**Nature and purpose of security and quasi-security**

This element explains the nature and purpose of security and quasi-security and how it is used in debt finance transactions.

**Introduction**

Having considered the loan agreement, attention now turns to the security package the lender may require and drafting the security document.

A lender can make a loan on an unsecured basis, but that would make the lender an unsecured creditor. If the borrower defaults and becomes insolvent, the lender's claim against the borrower will rank alongside other unsecured creditors. An unsecured creditor only has a personal claim against the debtor and has no direct claim against the debtor’s assets.

Due to the statutory order of payment of creditors on the winding-up or administration of a company's assets, other types of creditors will rank ahead of unsecured creditors, meaning the lender risks losing some or all of their money.

This is why a lender will want to be a secured creditor by taking security, as they will enhance their chances of getting their money back.

Essentially, security is where the lender has a proprietary right in an asset of the borrower.

By contrast, quasi-security broadly provides a lender with a way of recovering their money, but does not create rights over an asset of the borrower.

**What is security?**

The aim of security is to protect a lender from the possible insolvency of a borrower. If a lender holds security over the assets of a borrower, then this increases the likelihood of the lender being repaid.

When a lender holds security over an asset of the borrower, if the borrower defaults, then the lender can step in and take possession of that asset or sell that asset to repay any outstanding amount that is due on its loan to the borrower.

Depending on the type of security taken, the lender may effectively 'control' the asset in that it cannot be disposed of by the borrower without the involvement of the lender.

Taking security also gives lenders certain rights under insolvency legislation, for example the right for a 'qualifying floating charge' holder to appoint its own choice of administrator using the out-of-court procedure.

Under insolvency law, the claims of secured creditors rank ahead of those of unsecured creditors and shareholders.

The right for a lender to enforce its security will be triggered when a borrower defaults under the connected loan agreement.

**Which obligations are secured?**

The proceeds of sale of the secured assets can only be applied towards repayment of the secured debt (i.e., the monies owed to the lender). This is typically defined in the security document as the ‘**Secured Liabilities**’.

Secured Liabilities is usually defined in one of two ways:

- all monies; or

- limited to amounts under a specific loan agreement.

See slides below for examples.

**Secured Liabilities- 'all monies'**

As a simple example, with 'all monies' security the Secured Liabilities may be defined as:

**'all present and future liabilities and obligations of the Borrower to the Lender which are, or may become, due owing or payable on any account whatsoever'**

'All monies' security is used where all the borrower's financing arrangements are to be secured by the security and will cover the initial borrowing as well as future financing obligations (whether known or unknown at the point the security is entered into).

**Secured Liabilities- Limited to amounts under specific loan**

The alternative, and more common, formulation is for the Secured Liabilities to be limited to amounts owed under a specific loan agreement. This may (as a simple example) be defined as follows:

**'Secured Liabilities means all present and future monies, obligations and liabilities owed by an Obligor to the Lender, whether actual or contingent and whether owed jointly or severally, as principal or surety or in any other capacity, under or in connection with the Finance Documents, together with all interest (including, without limitation, default interest) accruing in respect of those monies or liabilities.'**

'Obligor' will include the borrower and any other entity providing security and/or gurarantees to the lender; and 'Finance Documents' will include the loan agreement, any security documents/guarantees and any separate fee letters.

**What are the secured assets?**

A lender may take security over just one asset, or over all the assets of a borrower, depending on the deal.

An important point to note is that it is not uncommon for a lender to take security over assets with a value far in excess of the amount of money lent. One reason for this could be that the lender is concerned that the value of the assets may reduce over time, or it may be driven by the desire of the lender to take security over all or substantially all the assets of the borrower in order that it has a 'qualifying floating charge'.

A borrower may agree to give full security as it has an “equitable right of redemption” to compel the lender to release the security as soon as the secured debt has been repaid even if the date for repayment has passed.

**How is security documented?**

There will be a separate security document which will set out matters such as in whose favour the security is granted, the scope of the security (i.e., the definition of Secured Liabilities), the identity of the secured assets and the type of security taken over that asset and various other undertakings and boilerplate provisions.

Security will also need to be 'perfected' i.e., brought to the attention of those who need to know about it for the security to be effective. Some examples of perfection methods include (but are not limited to) registration at Companies House, notification to third parties or registration at various other registries.

**What is quasi-security?**

- Guarantees

- Indemnities

- Comfort Letters

The above instruments are sometimes discussed by lenders in the same context as security, although they are not ‘security’ in the true legal sense.

Quasi-security differs from security as quasi-security only provides the lender with a contractual claim against the guarantor or indemnity provider.

Unlike security, these do not give the lender 'proprietary' rights over the borrower's assets- i.e., the lender has no right to take possession of or sell any of the borrower's assets.

However, in some cases guarantors may be required to separately provide security for the secured liabilities owed by the borrower in which case the lender would obtain proprietary rights over the assets of the guarantor.

Lenders will frequently require a guarantee/indemnity from each member of the borrower's group in respect of the borrower's payment obligations.

**Guarantees and Indemnities**

A guarantee is a promise by one party (the guarantor) to answer for another party's liability on a default (i.e., if a borrower defaults under the loan agreement, the lender can pursue the guarantor directly for repayment).

A guarantee is a **secondary obligation** between the parties in that its validity is dependent upon the **primary obligation** (i.e., the loan agreement between the lender and the borrower) being/remaining valid.

Linked to this is the fact that if the primary obligation is void (or is discharged) the guarantee will fall away. Lenders will therefore include provisions to the effect that the guarantee will survive failure of the primary obligation (the borrower’s obligation under a loan) and add **an indemnity** which creates a separate stand-alone primary obligation on the part of the guarantor to indemnify the lender for any loss if the borrower does not satisfy its obligations.

The key point is an indemnity will survive the invalidity of the underlying loan agreement, whereas a guarantee will not.

Consequently, the guarantee provisions in the LMA Agreement include both a guarantee and an indemnity.

**Comfort letters**

Comfort letters are usually seen in the context of support being given by a parent to support the obligations of a subsidiary where it may not be possible for a lender to obtain security or a guarantee and indemnity. For example, the parent company may be constitutionally or contractually prevented from doing so.

In such circumstances the lender may agree to accept a comfort letter (also known as a support letter or letter of intent) from the parent company. Such letters are not usually intended by either party to be legally binding, however they do represent a moral obligation which will provide some reassurance to the lender that a parent will stand by its subsidiary.

Care needs to be taken when drafting comfort letters, so as to make the terms non-binding.

Usually, they include very general statements of intention and support - e.g., that the intention of comfort letter provider is to maintain investment in its subsidiary , and that it is aware of and supports its subsidiary's borrowing.

**Summary of why would a lender want security/quasi-security?**

In short, it will protect a lender and give it a better chance of getting its money back. This is particularly important if the borrower is a higher credit risk to the lender.

**If security is granted to a lender, the lender:**

has direct recourse to the asset over which the security was granted;can avoid the need for litigation if the borrower defaults;obtains better priority against other creditors on the insolvency of the borrower; andhas an increased likelihood of recovering the debt.

**If quasi-security is granted to a lender, the lender:**

can pursue a separate contractual right against the guarantor or indemnifier;can take steps to pursue a moral claim against the comfort letter provider;has an increased likelihood of recovering all or part of the debt from an alternative source to the borrower.

**Why would a borrower (or other obligor) agree to give security or quasi-security?**

**Lack of credit history:** If a borrower is a newly incorporated entity, it will not have historic financial or trading data. Without this it will be harder for the lender to assess the credit risk and the lender may require security and/or quasi-security to be given at least for an initial period of time.

**Asset specific finance:** If a borrower is raising funds to acquire a specific asset it would be usual to grant security over that asset to the provider of the finance. If the asset were later sold the proceeds realised would be applied to prepay the loan.

**Weak credit status:** If a borrower has a weak credit status, a lender may refuse to lend to it without the benefit of security and/or quasi-security.

**Cheaper borrowing:** If a borrower is able and willing to give security and/or quasi-security, this may result in cheaper borrowing costs (the credit risk being taken by the lender is less, so a lower interest rate will usually be payable).

**What is recourse?**

An important element of assessing the risk of a loan is working out where the money will come from to repay it, either from the borrower’s operations (while it is still trading) or, in the worst case, from the sale of its assets on insolvency. The term used for the lender’s claim on certain assets for repayment of the loan is “recourse”, and the lender needs to ensure it has recourse to sufficient assets.

Therefore, the scope of the security package needs to be appropriate in the context of the transaction as a whole, taking into account the credit rating of the borrower, the lender's assessment of risk, size and structure of the transaction and the borrower's key assets. This will then determine both which assets should be subject to security and what type of security interests should be taken.

If a lender lends to a borrower in a corporate group, then the borrower and its subsidiaries and/or sister companies may be required to give guarantees and indemnities and security. Together we call the borrower, and any other group company giving a security/guarantee, the 'Obligors' (and each an 'Obligor'). This will be a defined term in the loan agreement.

**Task: can you think of any situations where a borrower may be unable to give security or quasi-security?**

**Why may a borrower be unable to give security/quasi security?**

**Restrictions in an existing loan agreement.**

**Negative pledge:** As you have seen, this is one of the general undertakings usually found in a loan agreement and it prohibits the creation of further security in competition with the lender which has advanced funds under the loan agreement.

**No further financial indebtedness**: There may also be an undertaking included that restricts the total amount of financial indebtedness incurred by a borrower. As guarantees and indemnities are likely to fall within the definition of ‘Financial Indebtedness’, the giving of these may breach any such undertaking.

**Financial Assistance.** The borrower's lawyers will need to be alive to whether the giving of any security or quasi-security (such as a guarantee or indemnity) as part of the transaction would amount to unlawful financial assistance under sections 677-683 Companies Act (‘CA’) 2006.

**Articles of Association:** The Articles of Association of a borrower may restrict or prohibit it from granting security and/or quasi-security. While it may be possible to amend the borrower’s Articles in order to permit it to do so, this will depend on the entity in question, as for a public limited company with a large number of shareholders this may not be feasible.

The check of a potential borrower’s Articles of Association is something that is key at the outset of a transaction and the lender’s lawyers (particularly trainees) are often tasked with checking this information. A particular concern in certain transactions will be restrictions in the Articles of Association making enforcement of security over shares problematic, such as directors having a discretion to refuse to enter a transferee (i.e., the lender) of the shares into the register of members of the borrower. Such restrictions will need to be removed from the Articles of Association.

**Commercial contracts.** Itcould be the case that commercial contracts may contain an absolute prohibition on assignment or prohibit security being taken over the benefit of the contract without the prior consent of the contract counterparty. In either case the issue needs to be investigated as part of the due diligence and if necessary, addressed before the security is taken.

**Summary**

The aim of security is to protect a lender against possible default by the borrower under the loan agreement.

When a lender holds security over an asset of the borrower, if the borrower defaults, then the lender can step in and can have the sale proceeds of the relevant asset applied in repayment of any outstanding amount that is due on its loan to the borrower.

Quasi-security does not give a lender rights over a borrower's assets but assists a lender in recovering its debt by allowing a personal claim against a guarantor or indemnity provider.

Where an entity (e.g., a parent company) is unable to give security or a guarantee (e.g., due to undertakings in its other loan agreements), a lender may require a comfort letter as reassurance of the parent's continued support of its subsidiary (to which the lender is making the loan).

Any contractual, constitutional or other legal restrictions preventing a borrower from granting security will also need to be considered by the lender at the outset.