

LEGAL STRUCTURING OF WAREHOUSE FINANCE FACILITIES IN VIETNAM



CURRENT SITUATION RE: WAREHOUSING AND INVENTORY FINANCE IN VIETNAM

- Inventory and Receivables Finance Demand Growing Rapidly in Vietnam, particularly in the Agri-Business Sector
- New Law for Secured Transactions over Movables and Registry, *but* Lack of Law Governing Warehouse Receipts and Other Documents of Title
- Concerns regarding Reliability of Warehouses and Collateral Managers and Competing Title Claims to Goods (retention of title)
- Lack of Licensing or other Supervision of Warehouse Operators and Collateral Managers

INVENTORY CREDIT-THE ADVANTAGES

- Inventory loans are normally short term and self-liquidating (repaid by application of sales proceeds)
- Inventory loan amounts normally reflect current market values and inputs rather than intangibles
- Inventory loans amounts can be geared to high seasonal borrowing requirements without reliance on land or equipment security
- Inventory loans are normally be converted to receivables loans when the inventory is sold
- Inventory can be liquidated by the bank if the borrower defaults

INVENTORY CREDIT-DISADVANTAGES

- Inventory is fast moving and value and quantity can be difficult for a lender or trader to verify
- Inventory is intended to be sold and if the proceeds are not applied to the repayment of the loan there is no security
- Inventory is subject to casualty risks such as fire, flood and theft
- Title to movables can be difficult to verify
- If the borrower is dishonest or is under severe financial pressure, he may borrow against non-existent inventory
- Inventory values, especially for commodities, can be volatile

RISK MITIGATION TECHNIQUES

1. CREDIT FACILITIES CAN BE CONTROLLED TO ENSURE PRODUCTION
 - Loan can initially be geared to cover costs of production and inputs (component parts, labor costs, packaging, transport, etc and only increased once the products are finished)
 - Loans can be disbursed directly to input suppliers wherever possible.

RISK MITIGATION TECHNIQUES

2. CREDIT FACILITIES ARE MONITORED TO ENSURE PRUDENT LOAN-TO-VALUE RATIO

- Inventory value should be recalculated daily for volatile commodities
- The lender must have access to current wholesale price information
- The lender must be able to verify location, quantity and quality of the inventory
- The lender should adopt appropriate policies and procedures to ensure that a prudent loan to value ratio is maintained

RISK MITIGATION

3. COMPREHENSIVE INSURANCE COVERAGE

- The borrower should have an insurance policy covering the inventory against fire, flood, theft, losses in storage and transit, and public and product liability and other usual risks
- Claims under the policy should be payable directly to the lender and the lender's interest as a pledgee should be written in the policy
- The lender should ensure that policy premiums are paid and that the coverage is adequate to cover full replacement cost of the inventory

RISK MITIGATION

4. VALUE FLUCTUATION

- If the inventory is pre-sold the lender should take an assignment of the sale contract and all sales proceeds
- If the inventory is a traded commodity and is not pre-sold, the borrower could enter into a futures or forward contract to protect against a decline in the market value
- Options are more expensive but safer than forward sales until the inventory has been produced

THE ROLE OF COLLATERAL MANAGEMENT

- Active procedures to monitor existence, value, title, quality and quantity of inventory and receivables collateral
- Can be continual or weekly, bi-weekly or monthly
- Can be carried out by the lender using own staff, or by collateral management service providers
- Can be limited to monitoring activities (a stock monitoring agreement, or SMA), or extended to a custodial role (a collateral management agreement, or CMA).

WHAT IS THE ROLE OF THE COLLATERAL MANAGER?

- Assure Physical Availability of Collateral
- Assure Legal Security of the Collateral
- Provide Practical and Cost-Effective Procedures for Monitoring Collateral
- Provide a Basis for other Types of Insurance

SMA COMPARED TO A CMA

- STOCK MONITORING AGREEMENT Periodic visits to a storage location and certification of the stock quantity, quality, value, and other agreed matters but without any responsibility for subsequent releases. No storage or other custodial documents are issued to the bank
- COLLATERAL MANAGEMENT AGREEMENT Continual and exclusive custody by the CMC of goods in a storage location temporarily leased by the CMC, with signs posted and locks in place. The CMC will usually issue a custodial document to the bank that may not have legal validity, but the CMC will take responsibility for the control of the goods under the Collateral Management Agreement.

LENDER COLLATERAL MANAGEMENT

ADVANTAGES OF AN IN-HOUSE COLLATERAL MANAGEMENT DIVISION:

- Good training for junior bankers if the bank is active in SME secured lending sector
- Staff have career path in the bank and motivated to protect the bank's interests
- Misconduct by bank employees covered by banker's blanket bond or similar anti-fraud policy
- Costs can sometimes be covered by separate loan administration fee

LENDER COLLATERAL MANAGEMENT

DISADVANTAGES OF AN IN-HOUSE COLLATERAL MANAGEMENT DIVISION:

- More difficult where inventory requires expertise to assess grade or value or where inventory is significant distance from the bank
- Intrusive inspections by bank staff may place stress on relationship with valued customer
- Normally the in-house option is impractical where full-time custodial arrangements are required
- In-house monitoring normally limited to banks that are committed to offering secured commercial credit as a core business

THIRD PARTY COLLATERAL MANAGEMENT

Advantages of Collateral Management Company (CMC)

- CMC will offer insurance covering negligence and employee fraud in significant amounts
- If the CMC is affiliated to an inspection company or accounting firm, it will have staff in many major cities and ports, reducing travel expenses
- If the CMC has expertise in the trade or industry involved, it will be able to provide reliable data on grade, quality, handling conditions, and other factors affecting value of the inventory
- If the CMC is working in the trade or industry involved, it may have useful information to share regarding the customer

THIRD PARTY COLLATERAL MANAGEMENT

Disadvantages of CMCs

- CMC services are costly and the customer may object to reimbursing the bank
- Customers will be concerned about the confidentiality of market sensitive information
- If the CMC is doing business with the customer (as an inspection company, for example) there will be a direct conflict of interest with the bank
- Unless the bank has a direct claim under the CMCs liability insurance policy, the bank may have difficulty collecting if the loss is large

THIRD PARTY COLLATERAL MANAGEMENT

Special Issues for CMC Custodial Services

- CMCs are normally unwilling to issue negotiable warehouse receipts
- CMCs are normally unwilling to certify that the customer has good title to the inventory
- If the CMC acts as a custodian, the CMC may have a lien for unpaid fees and may refuse to release the goods to the lender if the fees are not paid by the borrower
- Unless the law recognizes the “field warehouse” concept, warehouse receipts issued by a CMC may be invalid as title documents or pledge documents

THIRD PARTY COLLATERAL MANAGEMENT

Certain Technical Issues with CMCs

- CMCs normally offer form service agreements that limit their liability for negligence, and accept unlimited liability only for intentional misconduct or fraud. This can be difficult to prove.
- CMC insurance policies will normally exclude coverage for fraud involving senior management (which unfortunately is often the case in major frauds).
- If a bank hires a CMC after the bank learns that there is a collateral shortage and does not inform the CMC, the CMC might be able to resist any subsequent claim based on that shortage.

DRAFTING SUGGESTIONS FOR SECURITY AGREEMENTS FOR INVENTORY FINANCING OF GOODS IN WAREHOUSES

1. Identify the Collateral as “Inventory” collateral where possible to avoid prior perfected security agreements
2. The security agreement should identify the custodian of the goods (warehouse operator or collateral manager) as the exclusive agent for the secured party who is paid by the secured party wherever possible. This is to enable the secured party to demonstrate that the collateral is under the dominion and control of the secured party.
3. The custodian should accept appointment as the exclusive agent for the secured party and undertake to accept instructions solely from the secured party regarding the receipt, release and reporting of the collateral This is to enable the secured party to demonstrate that the collateral is under the dominion and control of the secured party, and to ensure that the custodian is legally responsible for any unauthorized release of the goods.

DRAFTING SUGGESTIONS FOR SECURITY AGREEMENTS FOR INVENTORY FINANCING OF GOODS IN WAREHOUSES

4. The security agreement should authorize the custodian to allow the securing party to replace and rotate the collateral, under the supervision of the custodian, so long as the minimum value of the collateral is 150% of the outstanding loan. This is to enable the securing party to operate its business normally while maintaining the agreed collateral to loan margin.
5. The security agreement should contain the standard pledge contract wording, including a description of the collateral and location of the collateral and value of the collateral.
6. The security agreement should be signed before a notary and should be registered if possible.

DRAFTING SUGGESTIONS FOR SECURITY AGREEMENTS FOR INVENTORY FINANCING OF GOODS IN WAREHOUSES

7. If the goods are stored in the borrowers warehouse the Collateral Manager should take appropriate steps to ensure its exclusive possession and control. These steps should be expressed in the Collateral Management Agreement and should include:
 - Installation of locks and seals on all entrances;
 - Temporary rental of the warehouse;
 - Placement of signs within and on the exterior giving notice that the goods are under the control of the CM and pledged to the secured party

WHAT ARE THE BASIC COLLATERAL MANAGEMENT SERVICES?

- Field Warehousing
- Warehouse Contracting
- Non-Custodial Verification
- Document Trusteeship
- Receivables Certification and Control

MODERN COLLATERAL MANAGEMENT SERVICE PROVIDERS

- International Terminal Warehouse Companies such as Steinweg
- International Inspection Companies such as SGS, Inspectorate and Bureau Veritas
- Local Bank-Owned Field Warehouse Companies
- Dedicated Collateral Management Companies such as ACE, Auxiga, Le Warrant and Douglas Guardian

ADVANTAGES & DISADVANTAGES OF TERMINAL WAREHOUSE OPERATORS

- Substantial Balance Sheets and Recourse
- High Degree of Physical Security
- High Degree of Legal Security and Insurance
- Inconvenience to the Customer if goods require processing
- Tendency to be Bureaucratic in Approach

ADVANTAGES & DISADVANTAGES OF INSPECTION COMPANIES

- Good Knowledge of Local Market
- Reliable Local Supervisory Personnel
- Important International Reputation
- A Preference for Inspection Services and Discomfort with Custodial Responsibilities
- Not well-versed in the Legal or Insurance Aspects

ADVANTAGES & DISADVANTAGES OF BANK-OWNED FIELD WAREHOUSE COMPANIES

- Good Knowledge of Local Market
- Good Knowledge of Local Laws
- Convenient to the Customer
- Generally Flexible on Pricing for Large Transactions but otherwise Bureaucratic
- Claims payable in Local Currency

ADVANTAGES & DISADVANTAGES OF COLLATERAL MANAGEMENT COMPANIES

- Sympathetic with Needs of Bank Customers
- Willingness to Operate Worldwide
- Flexibility on Terms and Pricing
- Little or no Tangible Assets but Provide Insurance Support
- Lack of Familiarity of Local Markets, Laws and Customs outside of Established Areas of Business

PARTICULAR INSURANCE AND LEGAL ISSUES

- Is the CMC licensed to issue Documents of Title?
- Are the Procedures Employed Legally Sufficient to Perfect a Possessory Pledge?
- Does the Insurance Coverage Protect the Bank Against Non-Existence or Unauthorised Release of the Commodities?

PARTICULAR ISSUES (CONTINUED)

- Does the Insurance Cover Losses Resulting from Failure to Observe the Required Procedures?
- Does the Bank have a Direct Claim under the Policy (as a co-insured or under a cut-through clause)?
- Has the Underwriter been properly notified of the Transaction so coverage is clearly bound?

PARTICULAR ISSUES (CONTINUED)

- Are the Goods Covered Against Fire, Flood, Theft and Other Casualty Risks?
- Will the Theft and/or Professional Liability Coverage Protect against the appropriation of the goods by the Borrower?
- Does the CMC has adequate local Supervisory Staff to regularly Audit the account?
- Has the Borrower agreed to pay the CMC fees in advance?

SUMMARY AND CONCLUSIONS RE: COLLATERAL MANAGEMENT

- Independent Collateral Management Services in Some Form are Necessary for Inventory Financing
- This is a High-Risk Service that needs significant revenues to create claims reserves and to pay insurance premiums
- The Legal and Insurance Foundations must be Examined Rigorously by both the Bank and the CMC

COMMON FEATURES OF INDEPENDENT WAREHOUSES

- Exclusive Possession of the Warehouse by the Issuer (third party access restricted)
- Notorious Possession (signs posted)
- Goods identifiable (records maintained and non-fungible goods segregated as necessary)
- Warehouse licensed and tariffs regulated
- Warehouse accessible to local commodities and transportation

CIVIL CODE AND NEW SECURED TRANSACTIONS DECREE

- The Civil Code of 2015 included provisions concerning the rights of secured creditors (Sections 292 to 350)
- The Decree of March 2021 includes provisions for implementation of the Civil Code provisions on security for performance of obligations.

PROVISIONS IN SECURED TRANSACTIONS DECREE RELEVANT TO INVENTORY FINANCE

- Article 6 applies to certificates covering collateral that moves in commerce. This could apply to situations where a transferable storage document issued for goods in an independent warehouse or bill of lading covering collateral is given to a third party (for example a freight forwarder for purposes of sale) and provides that the third party is liable to the secured creditor for any failure to use the certificate as authorized.

PROVISIONS IN SECURED TRANSACTIONS DECREE RELEVANT TO INVENTORY FINANCE

- Article 7 provides that security rights in the collateral are not be lost if the goods are sold or otherwise transferred unless the transfer is authorized by the secured party or if the collateral is lost or destroyed or the goods are replaced with goods of equal or greater value. Inventory collateral may be freely sold in which case the secured party has a priority claim to the proceeds. Civil Code Art 321 (4)

PROVISIONS IN SECURED TRANSACTIONS DECREE RELEVANT TO INVENTORY FINANCE

- Article 10 (2) provides that growing crops attached to land may be treated as immovable collateral so long as they have not been separated from the land.
- Article 13 provides that “valuable papers” may be used as collateral security. Valuable papers are not defined but may reasonably be construed to include negotiable warehouse receipts, bills of lading and other documents representing goods or a right to payment.

PROVISIONS IN SECURED TRANSACTIONS DECREE RELEVANT TO INVENTORY FINANCE

- Article 19 provides that commonly traded commodities in warehouses may be used as collateral provided that the security agreement specifies the location of the warehouse and value and type of commodities. Commodities may be in commercial circulation or in production (work in process).
- Article 21 provides that commodities undergoing processing or change the secured party retains security in the proceeds unless ownership changes under the security agreement.
- Article 21 provides that crops are harvested the yields obtained shall automatically become the collateral of the secured party.

PROVISIONS IN SECURED TRANSACTIONS DECREE RELEVANT TO INVENTORY FINANCE

- Article 23 and Article 24 provide that a security agreement may be enforce against a third party when the security agreement is notarized, registered in accordance with the Civil Code, or when the secured party “holds the collateral.” Holding means direct management, control or domination of the collateral, or the management of the collateral by another person acting under direction of the secured party.
- Clearly goods deposited in an independent warehouse in circumstances where the operator is bound to follow the instructions of the secured party should qualify as “holding the collateral.”

PROVISIONS IN SECURED TRANSACTIONS DECREE RELEVANT TO INVENTORY FINANCE

- Article 31 provides that a security agreement may require a pledge or the handover of tangible collateral to the secured party or to a third person (such as a warehouse operator).
- Article 309 and following of the Civil Code make clear that the pledge takes effect upon delivery to the pledgee or his agent (the warehouse operator) without registration (***although registration is always recommended to be certain***).

SUMMARY OF LEGAL ADVANTAGES OF INVENTORY FINANCING OF GOODS IN WAREHOUSES

- Pledges of inventory held by collateral managers or warehouse operators do not require registration.
- Pledges of inventory take priority over prior registered collateral security agreements or retention of title agreements
- Inventory collateral may be replaced, rotated, commingled and change form during processing
- Secured lenders acquire an automatic priority claim on sale and insurance proceeds
- Excess collateral may be released from the warehouse without formalities so long as minimum value is maintained

ANNEX I

If Vietnam adopts a Warehouse Receipt Law, What are the Benefits?

COMMON FEATURES OF WAREHOUSE RECEIPTS

- Document of Title (represents stored goods)
- Document capable of transfer by negotiation or assignment
- Creates superior rights against third parties
- Creates superior rights against the warehouseman
- Can be used to pledge or sell the underlying goods

PLEDGE AGREEMENTS AND WAREHOUSE RECEIPTS

- Even with title documents, a debtor's equity will be respected in insolvency proceedings
- A pledge agreement may describe agreed liquidation procedures
- A pledge agreement may include indemnities, such as storage fees, liquidation costs and third party liabilities
- If a pledge agreement is registered, additional legal protection may be afforded

SUMMARY OF BENEFITS

- Warehouse receipt finance is critical to the development of credit availability and efficient markets in agrarian economies and for commodity exchanges
- The warehouse receipt concepts are simple, common sense and have stood the test of long usage, but are dependent upon local statutory and regulatory support
- Borrowers who can provide warehouse receipts of proven reliability have a competitive advantage in both trading and raising capital.

ANNEX II

If Vietnam adopts a Warehouse Receipt Law, What Should the New WR Law Contain?

BEST INTERNATIONAL PRACTICES REGARDING WAREHOUSE RECEIPT LAWS

Key Issues Covered by WR Law:

1. Warehouse Receipts are Documents of Title to Goods
2. Warehouse Receipts and the Goods are transferrable by Negotiation or Assignment
3. Warehouse Receipts impose Obligations on Issuers, Endorsers and Endorsers
4. Warehouse Receipts have Essential Terms defined in the Law
5. The Rights and Obligations of Warehouse Receipt Holders are Clear and are Enforceable in the Courts

WAREHOUSE RECEIPT LAW BEST PRACTICES- DOCUMENT OF TITLE TO GOODS

- Title to Goods covered by Warehouse Receipts should be Transferrable to Good Faith Purchasers or Lenders Free of Claims by Third Parties
- Goods covered by Warehouse Receipts should not be Subject to judicial attachment by other Creditors or Title Claimants
- Good Faith Purchasers of Warehouse Receipt should obtain good Title to Goods even if the WR is lost, stolen, or issued fraudulently.

WAREHOUSE RECEIPT LAW BEST PRACTICES- TRANSFERABILITY

- The Law should define the differences between Negotiable and Non-Negotiable Warehouse Receipts
- Negotiable Warehouse Receipts and the goods are transferable by endorsement and physical delivery to a purchaser or lender
- Non-Negotiable Warehouse Receipts and the goods are transferrable by written assignment and written notice of transfer to the Warehouse Operator

WAREHOUSE RECEIPT LAW BEST PRACTICES- RIGHTS AND OBLIGATIONS OF HOLDERS

- Basic Legal Obligation: to deliver to receipt holder goods in the quantity and quality shown on the receipt
- Warehouseman is required to exercise due care in the storage and handling of the goods
- The Warehouseman is required to segregate the goods unless fungible
- The Warehouseman is liable for any failure to deliver unless legally excused
- The Warehouseman is subject to criminal penalties for intentional over-issue of warehouse receipts or intentional unauthorised release of goods

WAREHOUSE RECEIPT LAW BEST PRACTICES- ESSENTIAL TERMS OF RECEIPT

The Law provides the essential terms of the Warehouse Receipt

1. Name and physical address of warehouse operator
2. Date of Issue and Serial Number of W/R
3. Name of Depositor
4. Description of the Goods, etc
5. and may provide for paper and electronic form and for the requirement that the receipts be printed on security paper and for the requirement that the issuance is notified to a central registrar.

WAREHOUSE RECEIPT LAW BEST PRACTICE- RIGHTS ENFORCEABLE IN THE COURTS

- The W/R law should provide for the enforcement of claims under warehouse receipts in the courts independently of contractual claims
- The Law should forbid unreasonable limitations of liability in storage agreements that are contrary to the express provisions of the law
- The Law should include criminal sanctions for intentional misconduct by warehouse operators

WAREHOUSE AND COLLATERAL MANAGER REGULATION-BEST INTERNATIONAL PRACTICE

- Regulation and Licensing may be Imposed on Warehouses holding Certain Sensitive Commodities—Food Products, Internationally Traded Agricultural Commodities, Exchange-Traded Commodities, Goods Affecting Public Health, Hazardous Materials, etc.
- The creation of a Regulator and Licensing and issuance of Regulations is an expensive and time-consuming process that should not be undertaken lightly.
- Until the Regulator is well-organised and functioning, it is probably better to allow unlicensed operators so long as the unlicensed status is disclosed.

WAREHOUSE RECEIPT SYSTEM REGULATION BEST PRACTICE—THE REGULATOR

- Identity of the Regulator
- Powers and Authority of the Regulator
- Scope of the Regulations and Licensing

WAREHOUSE RECEIPT SYSTEM REGULATION BEST PRACTICE—THE REGULATOR

- Normally, the Warehouse Receipt Regulator (“Regulator”) will be an appropriate governmental agency charged with providing an enabling environment for the development of and management of an efficient warehouse receipt system in Vietnam.

WAREHOUSE RECEIPT SYSTEM REGULATION

BEST PRACTICE—THE REGULATIONS

The Regulator is given the authority to promulgate Rules and Regulations for:

1. The development of a national network of public and private warehouse receipts (in specific sectors to be established by regulation);
2. The prescription of duties and responsibility of licensed warehouse operators, inspectors, graders and weighers, and collateral managers in caring for the stored commodities;
3. The establishment of a commodity grading and weighing system to engender trust in the system and build accountability for stored goods;
4. The issuance and suspension or revocation of licenses for warehouse operators, collateral managers, inspectors, weighers or graders licensed under the Law;
5. The assessment, charging and collection of fees for examinations, inspections, issuance and renewal of registrations and licenses under the Law;
6. and the establishment of a dispute resolution mechanism.

Trân trọng Cảm ơn Quý vị!

Thank you!