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TRADE FINANCE

Ocean Fright — Financing Goods in Transit Covered by Sea Waybills

BY MICHAEL J. CLAIN

Goods worth over $2.2 trillion were imported into the U.S. last year, mainly by sea. While the vast majority were covered by bills of lading[1], a significant portion travelled under sea waybills. Lenders are coming under pressure to accept goods covered by sea waybills as eligible collateral, despite the lower level of protection such transport documents provide. The goal of this article is to help lenders understand what they're giving up when they accept sea waybills instead of negotiable bills of lading and how they can improve their position.

Bills of Lading and Sea Waybills

A bill of lading (a ''B/L'') is a document issued by a vessel operator (a ''carrier'') to confirm receipt of goods consigned to it for transport and evidence the existence of a contract of carriage. It typically describes the goods, shows the points of origin and destination, sets forth the carriage charges and method of shipment and identifies the person that consigned the goods to the carrier (the ''consignor'' or ''shipper'') and the person that is entitled to claim them when they reach their destination (the ''consignee''). It is said to be ''clean'' if it doesn't indicate any damage to the containers in which the goods are shipped[2], ''on board'' if it is issued after the goods have been loaded onto the vessel, ''negotiable'' or ''order'' if it indicates that the goods are to be delivered to bearer or to the order of a named consignee and ''nonnegotiable'' or ''straight'' if it indicates that the goods are to be delivered to the named consignee (and not to the order of the named consignee).

A negotiable B/L allows the consignee to transfer the B/L and title to the goods it covers by endorsing and delivering the original to the transferee. If the transferee is a good faith purchaser for value with no notice of any defense against or conflicting claim to the B/L (endorsement and delivery to such a transferee is generally referred to as ''due negotiation''), its title to the goods will prevail over almost any interest in the goods asserted by the shipper or anyone whose interest arises after the shipper has entrusted the goods to the carrier. Because title to the goods is ''locked-up'' in the negotiable B/L, the carrier may only release the goods to the holder of the B/L (properly endorsed to it, if the holder is not the named consignee) and will require the surrender of the B/L as a condition to the release. B/Ls, whether negotiable or nonnegotiable, are ''documents of title'' for purposes of the Uniform Commercial Code (the ''U.C.C.'')[3] and various international conventions.

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[1] More than 70 percent of all respondents to a survey conducted by the United Nations Conference on Trade and Development in 2003 (including many of the leading container service operators) indicated that they used negotiable bills of lading mainly or exclusively. See ''The Use of Transport Documents in International Trade'', United Nations Conference on Trade and Development (November 26, 2003).

[2] Carriers are not expected to inspect the goods themselves. Typically, the shipper is required to provide a separate inspection certificate from a third party as a condition to payment.

[3] U.C.C. § 1-201 (b) (16) (amended 2008) defines a ''document of title'' as ''. . .a record (i) that in the regular course of business or financing is treated as adequately evidencing that the person in possession or control of the record is entitled to receive, control, hold, and dispose of the record and the goods the record covers and (ii) that purports to be issued by or addressed to a bailee and to cover goods in the bailee's possession which are either identified or are fungible portions of an identified mass. The term includes a bill of lading, transport document, dock warrant, dock receipt, warehouse receipt, and order for delivery of goods. . .'' All references to the U.C.C. shall be to the official text published and distributed by The American Law Institute and the National Conference of Commissioners on Uniform State Laws and not to the text adopted

A sea waybill (a ''waybill'') looks very much like a B/L and it conveys essentially the same information, but it is designated a sea waybill on its face and it typically incorporates by reference the Uniform Rules for Sea Waybills adopted by the Comite Maritime International (the ''CMI Rules''). Like a B/L, it constitutes a receipt for goods consigned for transport and evidence of a contract of carriage, but it authorizes the carrier to release the goods to the consignee upon receipt of proof of identity, without the consignee having to produce the waybill. It may be helpful to think of a waybill not as an authoritative paper document (the carrier does not issue any originals) but as a printout of relevant shipping information from the carrier's database. Waybills are not bills of lading or documents of title for purposes of the U.C.C. or any international conventions.

Financing Goods Covered By Negotiable Bills of Lading

In the typical inbound transaction, a U.S. company (the ''importer'') purchases goods from an offshore manufacturer (the ''seller'', who typically is also the shipper) under a contract that provides for shipment FOB (port of origin)[4] on a vessel operated by a carrier chosen by the shipper and payment under a letter of credit (the ''L/C'') issued by the importer's lender (the ''Bank''). L/Cs generally require, as a condition to drawdown, submission to the Bank of a draft accompanied by various documents, including a commercial invoice, an insurance certificate, a certificate of inspection, a packing list and, most importantly, an original clean, negotiable onboard B/L naming the Bank as consignee. The shipper delivers the goods to the carrier, the carrier issues the required B/L to the shipper and the shipper sends it, and all other required documents, to the Bank. Following verification that the documents are conforming, the Bank pays the draft presented by the shipper and endorses and delivers the B/L to the importer or its customs broker so it can claim the goods from the carrier and clear them through customs[5]. I've taken the liberty of stripping the transaction to its bare bones, ignoring for purposes of this analysis the common use of freight forwarders and multiple carriers, which add complexities that are beyond the scope of this article.

This structure provides the Bank with robust legal and practical protection. A clean onboard B/L indicates that the goods have been loaded onto the vessel for shipment and the containers appear to be in good condition. A negotiable B/L reduces the risk that the shipper has retained any interest in the goods, transfers control over the goods while in transit to the holder of the B/L[6], and prevents the shipper from exercising its right of stoppage in transit[7]. By taking possession of a negotiable B/L, the Bank not only perfects its security interest in the B/L and the goods it covers[8], but ensures that it has priority over any conflicting security interest in the goods that is perfected by any other method[9].

Taking possession of a negotiable B/L also makes it more likely that a U.S. court applying state choice of law principles would find that the Bank's rights with respect to the underlying goods are governed by applicable state law. As a general rule, the perfection and priority of security interests in a debtor's assets are governed by the local law of the jurisdiction in which the debtor is located[10]. However, perfection and priority of possessory security interests (that is, security interests perfected by possession), and priority of nonpossessory security interests in certain types of collateral (including negotiable documents of title and goods), are governed by the local law of the jurisdiction in which the collateral is located[11]. Accordingly, if the importer is organized in Delaware, the Bank takes possession of a negotiable B/L in New York, and the goods are on board a ship at anchor in Tianjin, China, New York law would govern the perfection and priority of security interests in the negotiable B/L. Under New York law, the Bank's possession of the negotiable B/L would be sufficient to perfect its security interest not only in the B/L itself but also in the goods it covers, notwithstanding the fact that the goods are still in China. Once perfected by possession of the title document, the Bank's security interest in the goods would have priority over any conflicting security interest that is perfected by any other method.

Most jurisdictions will recognize the person named as consignee on a negotiable document of title as the owner of the goods it covers[12], so being the named consignee on a negotiable B/L and taking possession of the original provides protection even if the Bank's rights to the underlying goods are adjudicated under foreign law. There are two scenarios in which foreign law may

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by a particular state. The U.C.C. has been adopted, with variations, in all 50 states.

[4] FOB stands for ''free on board'', meaning that the shipper is responsible for clearing the goods for export, title passes to the importer when the goods pass the ship's rail and the importer bears all costs and risks of loss or damage from that point.

[5] It is also common to finance offshore inventory purchases under asset-based loan facilities that include in-transit inventory in the borrowing base. Since the funding mechanics are essentially the same, we will not distinguish between the two for purposes of this article.

[6] U.C.C. § 7-303(a) imposes liability on the carrier for misdelivery of the goods covered by a negotiable B/L (that is, delivery to a person or destination other than that stated in the B/L or as otherwise instructed by the holder of the B/L).

[7] U.C.C. § 2-705 allows a seller to stop delivery of goods in the possession of a carrier when he discovers the buyer to be insolvent (but only until receipt of the goods by the buyer or its bailee). If the goods are covered by a negotiable B/L, the carrier is not obliged to obey the seller's notification to stop delivery until the surrender of the B/L.

[8] See U.C.C. § 9-312(c)(1) (''While goods are in the possession of a bailee that has issued a negotiable document [of title] covering the goods: (1) a security interest in the goods may be perfected by perfecting a security interest in the document [of title]'') and U.C.C. § 9-313(a) (''. . . a secured party may perfect a security interest in negotiable documents [of title]. . . by taking possession of the collateral'').

[9] U.C.C. § 9-312(c)(2).

[10] See U.C.C. § 9-301(a) (''Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral''), U.C.C. § 9-307(e) (''A registered organization that is formed or organized under the law of a State is located in that State'') and U.C.C. § 9-102(71) ('' 'Registered organization' means an organization organized solely under the law of a single State or the United States by the filing of a public organic record with . . . the State or the United States.'').

[11] See U.C.C. § 9-301(2) and (3)(c).

[12] See Jose Angelo Estrella Faria, *Uniform Law and Functional Equivalence Diverting Paths or Stops Along the same Road? Thoughts on a new International Regime for Transport Documents,* 2 Elon Law Review 1, 17 (2011).

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be found to govern issues involving perfection and the priority of conflicting interests in goods that are physically located outside the U.S., even if the goods are covered by negotiable B/Ls held in the U.S.:

- In the example given in the prior paragraph, any legal action by the shipper or one of its creditors to settle conflicting claims to goods located in China will likely be brought in a Chinese court, which would apply Chinese law, including its choice of law principles. Given the relation the transaction bears to China (the location of the seller, the execution and performance of the purchase contract by the seller and, perhaps most importantly, the physical location of the goods), a Chinese court applying local choice of law principles, may well decide that issues regarding the priority of interests in the goods are governed by Chinese substantive law.

- If the trustee in a bankruptcy commenced by the importer under the U.S. Bankruptcy Code moves to avoid the Bank's security interest in goods that are physically located in China under the strong-arm clause of Section 544(a) of the Bankruptcy Code[13] — which provides, among other things, that the bankruptcy trustee has all the ''rights and powers'' of a hypothetical creditor that holds a judicial lien or an unsatisfied execution on the debtor's assets at the time of the commencement of the case, irrespective of whether such a creditor actually exists, and may avoid any interests in the debtor's assets that are voidable by such a creditor — the court would look to ''applicable non-bankruptcy law'' to determine what those ''rights and powers'' are[14] and may be required to use federal choice of law principles to identify the ''applicable non-bankruptcy law''[15]. Absent written agreement between the parties, courts applying federal choice of law rules to commercial transactions have generally focused on the significance of the contacts between the transaction and the jurisdictions involved and have typically considered the physical location of the goods in dispute to be one of the most significant contacts. A bankruptcy court may apply Chinese substantive law to determine whether the Bank's security interest in goods that are physically located in China has been perfected and whether any other party in interest would have rights to those goods that are superior to those of the Bank.

Financing Goods Covered by Sea Waybills

B/Ls have been the workhorse of international trade for more than 200 years, but as carriers have become more efficient at moving goods around the globe, instances in which the goods reached their destination before the original B/L reached the consignee have become more frequent (particularly when the B/L must first be presented to and processed by the consignee's lender). The inconvenience of having to track pieces of paper and the costs and delays resulting from storing goods at the dock while documents are located and delivered to the carrier have led to an intensive search for digital alternatives.

Significant efforts have been made to come up with legal structures that would accommodate paperless transactions while providing the parties with the same level of protection as that offered by possession of negotiable B/Ls, and technologies and business practices that would satisfy those legal structures. In the U.S. the efforts have centered on modifications to the U.C.C. (particularly Article 7 and related provisions), which have been adopted in 40 states, and the Uniform Electronic Transactions Act, which has been adopted in 47 states. International efforts have included the CMI Rules for Electronic Bills of Lading, the United Nations Commission on International Trade Law Model Law on Electronic Commerce and the United Nations Convention for the International Carriage of Goods Wholly or Partly by Sea (the ''Rotterdam Rules'').

All the drafters have taken essentially the same approach. Desirous to preserve the extensive body of law already developed around paper documents of title, they have generally responded by broadening the definition of ''documents of title'' to include electronic documents and setting forth the electronic equivalent of concepts such as ''original'', ''possession'', ''execution'' and ''endorsement'', which are central to determinations of rights to paper documents and the goods they cover[16]. They left to the marketplace the development of sufficient technologies and business practices to meet the tests. A number of institutions and entrepreneurs have responded and tried to create systems capable of generating electronic documents of title that satisfy the new legal structures[17], but those systems have struggled to attract users. The main obstacles appear to be cost, complexity and concerns about the enforceability of electronic documents (there have been practically no decisions involving electronic bills of lading; the few decisions involving ancillary issues, such as the admissibility into evidence of electronic records and electronic signatures have not been encouraging).

Shipping under waybills has provided a practical and cost-effective solution to the paper problem for shippers, carriers and importers, but the systems employed to generate waybills and keep track of the related shipments do not have the safety features necessary to satisfy the legal structures created to accommodate electronic documents of title. Until they do, secured lenders

[13] 11 U.S.C. § 544(a).

[14] See, e.g., In re Michigan Lithographing Co., 997 F. 2d 1158 (6th Cir. 1993).

[15] See, e.g., In re Lindsay, 59 F.3d 942, 948 (9th Cir. 1995) (a bankruptcy case in which the court found that in federal question cases with exclusive jurisdiction in federal court, such as bankruptcy, the federal, not forum state, choice of law principles apply); but see In re Gaston & Snow, 243 F3d 599 (2nd Cir. 2001) (another bankruptcy case, in which the court applied forum state choice of law principles, finding that the dispute did not ''implicate significant enough federal interests'' to justify doing otherwise).

[16] For instance, to provide for the electronic equivalent of an original document, the National Conference of Commissioners have required, in revised U.C.C. Article 7, that the system employed to generate electronic documents of title must establish a ''single authoritative copy [of the document]. . .which is unique, identifiable and. . .unalterable'' and must ensure that all copies that are not authoritative, including copies of the authoritative copy, must be ''readily identifiable as a copy that is not the authoritative copy''. To provide for the electronic equivalent of possession and endorsement, most of the approaches require that the system allow only one person to have control over the authoritative electronic document.

[17] Such as the Bolero system, founded in 1998 and operated by SWIFT, and the TradeCard system, founded in 1994 by the World Trade Centers Association.

should continue to insist on negotiable B/Ls for several reasons:

■ ***Diversion Risk.*** U.C.C. § 7-303(a) protects a secured lender who has taken possession of a negotiable B/L against diversion of the goods by the shipper. Waybills are not bills of lading and accordingly do not allow the secured lender to take advantage of the protections offered by that section.

It should be noted that many international waybills have incorporated the CMI Rules by reference. Section 6 of the CMI Rules provides, among other things, that the shipper is the only party entitled to give the carrier instructions in relation to the contract of carriage and to change the name of the consignee, unless it has exercised its option to transfer control rights to the consignee and the transfer has been noted on the waybill. Secured lenders asked to extend credit against goods covered by waybills must make sure that the shipper exercises this option before funding.

■ ***Risk of Stoppage in Transit***. Taking possession of a negotiable B/L cuts off the shipper's right of stoppage in transit under U.C.C. § 2-705. Waybills are not B/Ls and do not provide any protection against the shipper's right of stoppage. To reduce the risk of stoppage, lenders should consider requiring that the shipper expressly waive that right and that the waiver be noted on the waybill. Requiring such a waiver as a condition of funding is not part of current business practices.

■ ***Perfection and Priority***. As noted above, U.C.C. § 9-312(c) provides that possession of a negotiable document of title perfects the lender's security interest in the goods it covers and a security interest so perfected has priority over any conflicting security interest that is perfected by another method. Since a waybill is not a document of title under the U.C.C., the benefit of Section 9-312(c) is not available for collateral consisting of goods covered by a waybill.[18]

■ ***Choice of Law Principles***. As noted above[19], taking possession of a negotiable document of title would ensure that the local law of the jurisdiction where the document is held governs the perfection and priority of security interests in the underlying goods (as long as the court applies U.C.C. Article 9 choice of law principles). Since waybills are not documents of title under the U.C.C., determining the jurisdiction whose law governs the perfection and priority of security interests in the goods they cover requires a more involved analysis, but it would likely be the jurisdiction where the goods are located[20].

Conclusion

The era of the electronic record is tantalizingly close, but it's not here yet. Lenders are coming under increasing pressure to accept sea waybills and other transport documents that satisfy the desire of shippers and importers to handle cargo without paper documents, but don't offer the level of legal protection typically provided by negotiable B/Ls. Lenders who feel that they must accept waybills for competitive reasons would be well advised to require, in addition to all the other things they have traditionally required, (a) evidence that the shipper has exercised its option to transfer control to the consignee under Section 6 of the CMI Rules and has waived its right of stoppage in transit and (b) an acknowledgment from the carrier that it is holding the goods for the benefit of the lender. But the best advice may be to resist the pressure and insist on lending only against good old-fashioned negotiable B/Ls until electronic B/Ls have been judicially tested and have become widely used.

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[18] Perfecting a security interest in such goods requires either the filing of a U.C.C. financing statement (U.C.C. § 9-310) or the written acknowledgment of the carrier that it holds possession of the goods for the benefit of the secured lender (U.C.C. § 9-313). In light of the alternative methods of perfection, prudence would dictate that the lender do both.

[19] See text accompanying fn. 10 and 11 above.

[20] In a nutshell, (a) perfection of a security interest in such goods would be governed either by the local law of the jurisdiction where the debtor is ''located'' for U.C.C. Article 9 purposes (if the security interest is non-possessory) or the local law of the jurisdiction where the goods are located (if the security interest is possessory) and (b) the priority of a security interest in such goods (and the effect of perfection or nonperfection) would be governed by the local law of the jurisdiction in which the goods are located.

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