

RUSLAN KHARLAMOV uncovers the practicalities of customs bonded warehouses as a risk management tool

MY CARGO, MY BOND

As more customs bonded warehouses spring up around the globe, exporters are in a good position to benefit from this counterparty performance and credit risk management tool. Licensed by a country's local customs authority for temporary storage or processing of goods on which no duties are paid until the goods are cleared for internal consumption, customs bonded warehouses provide services such as deep freeze or bulk liquid storage, commodity processing and coordination with onward transportation.¹ A summary of the cargo flows is set out in Figure 1 and the theory of how the process should work is outlined below.

Summary of customs bonded warehouse theory

Two parties enter into an international sales contract that requires delivery of goods on a cost insurance and freight (CIF) or cost and freight (CFR) basis. The parties agree that the buyer will pay for the goods before their arrival at the port of discharge, and that the seller will keep the original bills of lading until receipt of payment.

Due to various reasons – for instance, a short distance between the ports of loading and discharge – the buyer fails to make the payment on time but assures the seller that it will be made in a

matter of days. The seller faces a dilemma: to unload the goods and accept uninsured credit risk on the buyer or postpone unloading operations until receipt of payment but run the risk of vessel demurrage.

There is an alternative if the port of discharge has an independent customs bonded warehouse. A legitimate holder of the bills of lading – usually the seller or his financing bank – may instruct the carrier to unload the goods in the bonded warehouse and hold them in custody until receipt of payment. This way the seller may retain control over the goods while avoiding demurrage expenses. Should the buyer default on the sales contract, the seller may resell the goods to other customers in the same market or re-export them without paying customs duties in the country of transit (which includes a considerable value-added tax in many jurisdictions).

The practical challenge

In practice, the seller must be prepared to manage this process very carefully, as it is not uncommon that the goods are misdelivered from the bonded warehouses – even considering the perceived security of government participation.

The following case is an example of a real situation I encountered a few years ago.

A commercial transaction began a long time ago. The goods were unloaded at the port of discharge, and the buyer made the payment a few days later. The seller informed the buyer that he instructed the carrier to deliver the goods. To the seller's astonishment, the buyer responded that most goods had already been shipped from the port of discharge.

When the seller enquired why the goods had been released to the buyer, the latter's forwarding agent replied that only the buyer had a stevedoring agreement (docker labour agreement) with the port, and the buyer was also indicated as the notify party in the bills of lading. Further investigation bore no fruit, as the parties engaged in the handling of the goods at the port of discharge accused each other of miscommunication on the goods' actual status, though agreeing that the goods had been misdelivered to the buyer. Taking into account that the goods were paid for, the seller decided not to pursue that case any further. As the seller's bank was aware of all developments, the whole story did not help the professional reputation of all parties involved.

The problem of misdelivery of cargo under a bill of lading is well covered, but most comments focus on emerging markets. In my opinion, developed markets

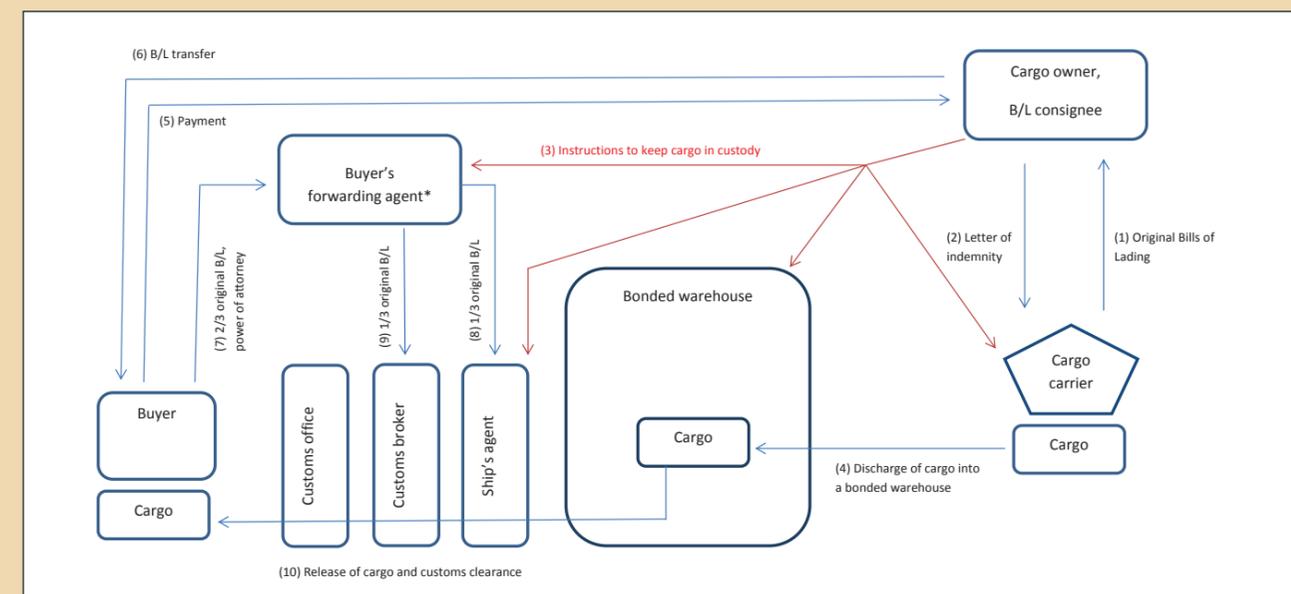
are no less prone to this problem – just for other reasons. The misdelivery outlined in the above example took place in a leading European port; one that is considered a paragon of efficiency. Too often, however, efficiency is provided at the expense of safety.

Obligations of the parties

To better understand what is happening to cargo when it is temporarily unloaded into a bonded warehouse, it is important to consider the parties involved and their respective obligations:

The carrier is represented by a ship's agent, who is often a local private company. The ship's agent may be acquainted with the buyer or even have a parallel business relationship with him. The ship's agent is the most important link in the chain, as he controls the delivery of cargo against the surrender of the original bill(s) of lading. This function involves identifying a legitimate receiver of the goods (consignee, endorsee, or assignee) and verifying the authenticity of the bill(s) of lading exchanged for the goods. If the bill of lading is presented by the receiver's representative – for instance, a freight forwarding company – the ship's agent must establish his identity and legal capacity. Although the ship's agent must exercise due diligence in carrying out these functions, he is not

Figure 1: Example of customs bonded warehouse function



supposed to conduct a thorough legal analysis of the receiver's right to take delivery (for example, verify legality of all endorsements made in string sales or validate whether the surrendered bills of lading were obtained in good faith).

The buyer is usually represented by a freight forwarding agent that subcontracts stevedoring, warehousing, and other functions to relevant service providers at the port of discharge. As a rule, the forwarder is not only contracted to unload the vessel and ship the goods from the port of discharge but also to represent the buyer when the goods are delivered by the carrier. Taking into account that storage space is in ever tighter supply at many international ports, the buyer and the forwarder are usually encouraged to collect and ship the goods out of the port as soon as practically possible. The forwarder is contractually required to act in the buyer's best interests.

A customs office and a customs broker may be a third party involved in the process. The customs office is responsible for enforcing customs laws and collecting customs duties, whereby the customs broker submits relevant documentation to the customs office and arranges for import clearance of the buyer's merchandise. In carrying out these primary functions, the customs office and the customs broker also control a lawful delivery of cargo. The problem is that many bonded warehouses have no permanent customs officer on-site. Worse still, the buyer's forwarder sometimes duplicates as a customs broker and... a ship's agent!

The ship's agent, the customs broker, and the customs office constitute the three 'lines of defence' in terms of compliance. In our example, the cargo delivery process failed because not having an independent customs broker or a customs office on the terminal where the goods were discharged increased the possibility of human error.

Furthermore, the ship's agent and the customs broker owe the duty of care to the legitimate holder of the bills of lading. Quite often the buyer's forwarding agent

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duplicates as a customs broker, which invariably creates bias in carrying out the latter's obligations. For example, article 6 of the Dutch Forwarding Conditions states, 'Unless agreed otherwise in writing, the supplying to the forwarder of data required for customs formalities shall imply an order to perform such formalities.'²

Accordingly, should the buyer fail to inform the forwarder about the agreement to unload the goods in a bonded warehouse, the forwarder may proceed to clear customs and ship the cargo without further instructions to the contrary, especially if he has already made related transportation arrangements.

As a rule, the customs office clears goods for local consumption against the presentation of the original bill of lading that is consigned or endorsed to a resident company, along with other shipping documents. In some countries, however, local legislation or a custom of the trade allows withdrawal of the goods before completion of customs formalities, especially when the bonded warehouse is not provided with a permanent customs office.

Getting it right

In order to ensure against unwelcome surprises, a party contemplating the use of a customs bonded warehouse as a risk management tool should consider the following:

- National legislation on bonded warehouses may substantially differ from one state to another, so make sure there is an appropriate regulatory framework in the country of destination.
- Not all merchandise is acceptable for storage in bonded warehouses. For example, perishable goods such as crops and foodstuffs may not be deposited in a bonded warehouse in some countries, or

their authorised storage may be limited in time. Make sure that the bonded warehouse is suitable for your cargo.

- The port of discharge should operate an independent, public bonded warehouse and not a private one. Entrust the cargo to an independent and impartial custodian acting in your best interests.
- Before entering into a contract of affreightment, inform the carrier that you may need to unload (but not deliver) the cargo at a bonded warehouse at the port of destination against a letter of indemnity (LOI). Make sure that the carrier agrees to follow the consignee's instructions in this respect.
- Issue negotiable bills of lading to your order or to the order of the financing bank. Coordinate with all parties concerned that part 1/3 of the original bill of lading will be sent in a ship's bag, and that part 2/3 of the original bill of Lading will be kept by the consignee until receipt of payment.

When the need to unload the cargo in the overseas bonded warehouse starts to loom, proceed as follows:

- Do not surrender the original bills of lading to unload the goods into the bonded warehouse. Instead, have the consignee instruct the carrier to unload the cargo against a letter of indemnity (LOI). Be proactive with all related formalities, as the carrier may require the original to start unloading operations. The more sub-charterers are involved in the sea voyage, the more time is required to complete related formalities.
- Do not attempt to manage the whole process through the carrier. Contact all parties concerned – the ship's agent, the discharge port authority, and the customs representative – and inform them about the forthcoming operation. Notify these parties about the legitimate owner of the cargo and about circumstances requiring its unloading in the bonded warehouse. Make it crystal clear that no delivery is possible to the buyer without the cargo owner's explicit instructions and the delivery of the original bills of lading. Ask the port authority about conditions of storage, and guarantee payment of stevedoring and storage expenses incurred by the cargo in case the buyer



does not fulfill his payment obligations. Whenever appropriate, request that all parties concerned acknowledge in writing agreement with your instructions. The carrier should be informed of your activities and copied on all related correspondence.

- Considering that the bonded warehouse is not necessarily separated from the main port area, ask the port authority about the exact location of your cargo, and request the port authority to issue a bonded warehouse receipt as soon as the cargo is unloaded from the vessel. You may also consider sending an independent surveyor to inspect the physical location and condition of the cargo, as well as having the surveyor randomly inspect the cargo throughout the storage period.
- Take into account the aspects of cargo safety. How is the bonded warehouse safeguarded, and what kind of insurance is in place? If the warehouseman's insurance is not sufficient, the easiest solution is to extend the marine insurance policy to insure the cargo at the port of discharge against all risks.
- Try to have a contingency plan in case the buyer defaults on the sales contract. Think about the next steps in advance.
- When the buyer makes the payment, have the retained bills of lading endorsed and delivered according to the buyer's instructions.

A wider perspective

The risk management method discussed in this article is based on the carrier's legal

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capacity to direct that delivery of the cargo be withheld until at least one original bill of lading is surrendered by its legitimate holder, even though the carrier loses physical possession of goods placed in the bonded warehouse. If the port of discharge has no bonded warehouse, in most jurisdictions the unloading of cargo is only possible to a local receiver. This requires surrendering one original bill of lading to the local receiver and leads to the loss of control over subject goods.

Professional negligence and corruption are two main reasons for cargo misdelivery from the bonded warehouse.

We consider that bonded warehouses in developed markets are more vulnerable to professional negligence because they usually involve lower levels of bureaucracy and red tape. In many developed countries, especially in North America and Northern Europe, customs clearance has become a declarative rather than a permissive procedure, whereby no authorisation from the customs authority is required before the goods could be physically shipped from the bonded warehouse. Accordingly, cargo owners may not rely on the three 'lines of defence' against professional negligence, as outlined above.

Many emerging markets are characterised by higher levels of both bureaucracy (customs officials are more likely to carry out their functions with more

rigour) and red tape (stricter regulations and procedures). The higher administrative barriers to pass the goods through customs mitigate the risk of professional negligence of other parties. On the other hand, some emerging markets are prone to corruption, which may negate the positive effects of higher administrative barriers.

To summarise, higher administrative barriers help safeguard the interests of parties applying the bonded warehouse as a risk management tool in international trade. Countries with higher administrative barriers and low corruption (for example some states in Southern Europe) provide the best environment in this respect, which is a rare example of bureaucracy actually being good for business.

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References

1. A useful summary from a UK perspective can be found at www.businesslink.gov.uk/bdotg/action/layer?topicId=1079819587
2. The Netherlands Association for Forwarding and Logistics. See <http://tinyurl.com/9m2g3yk>