**KEY POINTS**

- Fraud in commodity financing can manifest itself in a number of ways.
- Lenders need to be able to identify key indicators of the different types of fraud.
- There are a number of tools that lenders can avail themselves of to mitigate the risk of fraud – many of them are centred around due diligence and protective documentary provisions.
- There of course remains a trade-off to be made between adopting rigorous due diligence and documentation and the flexibility to strike a competitive deal.
- In the event of fraud the English courts are well-equipped to deal with this complex area of law and have the jurisdiction to grant a range of remedies.

Feature

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# Fraud in commodity finance: identification, mitigation and resolution

*When the sea was calm all boats alike*
*Show'd mastership in floating*

In our previous article, 'Commodity Finance: the complete security package' (2021) 5 JIBFL 351, we touched upon how disruption to commodity transactions, as a consequence of lockdowns, has led to the uncovering of fraudulent activities due to enhanced oversight of borrowers' businesses and how a well-constructed security package can mitigate this risk to a degree. In this follow-up article we examine in detail the different ways in which fraud can manifest itself in commodity finance transactions, the actions lenders can take to try and mitigate against such frauds occurring in the first place and the possible resolutions available should a lender find itself a victim of fraud.

You would never know a car's brakes are not working until that car needs to stop. During fair economic weather, frauds often go unnoticed because a company's satisfaction of its debt service suggests that it is operating profitably and in the manner in which it reports to its lenders. However, when a company hits choppy waters, the disguise conferred on its activities by a never-ceasing stream of transactions falls away, and nefarious goings-on are uncovered beneath. In some instances, the challenging times themselves lead to fraudulent behaviour – a company may deceive lenders to hide shortfalls and losses.

The coronavirus pandemic has decimated the businesses of many commodity traders, paralysing the ebb and flow of international trade. Frauds have been uncovered during post-mortems of a number of commodity trading businesses that have recently failed. This article briefly describes some of these frauds, examines ways in which lenders can protect themselves, and finishes with analysis of some of the remedial action defrauded lenders can take to mitigate their losses.

## COMMON VARIETALS

Below, in brief detail, are a handful of the most common frauds lenders have fallen victim to in recent times.

### "Fresh air" fraud

This fraud involves conjuring commodities, trades and/or invoices out of thin air/"fresh air" – they do not exist. This fraud in particular brings into sharp relief the trade finance world's reliance on paper and the risk all lenders face of disbursing money on the basis of forged or doctored documents. It also highlights the chink in the armour of even the most comprehensive security package – there is no value to any security interest if the asset being secured does not exist (for more detailed analysis of a typical commodity finance security package, please see our article 'Commodity finance: the complete security package' (2021) 5 JIBFL 351.

### The wrong commodity

At its most brazen, this fraud involves a lender financing what it is led to believe is a valuable cargo that turns out to be worthless. In March 2021 Mercuria made the headlines by purchasing multiple cargoes of painted rocks, disguised to look like blister copper. Other lenders have seen the actual quantity or quality of a cargo differ markedly from that specified in the documents presented, resulting in a shortfall between the value of the financing and the value of the commodity.

### Double financing

Here the commodity exists and matches the specification. The problem for the lender is that one or more other lenders also claim to have financed it. In what is the most infamous example of recent double-financing, Dezheng Resources fraudulently pledged the same warehouse receipts issued at the port of Qingdao multiple times to various financiers, leading to substantial losses for a number of international banks.

### Teeming and lading

This is commodity finance's take on a Ponzi scheme. Shortfalls associated with one commodity flow are disguised with fresh money corresponding to another commodity flow. None of the fraudster's lenders will be aware that their financing is not self-liquidating as intended provided that the debt service is satisfied on time. But at some point the wheels will stop and at least one financier will have disbursed funds to finance a flow only to discover those funds have been applied towards an unrelated flow. This technique was neatly summarised in PwC's report to the Singapore High Court following the collapse of oil trader Hin Leong as "a vicious circle whereby financing is required to sustain the scheme, which gives the false impression of the company's financial health, which in turn allows the company to obtain further financing, thereby perpetuating the scheme".

### Offtaker conspiracy

By conspiring together, a lender's client and the offtaker can together defraud that lender. Sham transactions can be documented, purchase prices or quantities inflated and offtake proceeds diverted to alternative accounts. On the client's insolvency, a lender may struggle to prove the offtaker was in cahoots with the client. Even in circumstances where fraudulent collaboration can be proved, the offtaker too may be insolvent and not worth pursuing. The authors have very recently advised a bank whose borrower was alleged by its counterparty to have forged a purchase contract, but upon further diligence a number of shared directorships between

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the borrower and the counterparty have been unearthed, and the bank is one of a number of financiers exploring fraudulent collusion between the two companies.

## LENDER MITIGANTS

It is easy to be critical of a lender's failure to spot the fraud after its details have been uncovered – hindsight is a wonderful thing. However, in reducing their exposure to fraud, commodity financiers are hamstrung by the following:

- the trade-off between adopting a rigorous due diligence process and the flexibility needed to strike a deal in a competitive market;
- the trade finance world's traditional reliance on hard copy documents;
- the number of parties involved in a commodity flow and the lack of communication between those parties.

Conversely, it is also easy upon discovering fraudulent activity to bemoan its prevalence and ascribe the resultant losses to misfortune. We set out below a list of ways lenders can reduce their risk of being defrauded:

- **Transaction Due Diligence**: This will uncover fresh air frauds and sham transactions. For example, a lender may wish to contact the client's customer to verify the trade, or the shipowner to verify a bill of lading. If the Lloyds Register records that a vessel was broken up for scrap in Pakistan nearly a decade before documents delivered by a client indicate a cargo of sugar was loaded on to that vessel in Brazil, then further investigation might be advisable before an LC is issued![1]
- **Client Due Diligence**: Due diligence of the client, and the client's business, is essential. Lenders may want to ensure their client has adopted good corporate governance, to ensure what the Monetary Authority of Singapore summarised in its recent commodity financing code of best practices as "segregation of roles and responsibilities within the board of directors" and "sufficient independence in the decision-making and exercising of [its] judgements".[2] Certainly, some lenders have veered away from SMEs and opted instead to lend only to established market players in what some are calling a "race to quality", but with so many financiers wishing to do business with a limited pool of large commodity houses, there has been an inevitable squeeze on pricing.
- **Commodity Due Diligence**: Independent warehouse inspectors can verify the quantity and quality of a commodity, and reputable warehouse operators can ensure the commodity is not tampered with or inadvertently released to a third party.
- **Document scrutiny**: Has there been any obvious tampering of any document (eg date or signature)? Fraudsters rely on banks failing to check the veracity of supporting documentation adequately, which is often voluminous and of poor image quality. The submission of large numbers of irrelevant or ancillary documents may mask the fact that key documents are missing or incomplete.
- **Documentation and structure**: Lenders should consider what information will enable them to keep track of the borrower's business and ensure this information is delivered in full and on time, and subjected to adequate scrutiny. Putting in place a structure that allows a lender to track the commodity and corresponding flow of money on each transaction will reduce the risk of phantom cargoes or misappropriation of loan or offtake proceeds. The finance documents should reflect these protections, and these requirements should be enforced by the lender without exception.
- **Independent credit support**: This could comprise surety guarantees from parent companies, or support from financial institutions in the form of insurance or avalised payment instruments. Lenders should always check the terms of their insurance policies carefully, as demonstrated by the legal proceedings issued earlier this Spring by Thera Agri Capital against its insurer following losses sustained after the demise of agri-trader Phoenix Commodities.
- **Digitisation**: Much criticism has been aired of the trade finance world's failure to digitise. With paper swapped for electronic entries using distributed ledger technology, doctoring documents and double financing should be rendered impossible. But this technology is only of use while its integrity remains uncompromised – talented criminals will inevitably find a way of circumventing technological protections in due course. And the trade finance world's appetite to embrace innovation does not seem to have been galvanised by the coronavirus pandemic, as exemplified by the recent outpouring of support in favour of the re-opening of London Metal Exchange's "The Ring" trading floor bull pit.

## LENDER RESOLUTION

The resolution of commodity fraud is of central importance to lenders, not just financially, but also from a reputational perspective. Fraud's nebulous and multifaceted nature, however, can make it difficult for lenders to know how best to pursue fraudsters and achieve redress.

A primary consideration is the fact that fraud has different definitions under the civil and criminal law in England and Wales, and even within each of these, there are several different claims or offences depending on the circumstances.

### Criminal Fraud

Fraud in a criminal context means fraud that is capable of being prosecuted in the criminal courts and of resulting in a criminal conviction, including imprisonment.

Criminal fraud is defined by way of common law and statute, namely the Fraud Act 2006. In order to make out an offence, the prosecution must prove the constituent elements of the relevant offence to the criminal standard, ie beyond reasonable doubt, which is much higher than the civil standard of the balance of probabilities.

As a starting point for criminal proceedings, a lender should report the fraud to the police, who can be notified using the Action Fraud service. This refers the matter to the City of London Police, the national police authority for investigating fraud, who may then transfer it to another appropriate authority, such as the Serious Fraud Office (SFO), National Crime Agency (NCA) or the Financial Conduct Authority.

There is no legal requirement for a lender who is the victim of fraud to report the matter to the authorities (unless the fraud involves suspected money laundering or terrorist financing), and often when civil proceedings are simultaneously pursued, the police do not get involved. It is important to remember that

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in criminal proceedings, the lender will lack agency as it is up to the authority whether they choose to investigate or not. On the flip side, this means that a lender will not have to fund any investigation that an authority chooses to commence. Moreover, the authorities have wider powers of investigation than a lender and its legal team.

A lender does not necessarily have to choose between civil and criminal proceedings, as they can both run in parallel. However, lenders should note that this could lead to an application to stay one set of proceedings until the other has been resolved.

## Civil Fraud

A lender may opt to initiate civil proceedings, because there is a greater likelihood of recovering its money than in criminal proceedings. The costs of the proceedings, however, should be factored into the overall recoverability.

In the civil sphere, fraud is not a cause of action in itself, but instead encompasses various activities, at the heart of which is the notion of dishonest conduct. The broad scope of fraud makes it a challenging area of law, but lenders should be reassured that the courts are well-equipped to deal with fraud and have the jurisdiction to grant a range of remedies.

A lender who considers itself a victim of fraud should first identify which cause(s) of action it may pursue via civil proceedings based on the factual matrix of the situation. In cases of commodity fraud, the most likely heads of claim will be fraudulent misrepresentation, the tort of deceit, unjust enrichment, or conspiracy. All of these claims are only available against the primary defendant(s), and thus not against any secondary perpetrator who assisted in the fraud in some way.

## Emergency Interim Relief

When a lender is considering making one of the above claims, the courts have the power to grant emergency forms of interim relief, without notifying the alleged fraudster, in order to prevent them from dissipating assets or destroying evidence.

Given the intrusive nature of interim remedies, the courts do not grant them lightly. The decision to make an application for interim relief will thus need careful consideration due to the onerous procedural requirements involved.

Below are some of the interim remedies for which a lender can apply:

- **Freezing order:** A lender should consider an application for a freezing order when there is a real risk that once the defendant becomes aware of the proceedings against it, it will move or dissipate assets. If granted, a freezing order will prevent the defendant from doing this. A freezing order will not grant a lender any proprietary interest over the assets.
- **Proprietary Order (including following and tracing):** A lender should consider a proprietary order instead of a freezing order if the lender alleges that the defendant has property belonging to it, which will likely be so in cases of commodity fraud (other than "fresh air" fraud of course). In order to identify the assets subject to a proprietary claim, a lender may need to undergo following or tracing. Following is the process of following the same asset as it moves from hand to hand, whilst tracing is the process of identifying new assets derived from, or obtained from, the lender's original asset. Common law only allows tracing in circumstances where the asset has not been mixed with other assets. However, a lender can trace mixed funds under equity if it can demonstrate that it would be unconscionable for the defendant to be permitted to retain the property. Tracing and following are not remedies themselves, but are evidential processes used to identify the assets over which an application for a proprietary order may be made. If granted, a proprietary order will give the lender priority over other creditors in an insolvency situation.
- **Search order:** A lender may consider an application for a search order when there is a need to preserve evidence relating to its case. If granted, a search order will require the defendant to allow the lender's solicitors into its premises (including residential premises) to conduct a search for the material outlined in the search order. In cases of commodity fraud, this can be extremely valuable to lenders, since there is a real risk that the fraudster would destroy evidence if it were put on notice.
- **Norwich Pharmacal Order:** This allows a victim of fraud to obtain information that allows it properly to consider what claims it should make and against whom. Banks are most susceptible to such orders, because the proceeds of fraud often pass through the defendant's bank account. If granted, such an order would require a bank to provide confidential information about their customer, the defendant, to the lender, in order to enable the lender to commence proceedings against the defendant.

## Jurisdiction

As a final point, the international nature of most fraud cases can raise tricky jurisdictional questions. Complete consideration of all jurisdictional issues is beyond the scope of this article, but the below offers a helpful starting point for the victims of fraud.

In the criminal context, jurisdiction will generally be determined by where the offence took place. With fraud, however, this is often difficult to determine as offences often take place via the internet. If the fraud did not take place in a specific jurisdiction, lenders should consider reporting the matter to the authorities of the jurisdiction in which the fraudster is based. A UK lender can also report the matter to the authorities in England and Wales, who have the power to seek assistance from overseas authorities.

In the civil context, since fraud is a non-contractual dispute, jurisdiction will depend on the domicile of the parties. Some of the relevant considerations for lenders include the jurisdictional regime that applies (taking into account that post-Brexit, the rules have changed slightly for cases with an EU dimension), and whether there are multiple defendants, which could affect which jurisdiction is most appropriate. Lenders should also note that to serve a claim form on a defendant located outside of England and Wales, the court's permission may be required.■

1 This example is taken from W X Huang's *Commodity Finance Principles and Practice.*

2 https://abs.org.sg/docs/library/code-of-best-practices-commodity-financing.pdf

*Further Reading:*

- Commodity finance: the complete security package (2021) 5 JIBFL 351.
- Trade finance and distributed ledger technologies (2018) 2 JIBFL 99.
- LexisPSL: Banking & Finance: Practice Note: Structured commodity finance – key issues for financing commodities.