

WAREHOUSE RECEIPTS: A ROADMAP FOR THE HARMONIZATION OF TRANS-PACIFIC LAW AND PRACTICE

Vassil D. Zhivkov, S.J.D.*

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I. INTRODUCTION

The Second Pacific Rim Colloquium on Economic Development and the Harmonization of Commercial Law in Shanghai, People’s Republic of China from January 8 to January 10, 2015, provided a great venue for scholars and practitioners from across the world to share their experience and knowledge in critical topics of the Trans-Pacific trade and investment.

During the electronic warehouse receipts panel discussion, both panelists and participants of the colloquium were able learn about the different electronic warehouse receipt systems around the world and the different commercial practices that derive from these systems. The author described the most common warehouse receipts practices, especially when using these instruments in securing agricultural financing.

Professor Drew Kershen preceded my presentation with an enlightening analysis of the concept of control as prescribed by Article 7 of the Uniform Commercial Code of the United States, of which he was one of the principal drafters. Mr. Ari Pozez laid out the chronology of the “living law” of the issuance, transfer, and negotiation of an electronic warehouse receipt (EWR) commonly used by the cotton industry, as well as by the growers, ginners, brokers and buyers of cotton, and the lenders who use such an instrument in the United States. Participants and panelists were also able to learn about the warehouse receipt systems in Latin America, particularly in Mexico and Colombia, as discussed by Licenciado Adalberto Elias.

On the other side of the Pacific Ocean, thanks to Professor Xu Den’s presentation, we were able to learn about the problems the Chinese warehouse receipt system faces and the recent case where a fraud for billions of Chinese yuan

* Dr. Vassil D. Zhivkov, S.J.D., graduated from the Judicial Faculty of the University of National and World Economy in Sofia, Bulgaria in December 2008. He successfully defended his Science Juris Doctor dissertation in July 2014. Recently, Dr. Zhivkov was accepted as a member in the Bulgarian Academy of Sciences and Arts, Sofia Bulgaria.

was committed using the warehouse receipt to deceive lenders. A case like this emphasizes the need for effective public and private law protection mechanisms that ensure the integrity and reliability of warehouse receipts. Vietnam's Professor Tien's presentation emphasized the need to develop a legal framework capable of enabling his agriculturally rich country to take advantage of its resources by creating a warehouse receipt system conducive to a better national and international marketing of its products, thereby contributing significantly to its economic development.

It became clear to all symposium participants that all the Trans-Pacific countries need to develop a warehouse receipt practice and law that can contribute to the development of their agricultural sector. Having recently completed a doctoral dissertation on global warehouse receipts practices and laws, this article will outline the author's views on the harmonization of warehouse receipt financing law and practices in the Pacific Rim countries.¹

II. PREREQUISITES OF AN EFFECTIVE WAREHOUSE RECEIPT LEGAL SYSTEM

A scholarly consensus exists on the prerequisites and the essential steps to successfully develop a warehouse receipt system in a given country.² The first

¹ Vassil D. Zhivkov, *Warehouse Receipts: A Method to Secure Agricultural Financing* (July 2014) (unpublished S.J.D. dissertation, University of Arizona, James E. Rogers College of Law) (on file with author).

² Henry Gabriel identified three factors for a functioning warehouse receipt system: (1) legal recognition and effective legal enforcement of the rights created and derived from warehouse receipts, (2) the physical infrastructure for warehouses and other transport facilities, and (3) effective markets to sell the agricultural products. Henry Gabriel, *Warehouse Receipts and Securitization in Agricultural Finance*, 17 UNIF. L. REV. 374 (2012).

Panos Varangis and Donald Larson go one step further providing four factors as preconditions of the warehouse receipt system: (1) "[a] viable storage industry;" (2) "[a]n appropriate legal environment. Warehouse receipts must be functionally equivalent to stored commodities. They must specify the quality and quantity of the goods stored;" (3) "[p]erformance guarantees. For warehouse receipts to be accepted by traders and banks, there must be a performance guarantee for warehouses;" and (4) "[i]nspection and licensing. Governments should develop a system of warehouse licensing and inspection of warehouse facilities so that they meet basic standards, both financial and physical." *How Warehouse Receipts Help Commodity Trading and Financing* 123-24, (World Bank, Working Paper 1998), http://www-wds.worldbank.org/external/default/WDSContentServer/WDSContentServer/2000/02/23/000178830_98111703554628/Rendered/PDF/multi_page.pdf.

Frank Höllinger et al. provided five prerequisite factors that are needed for a successful development of a warehouse receipt system: (1) an enabling legal and regulatory framework; (2) a regulatory and supervisory agency; (3) licensed and supervised public warehouses; (4) insurance and financial performance guarantees; and (5) banks familiar with the use of warehouse receipts. *The Use of Warehouse Receipt Finance in Agriculture*

factor is developing a regulatory framework for the operation of the warehouse receipt system. This includes the legal status of the warehouse receipt as a document of title for sales or pledges of the stored goods, the rights and obligations of the parties, and on the ability to perfect the lender's security interest into the local security register, an interest that should survive the initiation of bankruptcy proceedings.³ Thus, the first factor will require the development of secured transaction substantive, procedural, and administrative laws that will cover the attachment, or creation, of the lender's security interest, as well as its perfection and priority. Without proper description, and filing of the agricultural collateral, the warehouse receipt system will not be able to effectively protect the interests of the stakeholders and the interest of third parties in the due process of negotiation. As a solid foundation in this direction, we can point out the National Law Center for Inter-American Free Trade's (NatLaw) 12 Principles of Secured Transactions in the Americas.⁴ The secured transactions guidelines developed by NatLaw should be the first and most important step in developing the warehouse receipt systems. In the best-case scenario, both the secured transactions law and the warehouse receipt law should be promulgated at the same time. If this is not possible, the author recommends the warehouse receipt law to extend its scope and to provide provisions for the priority of the parties and perfection over the goods. This will ensure a smooth interaction between the parties and it will guarantee a successful operation of the warehouse receipt system. As discussed during the symposium, the rights and obligations of the agricultural producer are the core of the system, but without an effective procedure to enforce them, there will be little or no use for them.

The second factor in the development of a successful warehouse receipt system is the presence of trustworthy regulatory and inspection agencies. "A well-functioning mechanism for control and oversight of public warehouses helps to ensure that the warehouse receipts they issue are acceptable collateral for the financial community."⁵ The role of the regulatory agency that oversees the process of licensing and inspection of the warehouse is extremely important. "A warehouse receipt is only as good as the company issuing it whether this is in sub-Saharan Africa or elsewhere."⁶ In this sense, if the regulatory agency is not set up or functioning properly, it will not be able to effectively enforce the regulatory standards.

in Transition Countries 32 (FAO Inv. Ctr., Working Paper 2009), <http://www.fao.org/3/a-i3339e.pdf>.

³ Höllinger et al., *supra* note 2, at 24.

⁴ *NLCIFT 12 Principles of Secured Transactions*, NAT'L L. CTR. FOR INTER-AM. FREE TRADE, <http://www.NatLaw.com/content/nlcift-12-principles-secured-transactions> (last visited Jan. 15, 2015).

⁵ Höllinger et al., *supra* note 2, at 28.

⁶ *Securing the Frontier Supplies: Warehouse Receipt Financing*, TRADE FINANCE MAGAZINE (Mar. 15, 2002), <https://tradefinanceanalytics.com/Articles/2136333/Securing-the-frontier-supplies> (based on an interview with Christian Joerg).

When developing the regulatory agency, there are two approaches; one is minimalist and the other maximalist.⁷ The minimalist approach allows banks to oversee the work of the warehouses without government control and thereby relies on “market discipline” as the ultimate regulator of the financial health of warehouse receipt financing. In contrast, the maximalist approach focuses on government oversight over market transactions.⁸ Thus, countries such as the United States, Bulgaria, and Brazil rely on either a governmental or a delegated private entity to act as a regulatory body⁹ and to enact legislation that allocates regulatory and licensing functions.¹⁰ On the other hand countries such as South Africa and Zimbabwe have chosen a “market discipline” approach, where the warehouse operators regulate themselves.¹¹

In ancient Rome, one important question hovered over both governmental and market regulators: “*Quis custodiet ipsos custodes?*” (“Who will guard the guardians?”). In this author’s opinion, this question is especially applicable to the self-regulatory mechanisms. For self-interest being what it is, it will be very hard to prevent the drafting of totally self-interested laws or regulations, thereby ignoring the protection of third parties and of the public at large. This is one of the main reasons why the author favors the creation of governmental regulatory entities that are themselves subject to oversight of independent third parties. Such third parties should be charged with the prevention of conflicts of interest between those who write the laws or regulations and those who are expected to obey them and/or enforce them.

The third factor for developing an effective and trustworthy warehouse receipt system is the warehousemen’s duty to provide performance guarantees and insurance policies for the various risks involved in their businesses. Some of the performance guarantees establish minimum capital requirements for the warehouse operator, others provide for professional indemnity insurance to cover the warehouse operator employees against professional misconduct, and still others create indemnity funds.¹² The requirement of a minimum capital of the warehouse operator is essential to ensure that he has enough capital to operate his warehouse and can meet his obligation to pay salaries, required insurance premiums to his employees, utility bills, and so on. Having an insurance policy against professional misconduct by any of the warehouse operators protects the interest of their clients/depositors and their lending banks against risks, such as

⁷ Jacqueline Bass & Katrena Henderson, *Warehouse Receipts: Financing Agricultural Producers*, USAID 5 (Oct. 2000), http://pdf.usaid.gov/pdf_docs/PNA CQ697.pdf.

⁸ *Id.*

⁹ Gideon Onumah, *Warehouse Receipts and Securitisation in Agricultural Finance to Promote Lending to Smallholder Farmers in Africa: Potential Benefits and Legal/Regulatory Issues*, 17 UNIF. L. REV. 351, 364 (2012).

¹⁰ *Id.*

¹¹ *Id.*

¹² Höllinger et al., *supra* note 2, at 30.

theft, fraud, or negligence by the warehouse operator's staff.¹³ Similarly, an indemnity fund can be used in the case of bankruptcy of any of the warehouse operators. A major challenge for the creation of the indemnity fund is raising the startup capital for the fund.¹⁴ In raising the startup capital for the fund, the experience of Bulgaria is useful. The local government, through the Ministry of Agriculture, provided a three-year interest free loan to the fund as a guarantee for the receivables of the depositors and legitimate holders of the warehouse receipts.¹⁵ Once the warehouse receipt system gained momentum and more warehouse operators were licensed, the loan was repaid.¹⁶ The area of performance guarantees should be developed by the regulatory body and should include provisions regarding the license and operational requirements of the warehouse operator.¹⁷

An effective and fair warehouse receipt system requires a holistic approach. The practice and experience so far suggests that focusing primarily on the legal status of the system excludes the interest of the stakeholder—agricultural producers, warehouses, and banks.¹⁸ Here, we can mention the view of Francis B. James¹⁹ about the future codification of the warehouse receipt law in the United States in the early 1900s: “The merchants gave to the law their customs and the law should give their customs back to them clearly expressed and freed from mere technical expressions.”²⁰ The author agrees with this view and in his opinion any future laws regulating the warehouse receipts should be written in a language understandable to the ordinary people.

On the other hand, focusing mainly on the interests of the stakeholders does not allow the development of proper legislation of the warehouse receipt and the legal framework for the operation of the system.²¹ This is the reason we need a holistic (i.e., reasonable and fair) approach where the interests of parties, as well as the laws and regulations are developed and harmonized. Experience suggests that a well-balanced approach in developing a warehouse receipt system is more

¹³ *Id.* at 31.

¹⁴ *Id.*

¹⁵ Krasimir Kiriakov, Country Representative, Agric. Coop. Dev. Int'l/Volunteers in Overseas Coop. Assistance (ACDI/VOCA), Bulgaria-Sofia, Implementation of a System of Licensed Public Warehouses and Warehouse Receipts in Bulgaria at the Regional Workshop on Commodity Export Diversification and Poverty Reduction in South and South-East Asia 9 (Apr. 3-5, 2001), https://www.researchgate.net/publication/242682656_regional_workshop_on_commodity_exprot_diversification_and_poverty_reduction_in_south_and.

¹⁶ *Id.*

¹⁷ *Id.* at 3-4; Höllinger et al., *supra* note 2, at 28.

¹⁸ Höllinger et al., *supra* note 2, at 12.

¹⁹ Francis B. James was chairman of the Committee on Commercial Law of the Conference of Commissioners of Uniform State Law back in 1905 when he expressed his views about future codification the law of the warehouse receipts.

²⁰ Francis B. James, *Practical Suggestions on Codifying the Law of Warehouse Receipts*, 3 MICH. L. REV. 4, 284 (1905).

²¹ Höllinger et al., *supra* note 2, at 12.

likely to succeed.²² This leads us to the next section—the process of harmonizing the warehouse receipt system legislation.

III. PROCESS OF HARMONIZATION

The first step in the process of harmonization is to survey all relevant laws and commercial customs of the Pacific Rim countries, or where such legislation does not exist, it will be important to set a goal of implementing the warehouse receipt system. This is important because, as we have seen in the dual-document system that still plagues the warehouse receipt practices in many European and Latin American countries,²³ where the commercial practice is to keep both documents together, or to prevent their independent circulation, it becomes very impractical to develop a system based on a single document or electronic record.

The second step should include implementing a secured transactions law designed to support lending based on the warehouse receipts as the main collateral. The proper classification of collateral, developing a registry for security interest, and drafting procedures in case of bankruptcy is essential before the process of a warehouse receipt system begins. As mentioned in the previous section, if there is not secured transactions laws in place, or it is impossible for implementation of the local legislation at the moment the warehouse receipt legislation is enacted, then the provisions of the warehouse receipt act should extend to cover the aspects of priority among the parties and the way that perfection is obtained for the warehouse receipt.

The next step will be to gain consensus among scholars and practitioners of the Pacific Rim countries about the structure of the warehouse receipt system. This will include a series of meetings, seminars, and workshops where different ideas and solutions from other countries can be shared in order for the stakeholders to understand the process and function of the warehouse receipt. Once they have a proper understanding about the system, the process of drafting the actual law based on the local commercial practices can begin. Here, it is important to note that scholars and practitioners can benefit from the United Nation Commission on International Trade (UNCITRAL) experience in working in groups and drafting model laws in a given area.

After a prototype warehouse receipt based upon standard and best practices is drafted, the fourth step can begin where the law supporting the use of this prototype is presented for deliberation. It is important for the stakeholders i.e., the actual parties who will use the law (banks, traders, warehousemen, and agricultural producers) to feel comfortable with the new law. The bank's consent at this point is critical. If the banks are not comfortable with the law, it is more than likely that the system will fail because of their unwillingness to participate in

²² *Id.* at 12.

²³ *Id.* at 32; *see also* interview with Kiril Stanchev, Head of Risk Management Directorate SIBANK, in Bulgaria (June 30, 2012) (on file with the author).

such a model of financing. From the bank's perspective, there are four factors that we have to take into consideration in order to ensure their participation.²⁴

The first factor is the certainty that the products are actually in the warehouse. Banks have to have confidence in the document of title and that what is stated on the document is actually there and available. We have to remember that banks operate with documents, not with products, and the documents covering the agricultural products have to be good enough to be accepted as a monetary device.

The second factor is who the warehousemen are and what guarantees they can provide. This can be achieved by promulgating law and imposing performance guarantees on the warehousemen, some of which were discussed in the previous section. Here, the regulatory agency will have a central role in ensuring that the warehousemen are operating in accordance to the legislative provisions.

The third factor identifies the ultimate buyers of these products. Banks have to know to whom they are going to sell the collateral to in case the debtor does not pay. In order to answer this question, the banks will have to know the local market of agricultural products. Who has interest in buying these products? The obvious answer will be the local processing plant or a local exporter who can buy the goods at a discounted price. Still, the banks have to do their due diligence and ensure that they have a buyer interested in these goods in case of debtor's default.

The fourth and final factor is what recourse actions the bank can take against the agricultural producer. In order to address the following question, if a problem occurs, how are they going to get their money back? As explained during the symposium, "[t]he warehouse receipt is a self-liquidating loan product,"²⁵ that allows the banks very quick and inexpensive access to the stored goods by avoiding costly judicial or repossession procedures. In case the agricultural producer defaults on its loan, the bank, as a lawful holder of the warehouse receipt, can go to the warehouse, take the goods out, and ultimately sell them to a potential buyer without needing to go to court or using any other quasi-judicial mechanism to repossess the collateral.

Furthermore, if the local government is able to address these four factors and insure the banks confidence in the warehouse receipt financing mechanism,

²⁴ Interview with Astar Saleh, Executive Director, Structured Trade Finance at J. P. Morgan (May 3, 2012) (on file with the author).

²⁵ REUBEN JESSOP ET AL., CREATING ACCESS TO AGRICULTURAL FINANCE BASED ON A HORIZONTAL STUDY OF CAMBODIA, MALI, SENEGAL, TANZANIA, THAILAND AND TUNISIA 57 (July 2012), <http://www.afd.fr/jahia/webdav/site/afd/shared/PUBLICATIONS/RECHERCHE/Scientifiques/A-savoir/14-VA-A-Savoir.pdf>; *NLCIFT 12 Principles of Secured Transactions*, *supra* note 4, at 1. *See also* NLCIFT's First Principle of Secured Transactions Law in the Americas, where the self-liquidation can take place only when the security interested is recognized as a preferential right to possession or control of personal property and such concept is implemented by legislators, the parties, registries and courts. *NLCIFT 12 Principles of Secured Transactions*, *supra* note 4.

the probability of success would increase dramatically. It is important to note that the interests of the other parties—the agricultural producers and the warehouseman should also be taken into consideration. Finding the right balance between the interests of the stakeholders is the key to a successful warehouse receipt system.

The next step toward the implementation of the warehouse receipt system will include training and building regulatory capacity. Here, the role of the countries with greater experience in warehouse receipt financing should assist those countries that have yet to develop their own systems. Experienced countries can provide technical assistance and training at all levels of the system—government regulatory agency, warehouse operations, training banks, and last but not least, they inform the agricultural producer about the possibilities of the new system.

The last step will be featuring a small pilot project in the countries where the system does not yet exist or is underdeveloped. Once again, the role of the countries with more experience is important because they need to supervise the process. The warehouse receipt system is a complex agricultural instrument, and there is no place for “trial and error.” If there are any practical issues that can arise out of the pilot project, they must be addressed before the actual system begins operating. If the system begins operations and there are numerous changes, or the process is not refined, this will discourage potential participants and the system will likely be a failure.

