

Pledge and trust receipts – are financial institutions really protected?



Introduction

In a typical commodity trade transaction, a buyer may not wish to, or cannot, pay for the goods purchased from a seller until after the same goods have been resold to an ultimate purchaser. In this situation, the buyer may consider obtaining an import loan from a financial institution against a trust receipt, also known as a trust receipt loan.

A pledge and trust receipt form is therefore a classic trade finance instrument for a financial institution to release documents of title to the goods to the buyer exclusively for the purpose of taking delivery of and reselling the goods in order to use the sales proceeds to repay the loan. But how exactly are financial institutions' interests protected when goods are released to their customers for such purpose?

Pledge

When a financial institution (as pledgee) takes possession of the assets of its customer (as pledgor) as security for payment of loan facilities granted to the customer, a pledge is formed.

The rights over the pledged asset stem from the delivery of possession (effected either actually or constructively), which is necessary for completing an agreement for pledge. A pledge can be taken over any asset which is capable of actual or constructive delivery. While actual delivery involves the physical delivery of the asset (for example, pawning your watch), constructive delivery may occur when there is a change in the capacity of possession, for example, by:

- (a) giving control of the asset symbolically through the delivery to the financial institution of a key to a place in which the asset is stored and locked;
- (b) delivering the documents of title (such as a full set of original bills of lading which are properly indorsed) to the asset to the financial institution;
- (c) where the asset is in the custody of a third party, the customer giving notice to that third party asking it to hold the asset for the financial institution as bailee and that third party acknowledging that it is holding the asset as bailee of the financial institution (otherwise known as an "attornment", in which the third party is the attornor and the financial institution is the attornee); or
- (d) perhaps a lesser-known way of creating an attornment, the customer declaring to the financial institution that it is holding the asset as bailee of the financial institution, which similarly requires a concrete expression of fact by the customer as attornor, directed to the financial institution or its servant or agent as attornee, to the effect that the asset is now held as the attornee's and that the attornor is now bailee of the attornee. In the Hong Kong case below, this method of attornment was examined in further detail.

Decision in *Re Hang Fung Jewellery Company Limited*

In *Re Hang Fung Jewellery Co Ltd* [2010] 2 HKLRD 1, Hang Fung Jewellery Co Ltd (the "**Applicant**") applied to Standard Chartered Bank (the "**Bank**") for a letter of credit (the "**LC**") for the purchase of certain gold bars (the "**Goods**") from a seller (the "**Seller**"). The LC called for, *inter alia*, a cargo receipt to be issued and signed by authorised signatory(ies) of the Applicant evidencing receipt of the goods in good order and condition.

Pursuant to a trade finance supplement, the Applicant agreed to pledge the Goods and all relevant documents to the Bank and to hold them on trust for the Bank if any of them would be handed over to the

Applicant. A cargo receipt issued by the Applicant, which stated that the Goods were '*in good order and condition in trust for [the Bank] (under [the Bank's] L/C no. 315011445457-S)*', was then presented to the Bank through the Seller's negotiating bank. Subsequently, the Applicant went bankrupt, and the Bank sought to obtain the sales proceeds of the Goods from the provisional liquidators of the Applicant.

One of the key rulings of this case was that the cargo receipt, which served the dual purpose of identifying the Goods being pledged and acknowledging that the Applicant held the Goods in trust for the Bank, was sufficient for effecting constructive delivery by an attornment and completing the agreement for pledge. Therefore, a pledge was validly created.

It may be worthy of note that Kwan J.A. distinguished her rulings from the reasoning of Le Pichon J.A.'s in *Re Far East Structural Steelwork Engineering Ltd* [2010] 1 HKLRD 156 (that, *inter alia*, there was no attornment by the cargo receipt in that case as the attornment was made to the seller and not to the bank and the trust receipt was merely an agreement of a pledge) based on the following reasons:

- (a) there was evidence that the Applicant did have actual possession of the Goods when the cargo receipt was issued;
- (b) the cargo receipt should be considered with other contractual documents which governed the relationship between the Bank and the Applicant, including the trade finance supplement which evidenced the intention to create a pledge;
- (c) the fact that the Bank did not receive directly from the Applicant notice of the attornment in the cargo receipt was immaterial, so long as:
 - (i) all the parties involved knew that the cargo receipt would be presented to the Bank; and
 - (ii) the cargo receipt would be relied on by the Bank as a condition for releasing payment under the LC; and
- (d) delay in presentation of the cargo receipt should not be a valid objection to the existence of an attornment if possession was delivered within a reasonable time of the advance in pursuance of the contract to provide the pledge.

Trust receipt

As the validity of a pledge depends on the acquisition and retention of possession by the financial institution, a pledge will be extinguished when the financial institution loses possession of the pledged asset by releasing and redelivering it to the customer. Therefore, in order to preserve the pledge after redelivery, any release of the pledged asset or its document of title shall be made under a trust receipt arrangement and subject to the following terms:

- (a) the pledged asset or document of title is redelivered to the customer for specific purposes only;
- (b) the pledge created in favour of the financial institution shall not be affected by such redelivery; and
- (c) the customer shall hold the pledged asset, document of title and relevant sales proceeds in trust for the financial institution.

Please note that the security interest obtained by the financial institution is derived from the pledge instead of the trust receipt arrangement.

Conclusion

Having customers execute a pledge and trust receipt form does not always mean that financial institutions have successfully taken a pledge over the goods, or that it is safe to release pledged goods to the customers. Financial institutions may lose their security interest in the pledged goods and documents, if any, if their pledge and trust receipt arrangements are not properly documented. It is therefore important for financial institutions to revisit their existing templates to ensure that all of the following elements are present: (1) an agreement for pledge; (2) concrete and appropriate wordings for attornment (for example, when a full set of

original bills of lading properly indorsed cannot be obtained by financial institutions); and (3) a trust receipt arrangement.

For further information, please get in touch.

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