Financing banks in the commodities and trade sector hit some strong headwinds in 2020 in the shape of some substantial commodity and trade receivables finance losses in Singapore, the Middle East and other regions. Any sequence of events that shakes confidence in the international trade market and how it is financed is a potential concern for the wider market as the global economic effect of the global pandemic continues to hit many economies hard. Robert Parson, head of Clyde & Co’s Trade and Commodity Finance team, looks at the background to last year’s commodity finance losses and considers how the manner in which those losses are perceived to have arisen will impact trade lending generally and, in particular, the financing of trade receivables for both large and SME businesses as the global economy emerges from COVID.

The role of receivables finance in global trade post-COVID

Receivables finance is a multi billion dollar industry. Global merchandise trade for 2019 was around USD 19 trillion (a 5% year on year increase) according to the WTO’s statistics (the figure for 2020 is expected to be nearly 10% lower). Around USD 9 trillion was supported by some form of trade finance. The global factoring and receivables finance industry over the same period was estimated by FCI (Financial Conditions Index), the global industry body, to represent around USD3 trillion of that figure (representing 5% year on year growth). So, over 15% of international trade is supported by some form of receivables finance, making it a key component in supporting cross-border global trade.

Years of refining the legal structures have established familiar and trustworthy mechanisms which provide finance against the value of invoices issued for goods and services the world over. The robustness of factoring and receivables financing structures and their ability to stand up against legal challenges and abuse by fraudsters is constantly an issue on the radar of financiers, insurers and their customers globally. This is because of the strategic importance of this form of financing for global trade – one which may become even more important as global economies press the reset button.

We will look in this article at the legal building blocks that make receivables financing such an attractive proposition for lenders from both the bank and non-bank financing sector. At the same time, we will identify the elements of the receivables financing proposition that are potentially vulnerable to fraud or other criminal activity and examine the strategies available to minimize those risks. We will argue that receivables finance remains an attractive and low risk investment when properly documented and due diligence is performed.

Loss and fraud in receivables financing is low

No financing structure is guaranteed to be 100% "fraud-proof". However, when fraud is uncovered as the cause of loss, there is often little prospect of recovery – and often no insurance safety net to fall back on. The consequences can be financially grave for the victim. Allegations of fraud have been made in some of the
commodity trader failures in 2020, and these have in turn alarmed some trade financiers – many of whom took a hit. Despite those cases, which have had plenty of media coverage, the incidence of fraud in receivables finance and of loss generally across trade finance as an asset class is very low. So, are those concerns being overblown or are there issues that the market need to address in order to sustain the growth seen over recent years and attract new investors?

**Buying trade receivables – the building blocks**

The financier who is purchasing or financing a debt – representing the price of goods or services, needs to know with a high degree of certainty that (1) the underlying goods or services exist or existed at the time that they were invoiced for; (2) the debt was properly incurred pursuant to a genuine contract for those goods or services between the assignor and the debtor; (3) the assignor as the party entitled to payment of that debt is legally capable of selling it to the financier and perfecting the assignment of its interest; (4) that the debt in the hands of the financier is enforceable against the underlying debtor and incapable of being sold to a third party without the financier’s knowledge, set off, defended, or otherwise diluted so as to deprive the financier of the value of the debt he has purchased. The balance sheet treatment of the debt transfer will also be of crucial importance to both borrower (seller of receivables) and lender (buyer of receivables).

These, broadly, are the foundations that need to underpin the transaction. Any one of them being absent may strike at the recoverability of the debt by the financier.

**The legal agreement "toolbox"**

The financing agreement will contain a range of provisions that establish how the sale of the debt will take place and will provide a long list of information about the relationship which the financier holds with the debtor and undertakings as to how they will behave in relation to the performance of the underlying contract. A properly constructed agreement will explain precisely how the financier comes to own the debt and the legal agreement toolbox will include:

- Clear invoice processing/purchasing rules – how the offer to purchase or sell is made and how it is accepted – and the debt legally assigned.
- What recourse the financier will have against the seller in the event of breach of the financing agreement or the underlying contract should that undermine the financier’s rights.
- Who will be responsible for immediate credit control and debt-chasing and how and where the receivables are to be paid to the financier – including provisions which cover sums paid to the seller (or somebody else) in error by a debtor and creating a trust over those sums.
- Undertakings as to how the seller will behave to protect the financier’s interests and assist in dealing with the debtor if necessary.
- A negative pledge by which the seller promises not to deal with the debt in any way that is inconsistent with the financier’s ownership of it.
- Importantly, a notice of assignment provision and usually a form of that notice which will be sent by the seller to each debtor – or sent by the financier if the debtor fails to do so.

If the borrower/assignor is insolvent and the debt proves incapable of recovery because one of the "foundation" stone elements of the debt transfer described above is missing, the lender will be exposed. The lender must also take care to ensure that the transaction has not slipped through its AML (Anti-Money Laundering) and KYC (Know Your Customer) checks. The use of invoice financing to launder the proceeds of crime is a specific risk area recognised in the Joint Money Laundering Steering Group (JMLSG) guidance but deserves an independent assessment and is not covered in this article³.
The fraudsters' playbook

The impact of a fraud in a receivables financing transaction, however rare, can be devastating when it happens and can manifest itself in a variety of different ways. Take the following classic fraud scenarios as an example:

i) A fraudulent borrower/assignor presents fictitious invoices to the financier under a financing arrangement. The borrower/assignor becomes insolvent. The assigned debts do not in fact exist. There is no real debtor to whom the invoices have been delivered. No goods or services were provided. Notice of the assignment was dispatched or endorsed on the invoice but no genuine debtor ever received it. This is the territory of the money launderer.

ii) A fraudulent borrower/assignor presents to a financier duplicate invoices for genuine goods/services which have already been invoiced and paid for by the debtor. The borrower/assignor becomes insolvent. Notice of assignment was given but after the debtor has paid the receivable or has received an earlier notice from another financier and the notice is not acknowledged. The debtor has not received and denies knowledge of the duplicate invoices.

iii) A fraudulent borrower/assignor over-invoices a debtor and presents invoices to the financier but provides credit notes to the debtor to conceal the over invoicing. The credit note or other compromise of the debt is not disclosed to the financier. Notice of the assignment is given but is not acknowledged. When approached, the debtor claims to have received the credit note or agreed the compromise before receiving notice of the assignment and is unwilling to pay anything other than the discounted or compromised sum.

iv) A fraudulent borrower/assignor colludes with the debtor to raise fictitious or overcharged invoices. Cancellation of invoices/credit notes are not disclosed to the financier. Notice of assignment is given and acknowledged. However when the borrower becomes insolvent, it emerges that the debtor is simply not worth pursuing.

v) A fraudulent borrower/assignor diverts payments made by the debtor in settlement of invoices to an alternative account, i.e. different than the account to which the financier was expecting settlement to be made and then used to repay the financing. The debtor claims not to have received notice of the assignment and the designated payment account.

vi) A fraudulent borrower/assignor fails to disclose existing contractual set off arrangements which are likely to undermine the recoverability of the financed invoices. Notice of assignment is given but not acknowledged. The debtor relies on its set-off rights to reduce or extinguish the debt.

vii) The fraudulent borrower/assignor fails to disclose ongoing disputes with the debtor in relation to the invoices or knowingly ships un-contractual goods knowing payment will be refused. The debtor relies on its contractual defences to avoid payment.

viii) The fraudulent borrower/assignor refreshes/"re-ages" aged/problematic invoices to appear new or within current trading limits. The debtor is already in a distressed financial state and unable to pay.

The first thing that is striking about the list of problematic fraudulent acts is that in nearly every case the fraudster’s opportunity only arises through its breach of the trust placed in it by the financier. Each of the patterns of behaviour which has led to the loss has been pre-imagined by the financier and will have informed the content of the financing agreement and the measures put in place to ensure they are compiled with. The strategy is to set triggers appropriate for the borrower/assignor which will alert the financier to poor/dishonest behaviour. It does not follow that the financier will employ every tool in the legal toolbox or enforce its rights on
each occasion but at the same time it should not become conditioned to waive compliance – nor will many new investors tolerate such an approach to risk management. So few of the typical fraud losses occur because they are unforeseen, but rather because they are unexpected in the context of the specific relationship.

**Set up to defraud or just defraud to survive?**

Assuming that the financier will undertake a certain level of due diligence and have built a relationship with the borrower prior to the problem transaction, then the borrower will be running what, for outward appearances at least, is a bona-fide business. Whilst scam businesses (i.e. enterprises set up for fraud) and associated frauds do exist and from time to time grab the headlines, in reality these are often small time con men.

To establish an entirely fake business facade which would dupe major financial institutions and financing platforms to release receivables financing on any worthwhile scale would require great sophistication and substantial investment by the fraudster. Even major international trade fraud scandals such as the Solo Industries fraud perpetrated by Milton Kounnou and Madhav Patel in the late 1990’s (where losses were around USD500 million shared among some 17 banks) had been made possible by the fraudsters having a substantial independent steel products business as a starting point, from which the illusion of success and a fast (with hindsight fantastically fast) expanding business could be created.

More recently the collapse in 2017 of Transmar, the international cocoa trader with debts of around USD360 million raised on false accounting practices which included counting inventory that Transmar had already sold or was otherwise ineligible for inclusion in the receivables financing programme, counting accounts receivable for which Transmar had already received payment, recording fake accounts receivable, and arranging “circle” transactions through which friendly third-party intermediaries agreed to “buy” goods from Transmar with Transmar’s own money. Its CEO, Peter Johnson, was sentenced to three years in prison for his role. However, Transmar had been a bona fide business – the stuffing of the receivables finance programmes only occurred as the business hit problems from 2014 onwards.

In practice, nearly all the types of fraud described in (i) to (viii) above are capable of being discovered and disrupted by physical, financial and legal due diligence and monitoring at different levels.

**End of business life frauds**

The vast majority of frauds in receivables financing are opportunistic and arise because the relationship between the financier and borrower allows it to happen and, more often than not, occur due to end of business life distress suffered by the business. The reaction to an actual down-turn in business and profitability can be, in some cases, denial and an attempt to create a mirage of continued successful trading and revenue stream. Effective monitoring and linking between tell-tale business behaviours can often warn financiers that something is amiss. However, slimmed down financier business models and the impact of experienced staff leaving the finance sector, as profit margins thin out, can often leave financiers counting the cost. Receivables finance is now a key part of the funding landscape for both SME’s and major international traders. The impact of fraud on financiers in both markets can have a devastating impact not only on the financiers themselves but also on the vast majority of honestly run businesses which rely on that funding.

NJ Transport Ltd was a family logistics company based in Spalding, Lincolnshire, UK and it operated in a modest way since 2003. In 2009, the company obtained an invoice factoring facility from RBS Invoice Finance. The company’s debtor book then rose significantly from 2014 onwards so that by June 2017, when the company was insolvent, it had a debtor book which appeared at around £620,000. However, it transpired that between 2016 and 2018 some £425,000 of false invoices had been produced and fed into the RBS invoice factoring programme. In the ensuing liquidation process, it emerged that the real debtor book amounted to a little over £100,000 and even that was unlikely to be recoverable. In the same period, loans to directors (evident in the audited accounts) had
risen to an almost identical figure. The company had not been set up to commit an invoice fraud scheme but poor performance had led the directors to extract money which the company had simply not earned, and the submission of false invoices to the RBS factoring facility had been the means of balancing the books. RBS Invoice Finance Ltd were left with an unpaid debt of around £500,000.⁶

When National Electrical Wholesale Limited in Essex became insolvent, in 2017, it emerged that it had remained afloat for over 18 months in a difficult trading environment by submitting over £550,000 in false invoices issued to fictitious debtors, leaving the factoring company, Factor 21, short of £650,000 and creditors generally looking at losses of over £1.8 million.⁷

COVID pressed the pause button for many sectors of the economy – both in the UK and overseas. A sudden global event that entirely removes the market “cover” for false invoicing will almost inevitably flush out some further examples. There may be further bad news to emerge.

Concentrating on the wrong kind of risk?

In 2019 and 2020, the commodity financing world was shaken by a series of insolvencies and trade finance scandals which revealed a range of poor business practices by traders and, in some cases, outright fraud. The loss figures were eye watering – Hin Leong (USD 3.5 billion), Agritrade (USD 650 million) were huge losses on their own. When put alongside Coastal Oil (USD 350 million), Hontop Energy (USD 470 million) and Phoenix Commodities (USD 450 million) and others, it was a difficult year for some commodities lenders.⁸

More worrying for lenders was that unlike the Solo Industries fraud (where investigators arriving at the scene of the underlying debtor’s premises found a small abandoned office on a scruffy Essex industrial estate with a computer and two printers), the alleged frauds in Hin Leong and Agritrade occurred in plain sight within an apparently well run, sophisticated business employing hundreds of trade professionals in shiny offices and multi-banking across over 20 financial institutions each. They represented the type of international trading company into which banks were tacitly encouraged to concentrate their risk after the financial crisis. While lower tier and SME traders struggled for funding – even on highly structured and secured bases, Hin Leong and Agritrade had enjoyed relatively “hands free” financing. The use of so called “TR” or Trust Receipt financing (popular in the Singapore market) – where a high degree of trust is placed in the trader to make good its promises of collateral, is just one example of the relaxed access to funding which some companies enjoyed. The alleged frauds included the usual range of fake cargoes, fake invoices, re-used invoices, false inventory reports and so on.

The litigation surrounding the collapse of these regional giants of the commodity world has left some banks reconsidering their future in the market. What lesson will be drawn by lenders from this experience? Will it be (a) that over-concentration of risk and unchecked trust in a few major names can prove costly, or instead (b) that the underlying business of commodity and trade receivables lending is inherently too risky to be part of, however diversified the risk basket. For some financiers the jury is still out – and the litigation ongoing.

The departure of some major players from the commodity lending scene will certainly give opportunity to others – but may well see an upturn in margins paid by borrowers as lenders re-assess the ground rules for financing trade receivables, and someone (the borrower) will have to pay for the increased operational scrutiny involved.

As the global economy starts to imagine a post-COVID market, many financiers have cash to deploy – with substantial sums coming from non-traditional lenders – and many traders (particularly at SME level) are thirsty for funds to move ahead. Many of these new investors are looking for an easy to understand product. Unlike major banks who were (perhaps until recently) prepared to play the percentages and accept that in a low default sector the risk of some dilution, a sprinkling of fraud, and some litigation risk was an acceptable burden in a
profitable market, many non-bank newcomers want to see an orderly risk managed and dilution-free clean asset class presented to them. How is that to be achieved?

**Prevention**

The tools to provide that type of risk basket are all available and in current use:

**Effective due diligence** – COVID did not prevent Hin Leong's or Agritrade's lenders from kicking the tyres and looking under the hood of the businesses they were financing. One of the mantras commonly repeated among lenders now is that greater transparency is needed. Some of that transparency may come through a new blockchain driven trade goods and receivables register, which Singapore started to develop before the recent scandals. It is hoped this will prevent future losses by reducing the potential for double financing of the same invoices and goods. As many digitisation initiatives have already discovered, getting willing participants on anything other than a trial basis to work in a different way and corralling them into using your platform is not, however, straightforward.

Until the market migrate to that fully transparent market place, lenders will have to be prepared to dive deeper into the borrower’s business and their transactions and set the legal triggers that will offer protection. Following through on sample transactions, comparing supply figures to shipping, export and end-buyer buying data, understanding the sector and its seasonal norms and viewing audited accounts with healthy scepticism are all part of the process – the financing agreement can allow for all that. The Association of Singapore Banks (ABS) has recently published a Code of Best Practices for Commodity Lending including a recommendation that "Lenders should conduct proper and adequate business due diligence on each Trader regularly in order to assess and mitigate credit risk on a holistic and informed basis". Good – but hardly new – advice.

**Insurance** – Credit insurance is not for everyone or available in sufficient capacity to cover everyone. However, insurers respond to well organised and structured receivables programmes where the seller and financier have worked to exclude the types of dilution and liability for payment avoidance by buyers that will derail the cover. If a financing structure can be established to avoid the tripwire of dispute exclusion provisions, then it has likely avoided some of the obvious fraud hazards too – but it's no guarantee that fraud will not arise. Many banks are looking for credit insurance to go a step further and shore up their risk capital for the purposes of the Capital Requirements Regulation (and its post-Brexit UK onshore version), and that cover will need to give the banks a direct unconditional claim on the insurance if it is to qualify as Credit Risk Mitigation (CRM) for that purpose. Insurance will not, however, be a substitute for a financier's due diligence obligations and it is notable that the CRR does not expect compliant CRM to cover areas within a bank's operational risk control.

**Negotiable Payment Instruments or Payment Undertakings?** – there has been a resurgence of interest in structures that require the underlying debtor to accept a bill of exchange or promissory note as part of the payment process when it enjoys a period of credit from the seller. For decades, the practice of obtaining payment undertakings and, where possible, having them countersigned by a buyer’s bank, was a proven way to minimize post-delivery disputes about acceptability of goods and enhance recovery prospects. The advantage of an "accepted" bill of exchange, however, is that, in many jurisdictions, the act of acceptance of the bill legally precludes the buyer from subsequently defending an action brought by the holder of the bill. That preclusion prevents the raising of counterclaims and setting them off against the seller (and therefore diluting the receivable). Instead the debtor must first settle the "collection" of the bill by payment in full at maturity through the banking system. Use of the correspondent banking system in a bill of exchange collection also provides an authenticity check on the debtor (as well as some AML comfort) and reduces a number of potential risk areas (including fraud) in one go. The extra comfort comes at a price but many see it increasingly as a good option.
Documenting the deal – you won’t document away the risk of fraud but you can reduce opportunity and heighten the risk of detection – which may well achieve a similar result. Not all the borrower behaviours that brought some commodity traders to their knees in 2020 would have been avoided by tighter control and enforcement of reporting requirements, but there would undoubtedly have been some impact. Positive information commitments for financials, stocks, receivables and movement of goods, produce a set of data which can be analysed with increasing skill to expose false trails. However, without any quality data at all there is little to be achieved. Set correctly, the legal provisions and triggers will reduce the risks that travel with an adverse or, at worst, non-existent selection of receivables being fed to the financier and will bring greater visibility of the borrower’s business.

Cure

As many banks are finding to their cost, chasing the game after a fraud breaks can be a thankless - and fruitless - task. However, not every fraud loss leads the financier to a blind alley. The extent to which the financier can go on the offensive to stem the loss being incurred or make recoveries depends on how the fraud has occurred. The options are likely to vary depending on whether evidence is unearthed of:

- Non-existent assets/false invoices
- Diverted receivables
- Double financing/competing assignment of receivables
- Over-invoicing/dilution scams

Non-existent assets – options may be limited if the borrower is insolvent – which is highly probable. Credit insurance will in most cases be void as cover will never have attached. If fraud proceeds have simply been used to keep the ailing company alive, and nobody has hidden a secret stash of money to make a legal chase worthwhile, then the blame game may take the financier to look at its third party service providers, collateral managers, accountants and other professionals (even lawyers). Just like in The Apprentice, someone always gets fired when things go wrong. Do not, however, underestimate the costs and risks associated with "blame share" litigation. Small print in service providers’ terms and conditions is there for a reason, and, somewhere behind the scenes, there is probably an insurer fighting hard and expensively to avoid your negligence claim. Don’t bank on it providing a solution.

Diverted receivables – if cash has ended up in a different place than intended under the receivable financing arrangements, then you may have an opportunity to test the robustness of the agency and trust provisions (see "legal toolbox" above). Is there any evidence that the buyer colluded with the seller to divert monies despite being notified of a collection account or nominated bank account for settlement? Is the buyer still at risk for the debt as a result? The level of control which the financier exercised over any notice giving to the debtor, following the purchase of the receivables, will be a key factor here. Can the person/institution actually in receipt of the cash establish a set-off against the sums received – whether under mandatory (insolvency set off) rules or some contractual mechanism? As a general rule, follow the money and get discovery of the recipient’s paperwork to check your options.

Double financing/Competing assignments – timing is everything when it comes to sorting out priorities on assignment of debt. English law (and many other jurisdictions) operate a first past the post system for recognising the effectiveness of a legal assignment of debt. If the borrower has played a number of banks for financing for the same debt, then whoever (if anyone) gave actual notice of the assignment of the receivable to the actual debtor first will scoop the jackpot. One of them will make a recovery, and the others will spend money disputing the notifying financier’s claim but will ultimately fail. In some jurisdictions, an acknowledgment of the notice of assignment rather than just notice of assignment may be required – part of the pre-transaction legal due diligence that is essential.
Over-invoicing/Dilution frauds – unless the financier is only seeing one end of the invoicing process, then over-invoicing scams generally require a collaborative buyer who goes along (either tacitly or actively) with the inflated invoicing and helps to affirm (in the sight of the financier) the fraudulent seller’s actions. If the buyer is required to accept a bill of exchange (and has itself been the subject of due diligence to check that its credit profile and debt meets eligible receivable criteria), then it is plainly dis-incentivised from collaborating with the seller/borrower in permitting invoices to be inflated. However, speed may be of the essence in pursuing remedies as others may be following the same path to recovery.

COVID and fraud

While COVID undoubtedly uncovered some of the failures and alleged frauds in 2020, its role in causing or encouraging fraud is probably overstated. Much of the behaviour revealed in the commodity sector last year had been prevalent well before December 2019. As the pandemic continues to disrupt business and lending practices, extra care continues to have to be taken in relation to identity, corporate authority and the formalities of execution, when done remotely, to ensure that we make our contracts and facilities with legal effect. Remote due diligence can be equally effective as a site visit if done thoughtfully. Importantly AML and KYC is principally an online process so the continued restrictions on physical meeting should not prevent full processing of would be borrowers.

However, the economic impact of COVID will continue to influence business behaviour – and in some cases fraudulent behaviour - for some time. Only China of the world’s major economies avoided recession in 2020. Deloitte predicts that 2021 will see around 80–100 % more insolvencies than the average of the last few years. This is more even than the 50% increase in business failures experienced in the aftermath of the global financial crisis. End of business life frauds are likely to increase as a few previously sound businesses are tempted to take a wrong path, while the majority struggle on honestly for survival.

That shouldn’t encourage lenders to pull the financial rug from under the feet of small businesses – now is the time liquidity is required most – but as the world reopens for business we should make sure that money gets to those who are entitled to it and where it will make a difference.

A reality check

Fraud in receivables finance is, happily, relatively uncommon. In a market sector with very low probability of default, it is quite rightly a growth industry giving access to finance for the biggest to the smallest businesses – and can be done safely if care is taken in documenting and monitoring the transactions. The tools are there to execute on receivables financing operations in a way that will see the sector continue to grow – as it must.

1 https://data.wto.org/

2 https://fci.nl/en/media/26962/download


4 JMLSG Guidance at section 21 identifies that the main money laundering risks within the invoice finance sector are payments against invoices where there is no actual movement of goods or services provided, or the value of goods is overstated to facilitate the laundering of funds.