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Agricultural Finance*

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# Warehouse Receipts and Securitization in Agricultural Finance

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## I. – INTRODUCTION

As part of the exploration of the possibility of UNIDROIT undertaking or participating in a project to develop food security, I examine in this paper the role that warehouse receipts might serve as part of the overall structure of an agricultural finance system to develop sustainable and profitable agricultural markets. What I intend to show is how warehouse receipts can be an important piece of a larger set of business and legal tools for agricultural development. This is one small part of the broader question of whether UNIDROIT's expertise in private law may contribute to the development of global food security.

It is important to appreciate that no amount of legislation can create opportunities for agricultural development without the political and economic resources necessary for development. A law that provides for enforceable and transferable warehouse receipts is of little use without a warehouse.<sup>1</sup> A warehouse receipt has little use as well unless there is a viable and reliable legal system that will enforce the rights embodied in the warehouse receipt.

Moreover, warehouses and warehouse receipts are only part of the larger production and market framework. There must be transportation facilities to transfer physically the goods stored in the warehouse to the markets. There

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<sup>1</sup> The use of warehouses themselves creates great benefits for farmers. The greatest benefit is simply the ability to store products. From this flow many other benefits, such as preventing loss and waste (post-harvest losses are substantial in many places), being able to sell goods in bulk, reducing costs of transfer by selling goods without moving them, and choosing the optimum time to sell goods based on market demands and prices. Moreover, warehouses often do more than simply store goods. They often process and package them as well, which increases their value.

must be markets for the goods. Finally, there must be banks or other financial entities that are willing to finance agricultural production.

## II. – WHAT ARE WAREHOUSE RECEIPTS?

Every year, warehouses receive billions of dollars' worth of goods for storage. Modern warehouses not only store goods, but also often process and pack the goods as well as arrange for their transportation. The ability of farmers to store their agricultural products in warehouses can greatly increase the value of the goods, for example by allowing the farmers to decrease after-harvest losses, sell in bulk, and store until the market provides the best prices. Thus, warehouses themselves can add significant value to the goods that pass through them.

It is not warehouses themselves that are our concern here, but warehouse receipts. Warehouse receipts are a type of document of title. Documents of title can be briefly defined as writings, or their electronic equivalents,<sup>2</sup> that represent the title and right to transfer specific goods. The two main types of document of title are warehouse receipts and bills of lading. Our concern here is warehouse receipts.

A warehouse receipt is issued by a warehouse (bailee) to the owner of the goods (consignor) upon the deposit of the goods at the warehouse. Warehouse receipts can be either negotiable or non-negotiable.

A non-negotiable warehouse receipt is effectively nothing more than a receipt of the goods by the warehouse that acknowledges the exact goods deposited by the consignor with directions to deliver the goods to the consignee. Because non-negotiable warehouse receipts themselves have no particular legal significance, the receipts cannot be used to transfer or finance goods. However, it is common for a warehouse to record title transfers and security interests on its records, so that those transactions can be accommodated absent the issuance of a negotiability document.<sup>3</sup>

The negotiable warehouse receipt, like its first cousin the bank draft, has specific legal significance. The rightful possession of the actual receipt gives the holder both the title to the goods as well as the right to transfer the title.

<sup>2</sup> There are significant developments in both domestic and international law on electronic documents of title. It is assumed that any project UNIDROIT would undertake in the area of warehouse receipts would consider these developments.

<sup>3</sup> It is common in many parts of Africa to use non-negotiable warehouse receipts that are issued directly to the financing institution and not the depositor.

This allows the holder to transfer the rights while the goods are still in the possession of the warehouse. Moreover, the receipt can be used to create secured financing by allowing the receipt to pass to the lender.

What this provides in essence is the ability to separate the ownership rights in the goods from the physical possession of the goods. By doing so, possession, storage and physical transfer can be based on the optimal time for these transactions, while the ownership rights and security interests can be timed according to the respective needs of these transactions.

### III. – USE OF WAREHOUSE RECEIPTS IN AGRICULTURAL FINANCE

As warehouse receipts represent the ownership and title in the goods, the warehouse receipts themselves can be pledged as collateral for credit or sold outright for cash. The use of collateral in the financing of agricultural production is not as prevalent in developing economies as it is in more developed economies. As a result, the amount of credit to farmers is more limited than would be the case with farmers having access to secured credit. Moreover, because of the ease of transfer of warehouse receipts to creditors, farmers can prove the existence and worth of assets more readily than if they have to rely on the physical crops that are the basis for the assets.

In those economies where farmers sell their surplus at the time of harvest in local markets, a necessity without storage or major transportation facilities, the farmers are generally restricted to the prices that can be had not only at that market but also at the time of the year of the harvest. By storing the crops in warehouses, the farmers may be able to increase the value received for their crops both by adjusting the time of the sale based on the rise in fluctuating market prices<sup>4</sup> as well as by selling in different and larger markets.<sup>5</sup> Moreover, by combining their crops with those of other producers, the farmers may benefit from selling in bulk.

Equally important is the use of warehouse receipts as a basis for secured credit. At present in many developing economies, all that small farmers have to support a credit application is their current cash flow and possibly an interest in land if they possess such. The use of warehouse receipts can increase the ability of credit by supplying a new source of collateral. This credit can be used to increase the availability of inputs such as feed and fertilizer.

<sup>4</sup> This obviously assumes that the crops are not quickly perishable.

<sup>5</sup> This assumes the availability of transport and other mechanisms to deliver to different markets.

The use of warehouse receipts as a basis for secured credit assumes that there is a financial market that provides for secured credit and this market will recognize warehouse receipts as acceptable collateral. Just as there is no need for warehouse receipts without warehouses (and markets to sell the crops stored in the warehouses), warehouse receipts cannot be used for credit unless there is a credit market that will accept them as collateral. This fairly obvious point is a reminder that the use of warehouse receipts for agricultural development is only one small part of the necessary legal and business structure that is required.

Traditionally, warehouse receipts have been issued as paper documents. Currently, though, electronic warehouse receipts exist in some domestic systems<sup>6</sup> and are being developed internationally.<sup>7</sup> Whether the models for electronic warehouse receipts (which are primarily registry-based) are appropriate in developing agricultural economies depends on the availability of a registry system. This, in and of itself is not a simple question. Who would develop and run the registry system would depend to a large extent on who the issuers of the warehouse receipts are. A closed<sup>8</sup> system that is run by a cooperative or by large buyers would be easier to maintain than an open system supported by a government. Moreover, a small closed system could be more easily financed by the users. Yet the cost of any electronic registry or other electronic warehouse receipt system may be prohibitively expensive. Thus, it would appear, at this time, that any new development of a warehouse receipt legal regime should provide both for traditional paper warehouse receipts as well as electronic equivalents for if and when such a system is feasible.

#### IV. –HOW WAREHOUSE RECEIPTS MAY ENHANCE AGRICULTURAL PRODUCTION IN DEVELOPING ECONOMIES

For any discussion of the goals of agricultural development, it is customary to state the broad policy goals. For the question of the use and utility of warehouse receipts, the broad goals are generally consistent with any aspect

<sup>6</sup> This is provided for, for example, in American Uniform Commercial Code provisions on documents of title. See U.C.C. §§ 7-105 & 7-106.

<sup>7</sup> UNCITRAL Working Group IV is currently undertaking a project on transferable records which will include electronic warehouse receipts.

<sup>8</sup> By closed system I mean a system where there is a limited number of participants who all agree to abide by the rules and procedures of the system. This would exclude the larger public. Where all of the relevant participants in a local economy participate in a closed system, there is no particular need for an open, public system.

of agricultural development: poverty reduction, enhanced food security, increased exports, and increased liquidity in markets. Yet a statement of these broad goals does not really express the ways in which warehouse receipts may actually enhance agricultural production.

A more focused discussion of warehouse receipts shows that they can serve the important function of providing the basis for developing market exchanges as well as reducing overall transaction costs by allowing commodities to be stored, shipped and sold in bulk. Both of these goals can be enhanced and achieved by the fact that agricultural products stored in warehouses can be aggregated and thereby shipped and sold in bulk. By creating volume in a unified place, markets can develop which allow buyers to purchase in a single larger market than from individual producers. This will allow small farmers to band together to provide a larger amount of goods to market, thereby getting a better price for their products.<sup>9</sup>

Moreover, to the extent that the goods are stored in a central place to be sold, the farmers may be able to bypass certain middlemen and thereby gain additional profit. This appears to be happening in some places such as Tanzania, where there is a well-developed coop system.

Moreover, by being able to store goods for future sale or delivery, the delivery of goods can be regularized based on market demand and availability of transport facilities, not on growth and production schedules.<sup>10</sup> This can increase farmers' income by allowing transport, delivery and sale based on market prices and not on growth and production schedules. Moreover, predictability of income flow can be achieved by avoiding surpluses and shortages that can occur with irregular, seasonal delivery.

Although the discussion thus far has been on the warehouse receipts, it is important to keep in mind that the warehouses themselves are very much an important part of the discussion. Whereas the warehouse receipts provide an efficient method of legal transfer of ownership and finance, the warehouses are necessary for the storage and preservation of the agricultural produce. In many areas, post-harvest losses are substantial; warehouses can reduce these losses significantly.

<sup>9</sup> According to an excellent study of this area by Gideon Onumah (see elsewhere in this issue), evidence suggests that this would include 55% of Tanzania's coffee crop.

<sup>10</sup> This is already happening in some developing agricultural economies such as Zambia and Tanzania. *Ibid.*

## V. – NECESSARY FACTORS FOR A FUNCTIONING WAREHOUSE RECEIPTS SYSTEM

There are three necessary conditions to have a functioning system of warehouse receipts as a component for agricultural development: (1) legal recognition and effective legal enforcement of the rights created and derived from warehouse receipts, (2) the physical infrastructure for warehouses and other transport facilities, and (3) effective markets to sell the agricultural products.

The viability of ownership and transfer of rights based on a piece of paper or its electronic equivalent assumes recourse to a legal system that will recognize and enforce these rights. Thus, in those jurisdictions that do not have clear legal rules that govern these rights, such rules will be necessary. Moreover, the participants must have a realistic belief that the legal system will acknowledge and protect these rights in a timely and efficient manner.

The major function of the warehouse is storage; the major function of the warehouse receipt is the sale and finance of the agricultural products. These uses of warehouse receipts presuppose markets for the sale and financing of agricultural products, and there are mandatory minimums necessary for the markets. This includes reliable information on both supply and demand as well as a regulatory or licensing system for warehouses<sup>11</sup> that can guarantee both product standards as well as warehouse integrity.

## VI. –STRUCTURAL AND SYSTEMIC PROBLEMS

The contribution that UNIDROIT and its partners have to make in the area of food security is primarily legal assistance. But no amount of model laws and principles to govern warehouse receipts or any other aspect of agricultural production can be effective or overcome otherwise deficient physical facilities or inadequate markets.

The first requirement for any market for agricultural products is a surplus. Without that, there is only subsistence farming.

This can present somewhat of a chicken-and-egg problem. If a surplus is necessary to create assets that can be used to finance the development of agricultural production, it may be the agricultural production that is necessary to create the surplus. The solution to this problem, however, is beyond the expertise of an international commercial lawyer, and I will leave it to others to resolve.

<sup>11</sup> These exist, for example, in Tanzania and Uganda. *Ibid.*

Another systemic problem in many countries is the uncertain status of land tenure. Without specific land rights, farmers suffer both the problem of uncertainty of the right to the future use of land as well as loss of the ability to use the land as collateral. Although land tenure is ostensibly a legal problem that can be addressed by specific legal rules that govern land rights, the willingness to create and enforce land tenure relies on a political process and political willingness for this.

No fruitful discussion of the usefulness of warehouse receipts can be had without recognizing the need for physical warehouses. At present, in many countries these facilities are quite limited, and to the extent they do exist, they are often owned and used by large operators for export. Warehouses are expensive, both to build and to operate, and the capital necessary to build and operate them must come from somewhere. Again, this is one aspect of food security that the law cannot provide. Consistent problems of electricity to operate the warehouses, theft and fraud, the lack of insurance, and the credibility of the warehouse operators all add stress to the success of a warehouse system.

As agricultural products stored in warehouses are often sold in bulk from a multitude of suppliers, there is the need to regulate quality and uniformity. This requires commodity standardization and regulation. This can be done either by the government, by non-governmental organizations, or by industry, but it is necessary, and some facility or process must exist for it. This is another part of the overall development model that will not be solved by legal rules and principles.

Moreover, to get the warehoused agricultural goods to either or both domestic and international markets, there must be a transport infrastructure to provide the movement of the goods. This is yet another part of the overall development of food security that cannot be resolved by law but only by large inputs of capital.

Lastly, there is the need for markets for the agricultural goods, be they local, national or international. These markets have to provide confidence to the banks and other financing agencies that are necessary to provide the capital not only for the markets but also for the farmers and other agricultural producers and suppliers.



## VII. – CONCLUSION

The negotiable warehouse receipt has a long history as one part of the overall financing and distribution structure of agricultural products. It is, though, only a small part of the legal, market and infrastructure necessary to develop agricultural production and food security. But the legal rules that govern the creation, transfer and rights through warehouse receipts, as part of a larger set of legal rules and principles could have a significant impact on the development of food security, and the development of private law rules and principles is one place where UNIDROIT excels and may play an important part.

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