If you have questions or would like additional information on the material covered in this Alert, please contact the author, or the Reed Smith lawyer with whom you regularly work:

Philip Antcliffe
Associate, London
+44 (0)20 3116 2808
pantcliffe@reedsmith.com

Geraldine Butac
Associate, London
+44 (0)20 3116 2856
gbutac@reedsmith.com

Kyri Evagora
Partner, London
+44 (0)20 3116 2914
kevagora@reedsmith.com

Robert Parson
Partner, London
+44 (0)20 3116 3514
rparson@reedsmith.com

What's in store? Exploring issues in commodity storage and warehousing

As demand for storage capacity for the world's most commonly traded commodities grows, governments and major private commodity trading companies are investing heavily in warehousing and tank capacity.

Storage space is a real issue for any physical commodity that is not consumed or processed immediately such as grains, sugar, metals, coal, oil and petrochemicals, and natural gas. For such commodities, stockpiling in storage facilities permits greater flexibility of supply when production is disrupted, where there is an increase in consumption or simply to give the party storing the goods an opportunity to take a strategic position when the market price moves in the future.

Storing commodities gives rise to a number of risk issues depending on the physical characteristics of the commodity and the legal and regulatory environment of the storage location. Natural gas, for example, which is often stored underground in depleted reservoirs, is subject to extensive regulation in many jurisdictions. Oil and oil products stored on vessels offshore are subject to certain unique risks and there is an ever-growing body of regulation over both health and safety risks relating to certain bulk commodities. However, some common risks and particularly the legal issues that these give rise to are readily identifiable: protecting ownership rights, granting or enforcing or effective security over stored goods, obtaining appropriate and adequate insurance cover, mitigating and avoiding—where necessary—environmental risks and determining and computing liability for loss or damage.

This client alert summarises some of the risk issues arising from the storage of goods for those parties involved in the commodity business and clarifies the legal status of some of the documentation in current usage in the industry.

Key risk areas

Storage agreements will vary considerably from sector to sector in the commodity business. Some of the most important decisions influencing the choice of a warehouse or storage tank facility have little to do with strict legal risk. Who are the operators? What is their professional reputation? Have they the technical skill and capacity to handle these goods? What is their credit profile like? Legal due diligence will also play a big part in the decision-making process.

Protecting ownership rights in goods

Regardless of the legal regime that governs the storage agreement, the question of who owns the goods will fall to be determined by the law of the place where the goods are stored—the *Lex Situs*. A good example of this arises on an insolvency. Let us assume that Trader A enters into a storage contract with Warehouseman B for the storage of Trader A's goods in Nigeria. Warehouseman B enters a further contract to store Trader C's goods in the same facility. If Warehouseman B becomes insolvent and goods are found in the warehouse, then third-party creditors of Warehouseman B may seek to assert rights over the warehouse facility and the goods stored there in seeking satisfaction of their claims. The question of whether Trader A or Trader C owns any of the goods rather than the liquidators of Warehouseman B and whether the rightful owner of the goods may then remove them from the warehouse facility free of any restrictions or liens would fall to be governed principally by Nigerian law. So due diligence on the law of the place of storage is important. We advise clients to present a checklist of standard questions to local counsel, including whether title to the goods is affected by parting with possession to a third party and what form of receipt or title document (holding certificate/warrant/warehouse receipt/other document) should be requested from the facility operator. In some jurisdictions it may be necessary for the owner of the goods to enter into some form of lease arrangement to ensure its rights are protected. Prudent owners of goods should always ask these questions when storing goods in an unfamiliar jurisdiction. A typical checklist appears at the end of this client alert.

Client Alert 11-032
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ETC Partners:

Suzanne Bainbridge
Partner, London
+44 (0)20 3116 2815
sbainbridge@reedsmith.com

Gordon Bell
Partner, London
+44 (0)20 3116 3765
gbell@reedsmith.com

Peter Cassidy
Partner, London
+44 (0)20 3116 3697
pcassidy@reedsmith.com

Paul Dillon
Partner, London
+44 (0)20 3116 2893
pdillon@reedsmith.com

Kyri Evagora
Partner, London
+44 (0)20 3116 2914
kevagora@reedsmith.com

Siân C. Fellows
Partner, London
+44 (0)20 3116 2809
sfellows@reedsmith.com

Diane Galloway
Partner, London
+44 (0)20 3116 2934
dgalloway@reedsmith.com

Keith Hartley
Partner, London
+44 (0)20 3116 3694
khartley@reedsmith.com

Robert Parson
Partner, London
+44 (0)20 3116 3514
rparson@reedsmith.com

Vincent Rowan
Partner, London
+44 (0)20 3116 3772
vrowan@reedsmith.com

Stefan Schmitz
Partner, London
+44 (0)20 3116 3760
sschmitz@reedsmith.com

Richard Swinburn
Partner, London
+44 (0)20 3116 3604
rswinburn@reedsmith.com

John Varholy
Partner, London
+44 (0)20 3116 2933
jvarholy@reedsmith.com

Shai Wade
Partner, London
+44 (0)20 3116 3620
swade@reedsmith.com

Client Alert 11-032
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Co-mingling

What will happen if Trader A's goods and Trader C's goods are similar bulk commodities and have been co-mingled in the same storage facility and Trader A then wishes to sell and/or remove his goods. If there is an insolvency of the warehouseman or Trader C, Trader A's rights in the co-mingled goods will be determined by local law. Where there is no insolvency, Trader A may still face problems selling on the goods because the governing law of the sale contract may not permit sale of part of a quantity of goods in common bulk storage. English law permits parties to transfer title in a commingled bulk with the buyer becoming an owner in common of a share in the bulk. Section 20A of the Sale of Goods Act 1979 was introduced to regulate such sales. However, sales on this basis are rare. A buyer is also likely to be very wary of the difficulties it would face in insuring co-mingled goods or using them as collateral to obtain finance, and the risk of disputes with the other owners of the bulk is high. We recommend including suitable provisions in storage agreements to seek to eliminate or at least mitigate the risk of goods being co-mingled. In some jurisdictions, co-mingling of goods may prove fatal to the prospects of recovering them from storage. Co-mingling may however be a necessary evil in terms of both availability of storage and cost.

Insurance

Recent reports of disappearing grain in Russia and Ukraine highlight the importance of insurance. It was reported shortly before Christmas that $30 million worth of grain belonging to a Swiss grain trader had gone missing from warehouses in Ukraine. Around the same time in Russia, grain went missing that was reported to have been worth about $100 million. In each case the grain had been used as collateral to secure loans from banks. The insurance contracts taken out by the owners of the grain will no doubt be under heavy scrutiny. Many commodity insurance contracts are settled in London and governed by English law. English law treats insurance contracts very differently to other contracts. There is an implied duty for the parties to act in "utmost good faith". In practice, the insured party is required to disclose (both before the policy is issued and during its existence) any "material facts" that the insurer would have liked to have known in order to decide whether to take the risk and, if so, at what premium. Failure to disclose a material fact may entitle the insurer to terminate the policy and avoid payment in the event of a claim.

Additionally, careful consideration should be given to the requirements and limitations of insurance policies often described as "warranties". Breach of a warranty in an insurance policy can be and often is a bar to claiming under the policy.

Financing

Banks providing finance to a borrower (whether pre- or post-shipment) will commonly seek to take security over goods in storage to secure repayment on a default or borrower insolvency. Lenders will want to mitigate any risks involved and have adequate control over the goods. The transaction may be structured so that the lender has title to the goods (so called "ownership structures") or the lender may prefer that the borrower remains owner of the goods and that it takes local security over the goods.

As well as exploring whether and how it may take security locally, the lender should understand the level of control or possession it must have in order to achieve a valid security in the relevant jurisdiction. For example, does the lender need to have control over each and every release of the goods by the storage company? Where the goods may periodically be replaced by new goods, the lender will look at to what extent the jurisdiction offers workable security. In some jurisdictions each new deposit of goods may require fresh documentation which may be both commercially and physically unworkable.

There may be local law requirements, for example, to physically execute the security in the jurisdiction where the goods are situated and/or to "perfect" it (through some form of registration or notarial attestation). This is usually necessary to preserve the lender's rights and ranking as a secured creditor. Such conditions vary greatly across jurisdictions. If security is to be taken, the lender should be aware of the steps that need to be taken (and the time involved) to enforce the security in the local courts, or according to local law and procedure—how it would go about recovering the secured goods and effecting a sale if that became necessary?

Pledge Security

Under English law the form of security taken over stored goods is most commonly a pledge which is both effective and flexible. The pledgor (borrower) essentially retains ownership, transferring possession of the goods by way of security, and the pledgee (lender) has a power

What law applies to the rights of ownership and security of goods?

The question of who owns the goods is determined by the law of the place where the goods are stored, regardless of the legal regime governing the storage agreement.

What duties may arise under insurance contracts?

There is an "implied duty of good faith" that the insured party will disclose any "material facts". Failure to disclose facts may give the insurers cause to terminate the policy. However, insurance is not a guarantee.

How can lenders mitigate their risk in inventory or warehouse receipt financing?

The transaction may be structured so that it has title to the goods or alternatively, the lender might take security over the goods whilst the borrower remains the owner.

What law determines whether security is effective?

As with rights of ownership, security is governed by the law of the place of goods.

What form does security take?

Usually a pledge. The borrower retains ownership, transferring possession of the goods by way of security, and the lender has a power of sale in the event of default.

Is a warehouse receipt a document of title under English law?

English law does not recognise a warehouse receipt or a warehouse warrant as a document of title except where such documents acquire the status of title documents through trade custom or usage, or by Acts of Parliament.

How is title over goods held in storage transferred and proven?

Title is transferred by agreement. This does not require a formal document. A warehouse receipt or storage contract might be used as proof of rights to delivery.

of sale over the goods in the event of default. Lenders usually take "constructive" possession rather than "actual" physical possession of the goods. The third-party storage company or collateral manager with direct control and possession of the goods will hold the goods to the lender's order and deliver the warehouse receipt to it. He may in addition or alternatively give the lender a notice or other document confirming expressly that the goods are held to the lender's order. Under English law we call this an "attornment". It is therefore important for the lender to carry out due diligence on the warehouseman to satisfy itself as to the warehouseman's performance risk—his role is of key significance.

Just as storers of goods will want to determine the legal status of any warehouse receipt (or holding certificate) for goods to protect their ownership rights and if necessary, to understand how to transfer title in storage or in tank, lenders taking security will be equally concerned on this issue for the purpose of preserving and enforcing their security. It may be (and is often the case) that under local law the warehouse receipt is not a document of title. It may simply constitute an acknowledgement that goods have been received into the warehouse, tank or other container and that they are being held for the specified person.

Warehouse documents

Often warehouse receipts are mistakenly assumed by owners and lenders to be documents by which ownership of the goods themselves can be transferred, like bills of lading. As a bill of lading is a document of title under English law, a lender can take a pledge of a bill of lading. This would give it constructive possession of the underlying goods. A warehouse receipt under English law is generally not considered to be a negotiable document of title and cannot itself be pledged. In some short-term storage situations an owner of goods or lender may only be offered a Forwarder's Cargo Receipt or Forwarder's Certificate of Receipt, which do no more than confirm that a freight forwarder has custody of the goods. There are some very limited exceptions where documents issued by a warehouseman do acquire the status of title documents through trade custom or usage or by Acts of Parliament. LME warrants, for example, are traded on the London Metal Exchange and now allow for delivery of goods by electronic transfer of the warrant on an automated system called "SWORD". Banks recognise that LME Warrants are superior to ordinary warehouse receipts and will generally take a pledge over an LME warrant as security.

As a warehouse receipt is usually not a document of title that can be pledged, a lender will take a pledge over the goods themselves. The warehouse receipt held by it will usually evidence the bank's constructive possession of the goods. In addition to checking whether the warehouse receipt will in principle entitle the bank to possession of the goods locally, the lender would want to check whether the form of receipt complies with local law and regulation and whether the issuer of the warehouse receipt is properly authorised to issue valid documents.

Liens and other creditors

The lender will want to ensure that no other creditor or party has existing security or rights over the goods. The storage company, or collateral manager for example, is likely to have a contractual (and sometimes statutory) right of lien over the goods for unpaid storage fees. Therefore the lender may seek to establish the waiver (or at least the ranking) of these rights as against the lender in an agreement with the storage company and the borrower. The rights of other creditors with overlapping security may require separate negotiation for a waiver or subordination.

Co-mingling of the goods with those of a third party is likely to adversely affect the availability of financing. This is because it may affect a lender's security over the goods. In some jurisdictions it may simply not be possible to have ownership over commingled goods and therefore it will not be possible to give security. The lender should check how the goods are or will be stored and whether under local law they must be properly segregated. If co-mingling is bound to occur, the lender needs to enquire as to how this will impact the validity and enforceability of any security it may take.

Storage owners, operators or lessees

Those that have an interest in storage facilities (whether long or short term) or are considering doing so will be concerned about potential liabilities arising out of the operation of those facilities. Liabilities may arise in three ways: (1) through the storage owner's contract with those that store goods in the facility; (2) through employment/service contracts with those that operate the facility; and (3) by mandatorily applicable health & safety law, environmental law or legal duty to third parties in the place in which the facility is situated. A storage owner or equity investor will

wish to know how these latter regimes may impact its interest in the facility and seek to control them as far as possible through appropriate limitation provisions in the contractual documents.

In order to manage risk in the contract documents and put in place appropriate insurance, businesses should make themselves familiar with the law in each jurisdiction in which the facilities are situated. The litigation arising from the *Buncefield* oil storage explosion highlighted these issues in the context of an English storage facility. The case, which reached the Court of Appeal in March last year, considered Total UK Ltd's liability arising out of a huge explosion at an oil storage terminal in Hertfordshire in 2005 that damaged neighbouring property and another storage facility beneficially owned by Shell. More than 40 people were injured but fortunately there were no fatalities. Five companies were convicted of safety and environmental offences, which resulted in civil litigation between those parties.

The first instance High Court judgment was argued by 16 barristers (of which 11 were QCs) instructed by the five parties. The litigation found that Total was vicariously liable in negligence for the explosion at the terminal which was owned by a separate company. The most interesting legal consequence was the Court of Appeal's extension of the law of tort and trust law so as to hold Total liable in negligence for pure economic losses suffered by Shell, which was not a legal owner of any property damaged but was a beneficiary under a trust. An enquiry into the explosion resulted in sweeping changes to the regulation of similar facilities.

Legal risk management

Commodity storage involves risks which are different in nature from the risks encountered by commodity traders in their day-to-day trading operations. Particular and appropriate focus should be given to the legal regime applicable in the place where the goods will be situated. In our view it is worth maintaining a checklist of standard questions to be raised with local lawyers before each transaction. For new entrants in the storage/warehousing market, due diligence on the applicable legal regimes is advisable to ensure that insurance and other contracts achieve their intentions.

1. Will the documentation issued by the warehouse operator amount to a document of title? Will it entitle the holder to possession of the goods against the warehouse operator (and its liquidator)?
2. What form of security is available under local law for goods in the facility in question?
3. What is the procedure and timescale for enforcing such security locally? What obstacles in enforcement might arise?
4. How will the rights of the holder of a warehouse receipt or security over the goods be affected in the event of co-mingling of the goods?
5. What checks can be run to identify all the parties having an interest in owning/operating the warehouse against whom any warehouse receipt or security will need to be binding and effective?
6. What investigation can be made to check for compliance by the warehouse operator with any applicable environmental and other statutory obligation, and can breach of these by the warehouse operator affect the owner of goods or his secured creditor?
7. What will be the customs status of the goods in the warehouse? Can the goods be easily exported by the owner/lender in the event of a default/insolvency?
8. Does the country or residence of the owner or secured creditor of the goods affect its ability to be the owner or secured creditor of the goods locally?
9. Are there any local law issues affecting the ability of the owner/lender to take insurance over the goods?

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Reed Smith is a global relationship law firm with nearly 1,600 lawyers in 22 offices throughout the United States, Europe, Asia and the Middle East.

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