

Short Term Finance In The UAE And The Use Of Trust Receipts

by Hufriz Wadia - h.wadia@tamimi.com -

August – September 2011

With the strong focus on trading in the United Arab Emirates (“UAE”), traders often require short term financing and this is where banks and financial institutions step in.

With the strong focus on trading in the United Arab Emirates (“UAE”), traders often require short term financing and this is where banks and financial institutions step in.

While typically most banks and financial institutions restrict short term financing to letter of credit facilities, the financing of the retirement of the letters of credit is also in great demand and more and more banks choose to extend the existing L/C facility to a trust receipt facility to enable the customer to make payment towards the L/Cs and retire them by taking on a further short term loan. This type of financing is popular especially in the UAE where the options for creation of several types of security (that are otherwise available in most commonwealth countries) are not available. Financing by way of trust receipts does not amount to secured financing. However, it does create certain rights and obligations that put the lender in a better position than most other unsecured lenders.

From the customer’s perspective, financing by way of trust receipts is particularly relevant for importers of raw or semi-finished goods who require such materials for their manufacturing process. Given that a customer who is an importance of raw material would receive funds only once he sells finished goods in the market, such customers often seek financing from banks or other financial institutions for payments due to their suppliers during the manufacturing stage.

Typically under this structure, the financier pays the supplier of goods on behalf of the customer at the time the customer takes delivery of the goods (usually to retire the existing letters of credit). The ownership of the goods (being financed) is transferred to the financier and the customer is immediately provided with the authority to deal with such goods (under a trust receipt), including use the goods for manufacturing and sell the goods or the finished product.

While the customer is permitted to use the goods received from the supplier, the financier obtains and retains title to such goods, with the customer acting as agent, trustee and/or bailee on behalf of the financier in respect of such goods during the financing period. Any proceeds received from the sale of the finished goods, shall, to the extent these are related to the raw material supplied under the trust receipts, be held by the customer for and on behalf of the financier and for remittance to the financier.

What are Trust Receipts?

Trust Receipts are not defined under UAE law. In practice trust receipts are receipts issued by the owner of the goods permitting another party to deal with the goods on behalf of the owner.

UAE Law and trust receipts

The UAE is a civil law jurisdiction and does not recognise common law trusts. However trust receipts are commonly used in the UAE and would be recognised under UAE law provided the ownership of the goods clearly lies with the financier and the trust receipt issued by the bank clearly

permits the customer to deal with the goods as agent of the financier.

Trust receipt facilities are commonly used in the UAE as documentary credit financing. Banks and financial institutions issue letters of credit on behalf of their customers in order for the customers to avail their goods purchased (financed by such letters of credit) and enter into a trust receipt arrangement so that the goods may be released to the customer for sale in the local markets. The trust receipt ensures that the bank retains its title in the goods while releasing the right to deal in the goods to the customer.

The UAE Commercial Code and the UAE Maritime Code recognises bills of lading as the title and transport documents for the transport and shipment of goods. In practice most trade finance (including documentary credit) is based on either bills of lading in the name of the importer (the customer) or bills of lading 'to the order of' the financier. We find that financiers in the UAE often require bills of lading to be made to the order of the financier. In the event the bills of lading are issued 'to the order of' the financier then ownership and title in relation to such bills of lading would already vest with the financier. When bills of lading are issued in the name of the customer, it is essential (for the purpose of entering into a valid trust receipt structure) that the ownership to the bills of lading and the underlying goods be transferred to the financier. This may be achieved in the UAE by using the appropriate structure and documentation.

The Commercial Code specifically permits banks to entrust their customers with taking delivery of goods on a trust / agency basis and selling them on behalf of the bank (and to the bank's account) under terms and conditions agreed between the bank and the customer. The customer will act as commission agent and the bank shall have all the rights of the principal on such goods or their value. To this end, the customer and the bank may enter into a trust receipt arrangement whereby the bank entitles the customer to release the goods under the bills of lading as a commissioning agent on behalf of the bank.

The term 'trust' as referred to in the Commercial Code is different from the concept of trusts as understood in common law jurisdictions. The term 'trust' is literally translated from the term 'amanah'. The term trust or amanah is derived from the UAE Civil Code and relates to a custodianship or deposit arrangement created contractually where a party entrusts or deposits its property to another party for safeguard and preservation. The concept of amanah and/or a deposit contract would apply to the operation of trust receipts.

Note that in a trust receipt structure it would be essential that the customer (as agent) should be required to abide by the compulsory and express instructions of the bank (as principal), and if the customer violates such instructions without an acceptable excuse, the bank may reject the deal. The customer will also be responsible to the principal if the goods perish or there is any damage to the goods and other things that are in the customer's possession unless the damage or perish results from a foreign cause beyond the control of the customer, or from an inherent defect in the goods.

The UAE Civil Code also contains detailed provisions on 'deposit contracts' under which a depositor authorises another person to take care of his property and to maintain the said property (or use it under instructions of the depositor) and make restitution thereof in rem.

Enforcement Process

The trust receipt structure does not amount to a security but does place the financier in a better position for recourse than other unsecured lenders so long as the goods related to the relevant bills of lading or the proceeds thereof are adequately traced and identified.

If the customer trades with the goods in its custody with the permission of the bank, the proceeds arising out of such trade shall then be transformed to a debt owed by the customer to the bank and

will not be discharged except by returning the equivalent of the value of the goods to the bank.

Also, if the goods under the trust receipt arrangement are sold by the customer to a bona fide third party then the bank may not be able to trace such goods in the custody of such bona fide purchaser. Further, on insolvency of the customer, if the proceeds of the goods have been co-mingled with the other assets of the customer, the bank will need to claim in the insolvency, as an unsecured creditor.

Any breach or consequence of such arrangement attributable to the customer may be seen as a breach of duties by the customer as the commission agent under the Commercial Code and a breach of trust under the Penal Code.

Conclusion

To conclude, the trust receipt structure is a viable option for banks and financial institutions looking to fund short term requirements and for manufactures and traders in the UAE. However, while entering into the relevant documentation care should be taken to ensure that the title documents clearly pass ownership to the bank and that subsequently, the parties execute the trust receipt agreement in respect of the specific title documents granting rights of use to the customer.

Please contact the author for any further information on the subject of this article.