The borrower repays the funds advanced with the cash collected from the sale of the goods.

The bank will authorize release of the goods from the warehouse upon receipt of cash payment. Sometimes, however, in order to complete a sales contract, the proceeds of which will be used to repay the loan collateralized by the goods covered by the warehouse receipt, it may be necessary for the borrower to deliver the goods to the customer before payment is received. In such cases, the bank may authorize goods to be released from the warehouse into the possession of the borrower and obtain from the borrower a trust receipt. Under the terms of the trust receipt, the borrower acknowledges the bank's security interest in the goods and acts as the bank's trustee in delivering the goods to the buyer.

The trust receipt, unlike the warehouse receipt, is not a title document, but rather evidence of the bank's continuing security interest in a title document.

Uses

Warehouse receipts financing is commonly used by commodities dealers to finance goods stored in a warehouse prior to shipment. Manufacturers also sometimes use this type of financing to bring adequate inventory close to the point of sale without turning it over immediately to the purchaser, usually a middleman, such as a distributor, dealer, or wholesaler. The usual procedure is for the manufacturer to set up a warehouse at the middleman's location.

When the middleman needs some of the goods he can pay for them and, at the same time, obtain an authorization to withdraw a specified quantity from the warehouse.

Monitoring and Policing

Warehouse receipts financing requires considerable monitoring and policing by the bank to ensure that the three conditions of asset protection lending –**seniority, protection, and control** –are met. Warehouse receipts and trust receipts, as we have seen, are evidence of the bank’s title to, or security interest in, inventory goods that have been pledged as collateral for a bank loan. The value of a warehouse receipts or a trust receipt does not reside in the actual piece of paper, of course, but in the goods that it represents. Since the goods are not in the possession of the bank but of a third party (the Collateral Manager) or of the borrower himself (who may be authorized to take possession of the goods for delivery to a buyer), the bank must exercise the utmost vigilance in monitoring the collateral and assuring on a day-to-day basis that the bank’s priority claim is valid and subordinate to no other and that the pledged assets are safe, accessible, and of sufficient value to satisfy the bank’s claim.

Thorough understanding of the proper use of warehouse receipts and trust receipts is critical to ensure that necessary precautions are taken to guarantee the validity of the bank’s security interest in inventory goods covered by these documents.

Warehousing and Warehouse Receipts

Overview of Warehousing

Warehousing is the storing of goods or property of others for compensation. It may be conducted by a public warehouse, a private warehouse, or a state-operated or co-operative warehouse.

In order to discuss warehousing we must first understand the legal concept of bailment.

Bailment

Bailment is the Legal term describing the relationship when ownership of personal property resides in one person and possession of it is in another. The depositor of the goods is known as the **bailor**; the person engaged in storing the goods of the other compensation, i.e., the Collateral Manager, is known as the **bailee**. Two conditions are necessary for bailment to exist:

1. The depositor relinquishes possession of the property.
2. The Collateral Manager assumes “**continuous, exclusive, and notorious possession**” of the property.

Bailment is an essential prerequisite in warehouse receipt financing. Where an actual bailment cannot be shown, the warehouse receipt probably does not entitle the holder to any goods or proceeds. Therefore, the demands for delivery made by a creditor-receipt holder may not prevail over the claims of a third party.

Types of Warehouses

A warehouse may be public or private. Public warehousing companies may operate terminal warehouse or field warehouses.

1. Private Warehouses

A private warehouse is operated under the direct or indirect control of the firm owning the stored goods. The primary business of the controlling company is not warehousing but usually manufacturing, wholesaling, or retailing. The warehouse may be operated as part of its general business or through a “dummy” warehouse corporation. In either case, there are close relations between the warehouse and the owner of the stored goods. **Therefore, it may be difficult to prove that bailment exists.**

2. Public Warehouses

The public warehouse is operated by a warehouseman who has no ownership interest in the stored goods and provides his service for a set fee. (Should the warehouseman own some of the goods stored, that fact must be plainly stated on any warehouse receipt covering those goods.) It is much easier to establish that bailment exists when the warehouse is public.

There are two types of public warehouses:

A **terminal warehouse** is one that is separate and distinct from the physical plant of the firm or firms owning the goods stored in the warehouse.

It is usually a large storage area serving a number of different businesses and is at a separate location owned and operated by an independent warehouse company. Since a terminal warehouse is geographically removed from the depositor’s place of business, it is often not very convenient for him to deposit and withdraw inventory as needed. A terminal warehouse is used by businesses that require additional storage capacity. When a company wants to obtain financing collateralized by goods stored in a warehouse, it usually sets up a field warehouse.

A **field warehouse** is one that is on or near the premises of the firm depositing the goods; i.e., the goods remain in the field. The field warehouse is usually a segregated part of the firm’s own warehouse or is storage area. Although the field warehouse may be used for protection and control of the commodities, its primary function is to borrow against them and still have the goods close at hand. The field warehouse arrangement is established primarily as a tool to facilitate secured financing.

To qualify as a public warehouse and to ensure that bailment exists, the field warehouse must be run by an independent warehouse company engaged in the business storing goods, and possession and control of the goods must pass from the depositor to the warehouseman. The fact that the warehouse company is an independent, third party is very important, and the bank, before approving the use of a specific warehousing company should conduct a thorough investigation of it. The following procedures and requirements for establishing a field warehouse must be carefully observed:

- **The collateral management company must have legal right to possession of the space**, which is usually obtained by renting or leasing space on the property of the firm depositing the goods.
- **The area of the field warehouse must be separated from the premises of the depositor** by some kind of barrier (lock and key) and must be under the constant supervision of an employee of the independent warehouse company. (Actually, the warehouseman is often a “former” employee of the depositor. While acting as the warehouseman, however, he must be in the employ of the warehouse company, which pays his salary.) Only the collateral management company may have access to the field warehouse area.
- The collateral management company **must give public notice of his control** by posting signs in permanent places inside and outside the warehouse.
- The collateral management company **must establish general operating procedures**, including proper inventory controls and records.

Capability and Reputation of the collateral control company

The capability and reputation of the collateral control company are important considerations in the bank’s decision to become involved in warehouse receipt financing. Factors to consider include the collateral management company financial and moral responsibility, reputation in the trade, credit record, method of operation, adequacy of collateral control facilities, and insurance protection (legal fidelity and fraud).

If the field warehouse is being used, the bank should determine whether the requirements for a field warehouse listed above have been properly met, specifically whether:

- the premises are suitable for storing the particular goods
- the leasing arrangement is legal
- the pledged goods are readily identifiable and properly separated from unpledged assets
- the custodian fully understands and performs his duties, so that the bank’s dominion over the goods will not be jeopardized

The bank also considers whether and to what extent the collateral control company guarantees the adequacy and suitability of each warehouse and the extent to which field auditors of the company independently examine each warehouse.

Such examinations should occur at irregular intervals (for the surprise element) and should include a careful check of stocks, custodian records, and adequacy of markers.

The process of investigating a field warehouse can be time consuming, and it is advisable for the bank to deal with well-established and responsible collateral control companies.

Law Governing Warehousing and Warehouse Receipts in the United States – a guide on how field warehousing is conducted under the UCC

Article 7 of the Uniform Code covers the obligations and rights of the warehouseman, the issuance and contents of warehouse receipts, negotiation and transfer of receipts, and the rights of the holders of such receipts. The UCC supersedes previous statutory law governing warehousing, including the Uniform Warehouse Receipts Act, the Uniform Bills of Lading Act, and the Uniform Sales Act.

The UCC does not prescribe warehouse practices nor does it provide for licensing, inspection, or other regulations of warehouses. However, because licenses are issued by some states as a matter of routine upon application with no investigation by the state authorities of the party submitting the application, state licensing of warehouses cannot be assumed to indicate anything as to the liability of the warehouse receipts issued by him. Bonding may be of significance, although the statutes and enforcement procedures vary among the states. In some instances, the minimum required bonding amount is so small as to provide no real protection against the inability of the warehouseman to carry out his obligations. Adequate bonding, of course, can be an important factor of protection for a deposit of goods in a warehouse and for a holder of the warehouse receipts, it cannot be assumed that a warehouse legally labeled “bonded” provides such protection.

Warehouses that store agricultural products may elect to be licensed under the **United States Warehouse Act**, which provides for inspection, licensing and bonding of warehouses, inspection and grading of products in storage, and the maintenance of prescribed records. The specific requirements as to the contents of warehouse receipt under this Act are similar to those under UCC Article 7.

Legal Rights and Duties of Warehouseman (applicable to collateral management companies in other jurisdictions)

The duties and rights of warehouseman arise from two sources: applicable laws and the contract with the depositor. The latter may be extremely flexible provided there are no conflicts with the law.

The **duties** of warehouseman under the law relate to the issuance of receipts and to the custody and delivery of goods stored:

1. Issuance of Receipts

All receipts issued by a warehouseman must contain certain terms prescribed by law. The warehouseman is liable for any damages resulting from the omission of any required terms. Careless or irresponsible acts in issuing warehouse receipts are serious matters under the existing statutes, but culpability and punishment vary from state to state.

2. Care of Goods

The warehouseman is obligated to exercise such care of goods as a reasonably careful owner of similar goods would exercise, and he is liable for any loss or damage to the goods caused by failure to exercise such care. Courts have generally held that the warehouseman has the responsibility of knowing what the storage requirements of the goods are and providing facilities that are suitable for the particular item. In litigation disputes in some states, the warehouseman must carry the burden of proving that the required care was exercised, whereas in other states the warehouse receipt holder

must prove the warehouseman has been negligent before the warehouseman can be held liable for loss or damage.

3. Segregation of Goods

As a general rule, the warehouseman must store separately the goods represented by each warehouse receipt, except in the case of fungible goods. This requires enabling the warehouseman to identify and deliver the identical goods deposited.

4. Release of Goods

The warehouseman must release the goods upon stipulated conditions in the warehouse receipt as long as the demand for release of goods is accompanied by: (a) an offer to satisfy the warehouseman's lien; i.e., pay warehousing expenses, (b) an offer to surrender the duly endorsed warehouse receipt, if negotiable, and (c) a readiness to sign a receipt for the goods if requested.

The warehouseman may become liable to the warehouse receipt holder when the delivery of goods is made to a person who does not present and surrender the endorsed negotiable receipt. In the case of non-negotiable receipt, delivery may be made in response to a properly signed release order. (See below for definitions of negotiable and non-negotiable warehouse receipts.)

The rights of the warehouseman relate primarily to the right of compensation for storage charges and services rendered. The warehouseman can withhold delivery of goods until payment is received and, depending on the type of receipt, the warehouseman may have a broad lien on the goods for storage, transportation, labor, and certain other services. In the case of non-negotiable receipt, this lien exists even though such charges are not specified on the receipt. The broad lien gives the warehouseman the right to withhold delivery of goods until payment for services is received and, after a reasonable period of time, to sell the goods and apply the proceeds to the unpaid charges and expenses of the sale. The remainder of the proceeds must be held by the warehouseman for the account of the receipt holder.

The Warehouse Receipt

The warehouse receipt is a title document for goods on deposit in a warehouse. There are two types of warehouse receipts: **negotiable** and **non-negotiable**.

The **negotiable** warehouse receipt is made out to the order of a named person or bearer and is, therefore, a negotiable instrument and may serve as possessory collateral. Major characteristics of the negotiable receipt, relating to the negotiation and transfer of the receipt and the rights of the receipt holder are:

Delivery of goods stored against a warehouse receipt is made to the bearer of a properly endorsed receipt upon surrender of it to the warehouseman. Partial release of goods is permitted if the receipt is given to the warehouseman who endorses it for the goods released and returns it to the holder. The receipt must be surrendered to the warehouseman when final release of goods is made.

Delivery of the negotiable warehouse receipt represents symbolic delivery of goods.

If a negotiable warehouse receipt has been lost, it can be replaced or the goods delivered, only by court action or by posting bond, usually for twice the value of the goods.

Generally, the warehouseman's lien is limited to specific charges listed on the particular receipt.

Goods cannot be attached unless the warehouse receipt has been surrendered to the warehouseman. Movement of the goods cannot be prevented unless the negotiation of the receipt or the delivery of goods has been legally enjoined.

Bankers' acceptances collateralized by negotiable warehouse receipts are eligible for rediscount at the Federal Reserve.

Paperwork and control requirements are the main disadvantages of the negotiable warehouse receipt.

A **non-negotiable** warehouse receipt is made out to a specific party. Only the named party may authorize release of goods from the warehouse. The warehouse receipt does not have to be endorsed or surrendered. Major characteristics of the non-negotiable receipt are:

- The non-negotiable receipt may be assigned or transferred to another party. The warehouse company, however, must be notified before the assignment or transfer becomes effective.
- The receipt must be issued in the bank's name in order for the receipt to be possessory collateral. Otherwise, the bank merely has a security interest in non-possessory collateral (as long as there is a security agreement and the security interest in the collateral has been perfected by filing).
- Lost receipts can be easily and quickly replaced, and movement of goods is not restricted as a result of loss of the receipt.

An advantage of non-negotiable warehouse receipts is that they need not be surrendered to obtain release of the goods. As long as the receipt is made out to the bank, goods can be released upon written order of the bank, instructing the warehouseman exactly what types and quantities of goods are to be released to the person named in the order. In the case of a negotiable receipt, if the bank wanted to release only part of the stored merchandise, it must go to the warehouse to get the merchandise released and obtain a new receipt for what remains in the storage area. Alternatively, the bank could endorse the receipt over to the borrower, thereby allowing him to make the withdrawal himself. This cumbersome and sometimes risky procedure can be greatly simplified by the use of a non-negotiable receipt. In this case, to authorize a release of only part of the goods, the bank can issue a delivery order for the exact amount or number of units it wishes released. The delivery order can be turned over to the borrower, who picks up the needed merchandise.

Form of the Warehouse Receipt under the UCC - A guide to issuing warehouse receipts by warehouse operators. (Note: Although the reference hereunder is to a warehouse company, the same general principles enunciated under the UCC, would be applicable and relevant to collateral management companies in other jurisdictions)

The UCC does not specify a required form for the warehouse receipt. However, unless the receipt contains certain information and terms, the warehouseman under the UCC is liable for damages caused to persons as a result of such omission. Per UCC Article 7, the warehouse receipt must contain at least the following information:

- Location of the warehouse where the goods are stored.
- Date of issue of the receipt.
- The consecutive number of the receipt. (As a control procedure, all receipts issued by a warehouse company should be consecutively numbered.)

- A statement whether the goods in storage will be delivered to bearer, to the order of specified person, or only to the specified person. This merely means the receipt has to indicate whether it is negotiable or non-negotiable.
- The rate of storage and handling charges. (When goods are stored under a field warehousing arrangement, a statement of the fact is sufficient on a negotiable receipt.)
- A description of the goods or of the packages containing them. The warehouse company is responsible for delivering goods of the nature and type described in the receipt. Often warehouse companies are not in a position to inspect merchandise deposited with them. They therefore, add a disclaimer on the receipt such as “boxes said to contain” merchandise of a certain description.
- Signature of the warehouseman or authorized agent.
- If the receipt is issued for goods which the warehouseman owns, either jointly or in common with others, the fact of such ownership must be stated.
- A statement of the amount of any advances made of any liabilities incurred for which the warehouseman claims a lien or security interest on the goods. (If the exact amount is known, a statement of the fact that advances have been made or liabilities incurred and their purpose is sufficient.)

Protection to the Lender

The foregoing has been intended to provide an overview of the warehousing industry and the legal environment under which it operates so that the lender will be able to properly administer and monitor a loan secured by the assignment of inventory through warehouse receipts. The justification for secured lending is that the taking of a security interest in specific assets of the firm will ensure the seniority of the bank’s claim and will provide protection against loss by providing the bank the right to liquidate the collateral in the event the borrower defaults on the loan. Since in a warehouse receipt financing arrangement the collateral is not in the actual possession of the bank, the extension of credit against warehouse receipts requires a considerable amount of checking and policing by the bank to ensure that its interests are protected.

Existence and Quality of Collateral

The bank must, first of all, assure itself that the merchandise on deposit in the warehouse is indeed the collateral that it has agreed to lend against. It should be noted that, in general, the warehouseman is not responsible for the quality of the goods stored. Goods may be described on the warehouse receipt as “said to be, or said to contain,” and the warehouse receipt provides no guarantee of the grade or quality of the goods. For example, tanks said to contain salad oil on the warehouse receipt may, in fact, contain water, and bank lending against such receipts could incur substantial losses (as they did in actual case several years ago). It is important, then, that the bank make its own determination of the quality of collateral represented by a warehouse receipt. Outside appraisers or qualified bank personnel should make accurate counts of the collateral, determine its quality, and inspect the warehousing operations.

Protection of the Value of Collateral: Proper Warehousing and Insurance Coverage

A second major consideration is that the value of the collateral will be sufficient to satisfy the amount of the bank's claim. In a warehouse receipt financing arrangement, the bank would want to make sure that the stored goods are adequately protected against natural and unnatural hazards, harmful weather elements, damaging temperature and humidity, and any other factors that may affect their value and cause deterioration. While the warehouseman is legally obligated to exercise such care of goods as a reasonably careful owner of similar goods would exercise and is liable for any loss or damage caused by failure to exercise such care, many warehouse companies may not be financially able to claims for losses resulting from negligence. Therefore, the bank must assume responsibility for investigating the operations of any warehouse company storing goods collateralizing a bank loan and should deal only with the most reputable warehouse companies.

In addition, the bank must require that the borrower and the warehouseman maintain adequate insurance to protect against loss and should obtain certified copies of such insurance policies. Types of insurance available to the various parties include the following:

Insurance available to the warehouseman includes (1) crime insurance, (2) warehouseman's legal liability which covers liability imposed by law for the loss or damage to stored goods, (3) duty or performance bonds which guarantee delivery of goods stored, (4) fidelity bonds, and (5) coverage against tank leakage or collapse. This last type of insurance is often required by the commodity exchanges.

In addition, the insurance covering a variety of specific events or all-risk policies are available to depositors. Ordinarily, such coverage is available in inventories located on the depositor's own premises but may also be available for goods stored in a public warehouse. An "all risk" policy covers most insurable risks, with certain standard exclusions, which vary with the nature and location of the property. Such a policy does cover risks usually covered by other specific risk classifications.

The bank generally would not obtain insurance on the goods covered by warehouse receipts unless such insurance would directly protect the bank's own interests. Rather, the bank would be concerned primarily with the insurance coverage of the depositor-borrower and the warehouseman. The bank should require "loss payable endorsements" that, under normal conditions, obligate the insurance company of the borrower or of the warehouseman to make benefit payments directly to the bank. In addition, in cases where the collateral is negotiable or marketable, the bank may obtain insurance securities, which usually provide protection from losses resulting from forged signatures. This type policy is ordinarily available only to banks, stock-brokers, and other financial organizations.

Protection of the Bank's Security Interest: Validity of the Warehouse Receipt

In a warehouse receipt financing arrangement the bank's security interest in the inventory goods is evidenced by possession of the warehouse receipt. The validity of the security interest depends on the validity of the warehouse receipt. Before extending credit against a warehouse receipt, therefore, the bank should make sure that the receipt complies with the law of the state in which it is issued. The lender should check with the legal department if there are any questions regarding warehouse receipts.

The bank's rights as the holder of a warehouse receipt, and hence the value of its security interest in the goods, may be defeated in certain instances. A warehouse receipt is no guarantee of title if the depositor does not have full title to the goods because of fraud or previous liens. In addition to making sure that the depositor has good title to the goods and that they are free of previous liens, the bank should also check periodically with the warehouse company to make sure that storage charges are being paid, since these represent first liens on the stored merchandise.

Maintaining Margins

As in any secured lending agreement, protection against loss in warehouse receipt financing requires setting and maintaining adequate lending margins. The topic of setting margins has been discussed elsewhere but it is important to reemphasize here the importance of setting and maintaining conservative lending margins that take into consideration not only the quality of the inventory and the costs of liquidating it but also possible decline in the value of the goods over time due to market swings, deterioration in quality, or other factors.

Summary

In summary, lending against warehouse receipts can entail considerable risk to the bank, which is lending against goods that are in possession and control of another party. The bank must be concerned, first of all, establishing and maintaining a valid security interest by following the requirements governing secured transactions and the issuance and use of title documents. Secondly, the bank must ensure that the net realizable value of the stored goods will be sufficient to meet the bank's claim.

To reduce the risks involved, the bank should deal only with the most reputable warehouse companies, require that the goods be insured against all insurable risks, and set conservative lending margins that allow for possible decline in the value of the goods over time. Finally, due to the legal complexities of this type of financing, the bank's action should be guided by legal counsel.