**Documenting security**

This element explains how the security package will be documented and explores some key clauses found in a security document.

**Introduction**

· Straight-forward secured loans will often be documented with the bank’s standard form security document. However, more complex secured loan facilities require more sophisticated security documents.

· Such documents not only describe the security being taken (in what is known as the **'charging clause’**), but also contain provisions aimed at protecting the secured assets and the position of the lender against certain risks.

· The provisions incorporated into security documents will also depend on the type of underlying loan facility (i.e. a term loan or a revolving credit facility) and whether it is a bilateral or a syndicated facility.

· Terms defined in the underlying loan agreement will usually have the same meanings in the security document, to avoid having to repeat all defined terms in the security document.

· There will be wording in the security document to the effect that terms defined in the loan agreement (itself defined in the security document) will have the same meaning when used in the security document, unless expressly defined in the security document.

· Also, a number of provisions in the loan agreement such as the representations and undertakings will (where appropriate) be made in relation to the ‘Finance Documents’. As you have already seen, the definition of Finance Documents will also encompass any security document.

**How is security documented?**

· There are a variety of terms used in the market for describing security documents. For example, the term **‘Debenture’** is often used for security documents containing a comprehensive package of mortgages, fixed and floating charges and assignments. Other terms you may come across include ‘Mortgage Debenture’, ‘Charge’, ‘Security Agreement’ etc.

· You will see a Debenture document (adapted from the LMA form of debenture for teaching purposes) and consider some of its key clauses. The clause references below refer to the clauses in the Debenture.

· For the remainder of these slides, we will be referring to a Debenture.

· In a **bilateral loan** the Debenture will be executed by the borrower in favour of the lender (often referred to as the ‘**Secured Party**’).

· In a **syndicated loan** the Debenture will usually be executed by the borrower in favour of the **security trustee** (who may be labelled the 'Security Agent') for the Secured Parties(which will include all the lenders in the syndicate from time to time).

· This security trustee arrangement will create security for the syndicate as a whole, notwithstanding the identity of the lenders may change during the life of the loan.

**Structure of a Debenture document**

**Broadly speaking, the clauses in a typical Debenture can be categorised as follows:**

· scope of security and creation of security;

· perfection of security;

· protection of secured assets;

· enforcement of security; and

· boilerplate clauses.

**Scope of security and creation of security**

**The following definitions and clauses address the scope of the security a lender is taking and describes the actual security package:**

· **Definition of 'Secured Liabilities**' **(clause 1**): This defines the secured debt (i.e. the monies owed to the lender). The proceeds of sale of the secured assets can only be applied towards repayment of the secured debt plus certain costs associated with the sale of the secured assets. This was considered in Workshop 4 Element 1.

· **Creation of Security (clause 2)**: This clause is known as the 'charging clause' and it sets-out which of the assets of the borrower are being charged and, how each asset will be secured.

**Perfection of security**

**The following provisions assist with enhancing and perfecting a lender's security (as created by the charging clause) over specific assets, by requiring relevant registrations, notices to third parties and deposit of any documents to be carried out:**

· **Land (clause 4):** in particular, in relation to future property (over which there is a fixed charge) an obligation to 'upgrade' this to a charge by way of legal mortgage to be registered at the Land Registry.

· **Investments (clause 5):** in particular, depositing with the Secured Party documents of title relating to any investments (i.e., share certificates) and blank stock transfer forms required to create an equitable mortgage over investments (i.e., shares).

· **Accounts (clause 6):** in particular, how book debts should be dealt with to ensure sufficient 'control' required for a fixed charge and provides for forms of notice to be sent to banks where fixed charges are taken over bank accounts.

· **Insurance policies (clause 7) and Contracts (clause 8):** in particular, forms of notice to be sent to counterparties (insurance company and other contract counterparties) giving notice of assignment/fixed charge of insurance policy/contract to the Secured Party.

· **In addition, the following provisions assist with enhancing and perfecting a lender's security:**

· **Further assurances (clause 16)**: The Debenture will include an undertaking from the Chargor to generally take any steps and execute any documents the Secured Party may require to create, perfect and protect any security. This means the Secured Party could potentially ask for further security beyond the initially agreed package.

· The further assurances clause is backed up by the **power of attorney (clause 17)** which enables the lender to complete the upgrade if the borrower does not cooperate, by signing documents as attorney for the Chargor to take any action which the Chargor is obliged to take but has failed to do so either following that failure or following the occurrenc eof an Event of Default.

· **The following provisions assist with enhancing and perfecting a lender's security:**

· **Notices to third parties (e.g. notices to banks relating to blocked accounts and notices to contract counterparties)(clause 6.3-6.5, 7 & 8)**: Where security is being taken over bank account balances, the secured creditor will usually require the borrower to serve notice to the bank with which the borrower holds the account notifying it of the secured creditor's interest.

· Giving notice to a counterparty is a statutory requirement for a legal assignment of rights by way of security (creating a 'legal' assignment).

· No such statutory requirement exists for a fixed charge over rights, but in practice, a secured creditor would ensure this is done.

**Protection of secured assets**

**The following provisions assist in protecting the secured assets**

· **Undertakings (e.g. negative pledge and no disposals) (clause 3):** The Debenture will contain a negative pledge (even if the facility agreement includes one) to help ensure notice of the negative pledge is given to anyone searching the Companies Registry.

· The form MR01 used to register security and Companies House requires a box to be ticked if the Debenture contains a negative pledge.

· This ensures third parties (including other potential creditors) are notified of its existence and reduces the risk of the lender losing priority to other secured creditors.

· You would also expect to see undertakings protecting secured assets such as no disposals and to maintain and insure the secured assets.

**The following provisions assist in protecting the secured assets**

· **Collection of receivables/blocked accounts (clause 6.1 and 6.2):** To demonstrate sufficient control to constitute a fixed charge over receivables in line with the principles in the **Spectrum** case and the **Re Avanti** case(see Workshop 4 Element 2) a Debenture will usually require the Chargor to collect any book debts arising in the ordinary course of business and pay them into a specified account, which may be a blocked account.

**Enforcement of security**

**Enforcement of security (clause 9):** Although common law and statute provide the lender with implied rights of enforcement, the Debenture will expressly specify when and how the lender's right to enforce security arises, namely following an Event of Default.

The Debenture will give the lender a right to appoint a receiver of the secured assets, an administrator, or (if permitted) an administrative receiver.

By way of summary, a lender's options will be:

· appoint a receiver over the property and assets charged by its security document;

· place the borrower into administration under Schedule B1 IA 1986 (remember that if the lender has a qualifying floating charge, it will be able to appoint its own choice of administrator using the out of court procedure);

· if the lender has a 'grandfathered' floating charge or falls under one of the limited exceptions, it can appoint an administrative receiver; or

· petition for the borrower to be wound up (i.e. liquidation ss. 73-229 IA 1986).

**Boilerplate provisions**

As in any commercial contract, a Debenture will contain a number of boilerplate provisions dealing with administrative matters (e.g. notices, governing law, etc.). We are going to focus on certain boilerplate clauses which also help overcome certain problems posed by common law when taking security.

Creating and perfecting security is not always enough to protect a lender, especially in relation to an overdraft facility or revolving credit facility (“**RCF**”). The consequences of the three following common law rules play a role in how lenders draft security documents:

· the rule in **Clayton's Case** (presumption that money paid into a running account repays the earliest debt first);

· presumed discharge (repayment releases security); and

· the rule in **Hopkinson v Rolt** (loss of priority of further advances made by a lender to a subsequent lender).

Further explanation of these problems and the clauses a Debenture should include to 'overcome' these problems is covered below.

**How does common law affect the drafting of security?**

**‘Repay/release problem’** - at common law, if a borrower repays a sum of money for which it gave security, when it repays that sum, the security will be released. This rule also operates in relation to guarantees.

**‘Clayton's Case problem’** - The rule in **Clayton’s Case** (Devaynes v Noble (1816) 8 LJ Ch 256) says that, in the absence of an agreement to the contrary between the creditor and the debtor, repayments by the debtor will be used to repay loans in the order in which they arose - i.e. the oldest debt will be paid off first.

**‘Loss of priority problem’** - Under the rule in **Hopkinson v Rolt** (1861) HL Cas 514, where a borrower has granted security over its assets to two different lenders (firstly to lender X and subsequently to lender Y), the first priority of lender X in respect of any new advances made under its loan will be lost to lender Y once lender X has notice of lender Y’s security. This is particularly relevant in the case of an RCF where amounts are being continuously re-paid and re-lent during the term of the facility.

**Boiler plate provisions addressing common law issues**

**Boilerplate provisions (which also address issues posed by common law):**

A standard Debenture should include the following boiler plate clauses to deal with the common law rules mentioned above. These clauses should not be deleted:

· **a continuing security clause (clause 2.1)**

· **a ruling off clause (clause 18.2)**

· defining 'Secured Liabilities' as**'all monies'**, but only if this is part of the agreed deal.

**How are these issues dealt with in a Debenture?**

**Clayton's Case problem and repay/release problem**

· **Problem 1**: A bank lends a borrower £10,000,000 under an RCF. The borrower grants a fixed charge over its most valuable assets in favour of the bank to secure this loan. Subsequent to this secured loan, the bank offers the borrower a £500,000 overdraft without taking further security. The borrower utilises the whole £500,000 facility shortly after it is created to pay the salary of its staff. A week after utilising the overdraft, the borrower repays £300,000 to the bank. There is no agreement as to which facility (secured loan or unsecured overdraft) will be repaid.

· As per the rule in Clayton’s Case, the £300,000 will go towards repayment of the oldest debt first – i.e., part repayment of the secured loan. As a result, of the £10,200,000 now outstanding, only £9,700,000 is secured. Clearly the bank would prefer to use the repayment to pay off the unsecured overdraft first, so that it would have £200,000 unsecured and the whole £10,000,000 secured.

· A further complication arises as and when a total of £10,000,000 (i.e., the amount originally borrowed under the RCF) has been repaid - which may be sooner rather than later if the rule in Clayton’s Case is applied.

· This is because of the related common law rule that security will be released as soon as the secured debt has been repaid. If the borrower subsequently redraws the £10,000,000 under the RCF, it will be unsecured.

· The same principles will apply in relation to a term loan available in a succession of tranches – once the first advance (technically an individual loan) is repaid, the position at common law is that the security will be released. This is a risk for the lender.

**Clayton's Case problem and repay/release problem – solutions**

· A lender may seek to ensure that **‘all monies’** ever owed by the borrower to it fall within the ambit of the security – often this is done by expressing that the security is **‘all monies’**, in the definition of Secured Liabilities. Doing so will ensure that an original loan between the lender and the borrower will be secured alongside any additional arrangements entered into such as an overdraft. This makes the rule in Clayton’s Case less of an issue.

· A lender will also want to ensure that its security is described as **'continuing'** - this will mean that the security will not be discharged by repayment of the initial loan advance (such as when the initial amount of any loan agreement is paid). It will instead continue for the entire term of the loan regardless of any intermediate repayment and re-borrowing.

· It will be apparent why this wording is especially important in relation to a secured RCF, as this can involve the whole of the loan being repaid before being re-borrowed. The use of the word 'continuing' to describe the security effectively overrides the repay/release problem.

**Loss of priority to subsequent mortgagees**

· **Problem 2:** Bank X lends a borrower £100,000,000 under a secured RCF (with no negative pledge). A month later, Bank X receives notice of a subsequent charge created in favour of Bank Y, who has lent £50,000,000 to the borrower. The borrower then repays £50,000,000 to Bank X and re-borrows it under the terms of the RCF.

· The rule in Clayton's Case means that the repayment of the £50,000,000 to Bank X (after Bank X has received notice of Bank Y's charge) has the effect of discharging the debt owed to Bank X by that amount. This means Bank X now has first ranking for the remaining £50,000,000 of its loan.

· The re-drawn £50,000,000 ranks behind Y's loan.

· The solution is for the lender to 'rule off' the customer's account in the lender's books when it receives notice of the subsequent charge and open a new account to which all subsequent payments are credited. It is common for a Debenture to provide that this shall be deemed to have been done even if, in practice, the lender does not get round to doing it.

· By opening this 'new account', the whole of the debt on the date when bank X receives notice of Bank Y's security, remains secured and keeps its first ranking priority.

**Loss of priority to subsequent mortgagees – ‘tacking’**

· Tacking allows a lender to secure further advances under existing security which will rank in priority to any subsequent security created in favour of another lender.

· It relates to security over**registered land only.** Under s.49(3) Land Registration Act 2002, a lender is permitted to ‘tack’ where a lender is obliged to make further advances under a loan facility (as would be the case under an RCF or a term loan with outstanding tranches to be drawn). This will be called a 'further advances' clause in the loan agreement.

· This is provided the obligation to make further advances to the borrower is noted on the Charges Register at the Land Registry. In addition, in an RCF the security would need to be described in the Debenture as **'continuing'** (as explained previously) to ensure the security is not discharged when repayments under the RCF are made.

· Applying this to the previous example, assume Bank X is only taking security over registered land and that at the time of registration of the security at the Land Registry, Bank X had noted on the Charges Register its obligation to make further advances up to £100,000,000 pursuant to the RCF. Subsequently, Bank Y notifies Bank X of its security over registered land for £50,000,000 lent by Bank Y to the borrower.

· Because Bank X ‘tacked on’ further advances under the RCF on the Charges Register at the time of registering its security, the new advance of £50,000,000 by Bank X (the borrower having repaid and asked to re-borrow the same amount in accordance with the RCF) will not rank below Bank Y’s security (as would be the case on application of the rule in Hopkinson v Rolt). Consequently, Bank X preserves its first priority for the full £100,000,000, so ‘tacking’ has defeated the rule in Hopkinson v Rolt.

· The concept of tacking also exists in respect of unregistered land, but further consideration of this is outside the scope of the knowledge stream.

**Consecutive secured loans**

· **Problem 3:** Three years ago, Bank A took security over the borrower’s food factory for a £40,000,000 loan. One month ago, the same bank took security over the borrower’s warehouse for a £55,000,000 loan. Shortly after taking out the second loan, the borrower repaid £15,000,000 to Bank A, with no indication as to which loan was to be repaid.

· Under the rule in **Clayton’s Case**, in the absence of agreement to the contrary, the **earlier** loan will have been paid off first. Since the ‘**hardening periods**’(see below)for the security granted in respect of this loan had expired, whereas those for the security granted in respect of the later loan had not, this would have left the bank unnecessarily exposed to the risk of the security granted in respect of the later loan being disapplied.

· **Solution:** The bank can draft the security document to permit it to appropriate sums in any way it wants. This allows it to override the rule in Clayton’s Case and to apply repayments to the more recent loan first.

**Hardening Periods**

Security granted by a company which enters an administration or liquidation shortly afterwards may be challenged or avoided in certain circumstances under the Insolvency Act 1986:

· as a transaction at an undervalue if the consideration received by the company in exchange for granting the security is significantly less than the value of the security (any transaction in the two-year period before the onset of insolvency can be challenged) (s.238);

· as a preference if the granting of the security placed the lender in a better position in the subsequent insolvent liquidation of the company (any transaction during the six-month period before the onset of insolvency, or any transaction with a ‘connected person’ in the two years before the onset of insolvency can be challenged) (s.239); or

· by floating charge avoidance (any floating charge not granted for valuable consideration created in the 12 months before the onset of insolvency and any floating charge created in favour of a ‘connected person’ in the two years before the onset of insolvency is void) (s.245).

For ss.238, 239 and 245 to apply, the company must be “insolvent” at the time it grants the security or become insolvent as result of entering into it. ‘Insolvent’ for these purposes means cash flow or balance sheet insolvent.

The periods of time in which these transactions can be challenged are referred to as **‘hardening periods’**. One of the reasons that a lender will seek a directors’ certificate as a condition precedent to the initial drawdown of a loan is to get the directors of a company to confirm its current solvency. In this way, the lender seeks to reduce the risk of a subsequent attack of its security package by an administrator or liquidator.

**Summary**

· There will be a separate security document in a secured loan transaction. A security document containing a comprehensive package of mortgages, charges and assignments is known as a Debenture.

· A typical Debenture will set out the parties, the borrowings the security relates to (secured liabilities), the assets secured by the Debenture with security interest (charging clause) and various boilerplate provisions, including enforcement provisions and provisions relating to the perfection of the security and protection of the secured assets.

· Certain boilerplate clauses in a Debenture help overcome problems created by common law when taking security, such as release of security on repayment or loss of priority to a subsequent secured creditor.