**Types of security**

This element explains the different types of security interest available to a lender, the assets that may be secured and some practical and commercial considerations when taking security.

**Main types of security**

* Assignment by way of security (e.g. borrower's rights against a third party)
* Taking physical possession of asset:
  + Pledges
  + Liens
* Transferring ownership in asset:
* Mortgages
* Giving rights over assets:
* Charges

**Charges**

**What is a charge?**

A charge is an equitable, proprietary interest in and to the asset.

**What does the lender achieve?**

A charge gives the lender the right to have recourse to the charged asset in order to satisfy the secured debt. There is no transfer of title to the asset itself.

The main types of charges are fixed and floating charges which we will look at in further detail on the next slide.

**Fixed Charges**

A fixed charge attaches to an asset as soon as the charge is created. It gives the lender a claim over the proceeds of sale of that asset in priority over other creditors of the borrower.

For a fixed charge to be validly and effectively created as such (so that it is not instead classed as a floating charge), the lender has to show a sufficient level of **control** over the asset. This is normally done by insisting, in the security document, that the owner of the asset (the borrower) gets the consent of the lender to deal with the asset, e.g. to sell it or to create further charges over it.

If the borrower sells an asset subject to a fixed charge, the buyer of that asset takes subject to the fixed charge as long as it has notice of the charge. Provided the fixed charge has been registered at Companies House in accordance with s. 859A-Q CA 2006, the buyer will have 'actual notice' of the fixed charge if it carries out a search of the charges register. The law is unclear as to whether registration would operate as 'constructive notice' on a buyer who has not carried out a search of the charges register, but further consideration of this point is outside the scope of this knowledge stream.

A key element of a fixed charge to consider is that it will not be suitable for every type of asset, because a fixed charge will severely limit the borrower’s ability to deal with that asset.

**Floating Charges**

There are certain types of asset which the borrower needs to be able to deal with freely as part of its business, such as stock. The value of such assets will therefore regularly fluctuate. The most appropriate form of security for fluctuating assets is a floating charge.

Under a floating charge, a borrower is able to deal with the charged assets in the ordinary course of its trade – e.g. to sell, hire or lease them without first obtaining the consent of the lender.

A floating charge ‘floats’ over the charged assets until the occurrence of certain events. On the occurrence of one or more of these events, the charge ‘crystallises’ and fixes on the charged assets. The floating charge effectively becomes a fixed charge, in that the borrower no longer has the ability to deal with the assets over which the charge has crystallised without the lender’s consent.

However, for insolvency purposes the charge itself is still treated as a floating charge for insolvency ranking. This means that the proceeds of sale of the assets subject to it will be applied in paying the fees, costs and expenses of the relevant insolvency office-holder, the debts owed to preferential creditors and in setting aside the prescribed part fund (discussed later) before being applied in satisfaction of the debt owed to the floating charge holder.

**Crystallisation of floating charges**

Crystallisation can occur as a matter of law on the following certain events:

* on the liquidation of a borrower;
* on the appointment of a receiver; or
* if the borrower ceases to carry on business.

A typical security document contains a list of additional triggers, for example an event of default under the loan agreement or any event which, in the opinion of the lender, would put the assets in jeopardy. If any of these events occurs then the floating charge would crystallise.

**How to identify a floating charge?**

**Key case: Yorkshire Woolcomber's Association Ltd [1903] ('Yorkshire Woolcombers')**

In this case the court discussed the characteristics of a floating charge. It was held that a charge would be deemed floating if:

* it is a charge on a class of assets of a company present and future;
* that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and
* by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets.

**Distinction between a fixed and floating charge**

**Key case: National Westminster Bank plc v Spectrum Plus Limited and others** **[2005] UKHL 41** (**‘Spectrum’**).

The House of Lords reviewed the distinction between fixed and floating charges in the above case. The judges generally approved the Yorkshire Woolcomber’s definition but focused particularly on the third element of that definition (i.e., until action is taken by the lender the borrowing company may carry on its business using those assets in the ordinary course of its business).

According to the leading judgement, the essential characteristic of a floating charge, which distinguishes it from a fixed charge, is that “the asset subject to the charge is not finally appropriated as security for payment of the debt until the occurrence of some future event. In the meantime, the borrower is left free to use the charged asset and to remove it from the security”. Conversely, it is an essential characteristic of a fixed charge that assets can be disposed free from the security only with the “active concurrence” of the lender.

Note that the **substance** of the charge is more important than the **label** applied by the parties. To determine whether a charge labelled as fixed by the parties is in fact floating, you need to look at the element of **control** over the asset granted by the charging document, and the nature of the charge evidenced by the terms of the security document, **not** the name which the parties have given to the charge.

**Key case: Re Avanti Communications Limited (in administration) [2023] EWHC 940 (Ch) (‘Re Avanti’).**

The recent case of Re Avanti is the first major case to have considered the Spectrum principles further in relation to the control required for a fixed charge.

In Re Avanti, the High Court held that there should be a more nuanced approach than that taken in Spectrum and that it will not always be necessary for there to be an absolute prohibition on the chargor (i.e. the party providing security) dealing with the charged assets for a fixed charge to be valid.

Instead, there should be a number of factors taken into consideration, including:

* + The nature of the assets;
  + The nature of the business of the chargor; and
  + The level of flexibility and freedom the chargor will have to deal with the charged assets.

Where the chargor agrees to ‘material and significant’ restrictions on the disposal of the assets and a prohibition on the disposal of such assets in the ordinary course of business, the charge likely take effect as a fixed charge. This is on the basis that the lender (as chargee) will be retaining ‘very significant control’ over the charged assets.

Equally, if there are some careful and considered exceptions to the prohibition on disposal, this does not always mean that the charge cannot take effect as a fixed charge.

Therefore, control remains a significant factor in the determination of the charge as a fixed charge under both Spectrum and Re Avanti.

**What are the disadvantages of a floating charge for a lender?**

The borrower is free to deal with the assets subject to a floating charge. Whilst this flexibility enables a borrower to run its business day to day, the risk for the lender is the reduction of the 'pool' of assets available to it on enforcement of its security. Although the lender will benefit from certain contractual protections to mitigate against this, the lender will nonetheless prefer to take fixed charges over important assets.

Floating charges rank behind fixed charges (even those entered into after the floating charge), preferential creditors (such as employees) and the prescribed part fund.

Administrator/liquidator fees, costs and expenses are taken out of floating charge assets (including any tax liability on capital gains arising from disposals made by the administrator in the course of administration.

It is subject to more stringent avoidance rules as in certain circumstances floating charges are void if the borrower enters into liquidation or administration.

A floating charge may not be recognised in other jurisdictions.

**What are the advantages of a floating charge for a lender?**

The lender obtains security, but the borrower retains flexibility to run its business day to day as it is able to dispose of assets subject to a floating charge in the ordinary course of its trading.

Provided the floating charge together with any other security the lender holds over the borrower's assets is over all or substantially all  of the assets of the borrower, a lender will be a holder of a '**qualifying floating charge'**giving it the right to appoint an administrator out of court - see next slide.

Historically, a lender with a floating charge could appoint an administrative receiver with wide-ranging powers to manage the borrower and sell the borrower's assets to repay the lender.

However, for floating charges **created on or after 15 September 2003**, the lender will only be able to appoint an administrative receiver if the charge falls into one of the **‘limited exceptions’**(e.g., the floating charge was created in relation to certain project financing or capital markets transactions). The detail of these exceptions is outside the scope of this knowledge stream.

Therefore, if the floating charge was created on or after 15 September 2003 and **does not fall within one of the ‘limited exceptions’**, the lender can **no longer** appoint an administrative receiver, but as a holder of a ‘**qualifying floating charge’** (as defined below) such a lender has the power to appoint its own choice of administrator by using an out-of-court procedure, which is quicker and cheaper than the court-based process of appointing an administrator.

A ‘**qualifying floating charge**’ is one which fulfils the requirements of paragraph 14 of Schedule B1 to the Insolvency Act 1986.

Essentially, this means that (i) a floating charge, which together with any other security the lender holds over the company's assets is over the whole or substantially the whole of the company’s assets and (ii) the document creating the floating charge must state that paragraph 14 applies or purport to grant to the lender the power to appoint an administrator.

**Mortgages**

**What is a mortgage?**

A mortgage is a transfer of ownership of an asset to the lender.

In the case of a legal mortgage, it involves the transfer of legal ownership. In the case of an equitable mortgage, it involves the transfer of beneficial ownership.

With a legal mortgage the lender then becomes the owner of the asset, subject to a right of redemption following repayment by the borrower.

[Diagram:

“Legal mortgage” arrow to “Legal Ownership”

Equitable Mortgage “arrow to” Beneficial Ownership]

**Legal mortgage**

A legal mortgage involves a transfer of legal title to an asset to the lender, subject to:

* an obligation on the lender to transfer the asset back to the borrower on repayment of the loan (known as the ‘equity of redemption’); and
* a right to take possession of and sell the asset on default.

Assets which may be subject to a legal mortgage include ships and aircraft. Provided the mortgage is created by deed, the lender will enjoy a power of sale pursuant to s. 101 Law of Property Act 1925 (the **'LPA 1925’**).

A transfer of legal title to certain assets (such as shares) bring greater administrative burdens and potential liabilities, so an equitable mortgage or fixed charge may be preferable, as there is no transfer of legal title on their creation. Taking security over shares is considered further later on in these slides.

Legal mortgages cannot be taken over future property- the asset must be owned by the chargor when the security is created. Also, legal mortgages can only be created over legal interests in assets (not equitable interests).

**Mortgages over land**

Under the LPA 1925, a legal mortgage over land can only be created by way of a “charge by deed expressed to be by way of legal mortgage” (s. 87 LPA 1925). It does not transfer legal title to the asset but gives the secured creditor similar rights. Crucially, the lender benefits from a power of sale over the land.

In practice this may be referred to as ‘a charge by way of legal mortgage’, ‘legal mortgage’ or a ‘first legal mortgage’. In addition to registration at Companies House, charges by way of legal mortgage should also be perfected by registering at the Land Registry in order to obtain priority over subsequently created security interest.

As it is not possible to create a charge by way of legal mortgage over land acquired after the date of the security document (a debenture) then a lender will usually take an equitable mortgage over any future land with an assurance from the borrower that they will ‘upgrade’ the fixed charge over such land to a charge by way of legal mortgage as and when the lender requires it. This ‘upgrade’ will occur by the borrower executing a short supplemental mortgage and registering it at Companies House and the Land Registry.

**Equitable mortgages**

Equitable mortgages do not involve a transfer of legal ownership but a transfer of the beneficial interest in an asset. An equitable mortgage is created with less formality than a legal mortgage. There is no practical difference between an equitable mortgage and a fixed charge – both will give the lender a proprietary interest in the asset concerned.

A ‘bona fide’ purchaser for value without notice of an equitable mortgage would buy the asset free of the mortgage. Registration of the equitable mortgage at Companies House is therefore very important (and is a requirement pursuant to s.859A CA 2006 in any event).

This will ensure a purchaser has 'actual notice' of the equitable mortgage by searching the charges register. The law is unclear as to whether registration itself would operate as 'constructive notice' on a purchaser who hasn't carried out a search of the charges register, but further consideration of this is point outside the scope of this knowledge stream.

**The differences between mortgages, charges and charges by way of legal mortgage:**

The theoretical difference between these three types of security is that:

* a **mortgage** is the conveyance of an asset to the lender - i.e., the transfer of title (either legal or beneficial) to the asset. The lender becomes the owner of the asset subject to a right of redemption – i.e., the lender has to transfer it back to the borrower following repayment of the underlying loan.
* a **charge** gives the lender proprietary rights in the asset, but there is no transfer of title to the asset itself.
* a **charge by way of legal mortgage (applies to land only)** does not transfer title to the asset. Instead, it grants the lender the same powers, protection and remedies as if the mortgage had been created by way of a lease for a term of 3,000 years.

**Security by taking physical possession of an asset**

**(Note: these are not commonly used in debt finance transactions)**

**Pledge**

A pledge arises where a lender takes actual or constructive delivery of an asset until repayment of a debt. An example of constructive delivery is where the lender receives the keys to a safe deposit box which contains the relevant asset. No other formalities are required, but to avoid any argument that an item has merely been deposited for safekeeping, a letter of pledge or a memorandum of deposit is usually provided. There is an implied power to sell the asset if the debt is not repaid.

To be valid, the pledge must provide the lender with control of the asset. The lender taking a pledge has liability as bailee and it must keep safe custody of the asset alongside ensuring that the asset is insured.

The borrower loses possession of the asset for income-generating purposes.

**Lien**

A lien is a right to retain another’s property until that person meets an obligation such as payment for services. This is different from a pledge where an asset is delivered to and retained by a lender until a debt is repaid. The right arises automatically by operation of law and typically (although not always) involves possession of the property.

For example, where a mechanic is in possession of a car for repair they are able to retain the car until the owner has paid the repair bill.

**Assignment by way of security**

The borrower’s rights under a contract (also referred to as a ‘chose in action’) can be a valuable asset over which the lender may wish to take security. Examples of a borrower’s contractual rights against a third party include where a borrower has (i) the benefit of an insurance policy with an insurance company, or (ii) is owed interest and principal under a loan it has made, or (iii) has a valuable income-stream under a supply contract with a third-party (the contract counterparty).

The borrower can create security over the benefit of each of these arrangements in favour of a lender.

This is subject to checking first whether the consent of the counterparty is required for an assignment, or whether a contract contains a prohibition on assignment. This issue needs to be addressed before security is taken. If consent cannot be obtained, there is little point in taking the security in the first place.

Security over contractual rights is usually taken in the form of an assignment by way of security or a fixed charge – this will generally be a matter of preference for the lender.

An assignment will either be legal or equitable depending on how it is created, as discussed below.

**Difference between legal and equitable assignment**

**Legal Assignment**

If the assignment satisfies the criteria set out in s. 136 LPA 1925, it will be a **legal** assignment (or a ‘statutory assignment’) and will be equivalent to a legal mortgage in that the ownership of that right passes to the lender. However, because the assignment is only intended to serve as security, the security document will also contain a proviso for re-assignment on satisfaction of the secured obligation by the borrower.

Section 136 LPA 1925 sets out the requirements for a legal assignment. It must be:

* in writing;
* an absolute assignment (subject to a proviso to re-assign) in that the **whole** of the asset must be assigned, not just part of it;
* signed by the assignor; and
* **notified** to the original debtor/contract counterparty.

**Equitable Assignment**

An **equitable** assignment will arise if the parties intend to create an assignment, but one or more of the elements of s. 136 LPA 1925 are not satisfied. The element most likely to be missing in an assignment by way of security is notice to the original third party involved in the arrangement.  For practical purposes, it is less important whether an assignment is legal or equitable and more **important whether notice has been given.**

**Practical and commercial considerations when taking security**

The key point to bear in mind when considering the adequacy of a security package is that it is not its value at the time the security is taken which matters, but what its value would be in an enforcement situation – particularly in the event of the borrower’s insolvency. So, in considering what security to take and which other matters to consider, it is the enforcement of the security which must be uppermost in a lawyer’s mind.

**Consequently, the lender and its lawyers must consider various issues, such as:**

* if the consent of the contract counterparty is required for the assignment of a key contract, that issue needs to be addressed before the security is taken. If consent cannot be obtained, there is little point in taking the security in the first place;
* will the lender enforce security over the whole of a business by way of a share sale or an asset sale, or will the lender want the option of being able to do either - i.e., should the lender consider taking a charge over the shares of the borrower in addition to charges over the assets owned by the borrower?

Continued

**Practical and commercial considerations when taking security**

* will each secured asset retain its value? Is it a perishable item or an item which could quickly become obsolete? A lender needs to be aware of the risk of depreciation of certain assets (e.g. plant and machinery), although this in itself will not prevent a lender taking security over such assets;
* is there existing security over any asset(s)? If so, assess whether it will be possible for the borrower to grant further security over such asset(s) - i.e. will any negative pledges be triggered? Also, even if it is possible to grant further security, consider the implications of having more than one competing security over the same asset (i.e. a subsequent lender will rank below an original lender with prior security correctly created and registered);
* can the asset be sold easily? Is there a ready market for it? Can its value be ascertained? For instance, there may be no ready market for shares in a small private limited company; and

For certain assets there are further issues which need to be considered when contemplating taking security, which are discussed in the next few slides.

**Fixed charge over book debts**: It is not sufficient for the security document to describe the charge as ‘fixed’. The judgement in *Spectrum* stated  that the categorisation of whether a charge is fixed or floating depends upon the commercial nature and substance of the arrangement, not what the parties have called the charge in the security document.

* The label that the parties have given to the security may indicate the parties’ intention in this respect, but it is not conclusive. It is a question of substance over form.
* The lender needs to demonstrate sufficient control over book debts and the proceeds of their collection for there to be a fixed charge. If control is lacking, it may be re-characterised as a floating charge.
* If a fixed charge is to be taken over book debts, some controls will usually be documented in the security document. It is common for a floating charge to be taken in respect of book debts arising from the sale of goods and services.

**Security over shares:** Practical steps to take when taking security over shares include checking that:

* the directors do not have the right to refuse to register a transferee (i.e., the lender or a buyer of the shares following enforcement) in the register of members of the company; and
* pre-emption rights do not apply to a transfer of the shares on enforcement.
  + If there is a right to refuse a transfer or pre-emption rights do apply, the Articles of Association of the relevant company must be amended **before** the relevant security is granted. This type of check is done at the outset of the deal through due diligence and can be a common trainee task. The Articles of Association (with any amendments) will be one of the conditions precedent documents.

Practical steps to take when taking security over shares include checking that:

* Will the lender become a person of significant control ('PSC') (as covered in Business Law on the SQE 1 preparation course), giving rise to a registration requirement on the borrowing company's PSC Register. A company is required to request information from any legal entity it knows or reasonably believes to be a PSC required to be registered on its PSC register. If a legal entity with a relevant interest in the company (i.e. shares) fails to respond to the request, the company may issue a restrictions notice freezing the relevant interest. From a debt finance perspective, this is relevant in the context of taking security over shares. If a restrictions notice is issued, it could affect whether the security over shares can be taken, enforced or whether voting rights can be exercised.
* Will the grant of security over shares trigger a mandatory notification requirement to the Secretary of State for Business, Energy and Industrial Strategy under the National Security and Investment Act 2021.

Further checks to make include:

* Are the shares in an **un**limited liability company? In this situation, the liability of the shareholder is not limited to the nominal value of the shares but is unlimited.
* Is there any amount unpaid on the shares?
* Are there any liens over the shares?
* Does the company whose shares are mortgaged or any of its subsidiaries operate a defined benefit pension scheme? If so, the lender needs to be advised that, should the scheme be in deficit at the time, or after enforcement, of the legal mortgage, the lender may be liable for that deficit if it is ‘associated’ or ‘connected’ with the company (see below). This can be the case even if the liability is in a subsidiary of the company whose shares are mortgaged.

The strongest form of security which can be taken over shares is a **legal mortgage**.

* In order to perfect a legal mortgage over shares, the borrower will execute a stock transfer form in favour of the lender and the lender will then be registered in the register of members of the company whose shares are being charged.
* The lender will also receive share certificates in its name – in other words, the lender becomes the legal owner of those shares, subject only to the right of redemption.
* This means the lender has the right to receive notices to vote, to receive dividends, to receive bonus shares, is treated as a member of the company and can more easily, effect a quick sale of the company.

However, there are disadvantages to a lender in taking a legal mortgage of shares, namely:

* being a member of the company will involve a degree of administrative duties such as attending meetings and voting. A lender may appoint a nominee for this purpose;
* if the shares are partly paid, the lender (as new owner) will be liable for the uncalled amount;
* there is a risk to the lender of the company whose shares have been mortgaged to it becoming a subsidiary for the purposes of the CA 2006, or an associate company of the lender for the purposes of the Insolvency Act 1986;
* the risk to the lender that it becomes liable for a deficit in a defined benefit pension scheme or for environmental issues; and
* the risk to the lender that it becomes subject to the PSC regime (under Part 21A CA 2006).

Because of the disadvantages of taking a legal mortgage discussed above, a lender may choose to take an **equitable** **mortgage** or **fixed charge** over shares instead.

* In order to perfect an equitable mortgage/fixed charge, the lender will usually require the company creating the security to provide it with a signed, but undated, stock transfer form as well as the relevant share certificates.
* The charging document will generally also contain a security power of attorney. The intention is that the lender is able to date the stock transfer form and present it to the company whose shares are secured at such time as the lender wishes to become the registered holder of those shares on enforcement of the security.

**Assignment by way of security/fixed charge over contractual rights:**Where rights under a contract has been assigned, it may provide for payments to be redirected so that they are paid by the contract counterparty directly to the lender from the date of the assignment in which case clearly notice of the assignment will need to be given to the contract counterparty.

* Alternatively, the lender may be happy for payments under the contract to continue to be made to the borrower until an Event of Default or other trigger has occurred at which point notice will be served on the contract counterparty requiring payments to be re-directed to the lender.
* An unnotified assignment is not capable of being a legal assignment because it does not comply with the requirements of s. 136 LPA 1925 (mentioned  above) but more importantly not giving notice will mean that the counterparty will be entitled to: (1) make payments under the contract to the borrower; (2) set off amounts owed to it by the borrower against the payments which it owes under the contract; and (3) amend the terms of the contract by agreement with the borrower, without requiring the lender’s consent.

**Security over insurance contracts:**The lender may wish to take security over rights under insurance contracts by way of an assignment by way of security or a fixed charge. The main types of insurance contract over which a lender will take security are:

* ‘Keyman’ insurance (this covers the risk to the borrower of something happening to an individual who is key to the business); and
* buildings insurance.
* Insurance contracts are entered into on the basis of utmost good faith. If the insured misrepresented facts when entering into the contract, the policy will be void. Non-payment of premium will also invalidate the policy.
* Lenders may try to overcome these two issues with a clause in the security document and a specific agreement with the insurer that states that misrepresentation or non-payment will not invalidate the insurance policy. This is normally strongly resisted by insurers.
* Lenders will generally not want to be ‘**jointly insured**’ with the borrower, as this may increase their potential liability (e.g. they may be liable to pay the premium, and there is the risk that the lender may do something which invalidates the policy).
* Equally, being ‘**noted**’ on the insurance policy is not sufficient protection for the lender, as it will not be a party to the insurance policy and will not be able to enforce the policy directly. The best position for the lender is for it to be referred to as **“co-insured in respect of its separate rights and interests”**.This means that the cover provided is ‘composite’ (i.e., the policy contains two contracts of insurance (1) between the insurers and the borrower and (2) the insurers and the lender). If the borrower’s interest falls away – for instance as a result of the borrower having failed to disclose something relevant or in the event of the borrower’s insolvency – then the lender’s interest should still stand.
* As an absolute minimum, the lender will want to ensure that its interest is noted on the insurance policy so that the bank is notified if the policy is varied in a material way, cancelled or not renewed and the insurers are aware that the bank may be able to claim the charged insurance monies directly or that they may be held by the borrower on trust.

**Summary**

* The main types of security explored on this workstream are:
* Charges (fixed and floating)
* Mortgages (legal mortgages, equitable mortgages and mortgages over land)
* Taking physical possession of an asset (pledges and liens)
* Assignment by way of security
* Certain practical and commercial issues (applicable to all assets and specific to particular assets) also need to be considered when determining the security package for a transaction.
* Broadly, lenders are more concerned about enforceability of security rather than the value of security on creation.