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In Practice

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Second ranking security – drafting pitfalls

In this article the authors discuss the situation where existing security has been granted (from here on S1) and at some later date it is agreed that the chargor will grant fresh security (S2). The beneficiary could be the same under S1 and S2, or there may be a third party financier who is to benefit from second ranking security.

UNDERLYING DEBT AMENDED

S2 is often required in situations where the documentation for the underlying debt has been materially amended. In such cases, S1 will only extend to obligations in the contemplation of the parties at the time it was entered into. This is a complex area of law and various factors will dictate whether S2 is required when amendments are made to the underlying debt documents. Sometimes lenders rely on "security confirmations" from the chargor instead of requiring long-form charge documents for S2. However, the legal effect of a security confirmation is sometimes uncertain and will depend on the nature and scope of the underlying amendments. If significant amendments are to be made to the original debt documents, there is a possibility that a short-form security "confirmation" could be construed as a grant of fresh security (the courts looking at the substance rather than the form of the transaction). If not registered pursuant to s859A of the Companies Act 2006 (CA 2006), this "charge" would be void and lenders relying on the confirmation may also find that S1 does not extend to the amended debt obligations. Practitioners and lenders therefore need to consider the substance of any proposed amendment to the underlying debt documentation in detail. If the amendments are significant such that they cannot be said to have been in the contemplation of the parties at the time S1 was entered into, it may be the case that the full security package comprised in S1 will need to be re-taken.

ASSET TRANSFER

Another scenario arises where an asset is transferred subject to existing security; in this situation the chargor under S2 will be the new owner. This is common where an intra-group reorganisation results in shares or other charged assets being transferred between operating companies; the lender(s) will wish to retain the benefits of S1 but take fresh security from the new owner.

HOW TO DRAFT S2

In both the above scenarios, if S1 is not maintained (or if it is subsequently deemed not to cover the amended obligations), new "hardening periods" will start for the purposes of insolvency clawbacks and interveners could obtain priority. If S1 is kept in place and S2 is to be granted via new long-form charge documents, several drafting consequences follow when drafting S2. The easiest way to draft S2 is to start with the charge document for S1 (which will already reflect the bespoke requirements of the chargor's business, of the chargee and the wider deal) and to make only minor amendments. Key points to note are as follows:

- English law rules on priority are complex and priority will depend upon multiple factors. S1 will commonly purport to grant a "first" fixed charge. While the use of the word "first" in charge and assignment clauses would not be conclusive as to the ranking of S1, it will look out of place in S2 and so the word "first" is usually deleted. The S2 debenture may, for clarity, be labelled "second ranking"; again, however, this label alone will have no bearing on priority.
- If security is granted with "full title guarantee", section 3 LP(MP) A 1994 implies a covenant that the disposition is free from all charges and incumbrances. However, section 6 states that the chargor will not be liable for any matter to which the disposition is expressly made subject. Consequently a construction provision may be added in S2 to state that all references to "full title guarantee" are to be qualified by reference to S1.
- Where the underlying debt obligations have been substantially amended, the express grant of S2 could fuel an argument (eg by an out-of-the-money third party creditor) that S1 did not contemplate (and so does not secure) the amended obligations. This will be considered on a case-by-case basis, but S2 will often include recitals defining S1 and stating that the parties consider that the security interests created under S1 secure payment of the secured obligations, but enter into S2 in case they do not.
- If the underlying debt obligations have been amended or otherwise restated, the secured obligations and the covenant to pay are also likely to require consequential amendment.

PRACTICAL POINTS

There follow a number of minor drafting points based on the common sense guiding principles that the chargor (a) cannot give what it does not currently have and (b) must not tell any lies!

- Most charging clauses imported from S1 into S2 will require little amendment but any mortgages (which entail transfer of legal title to the mortgagee) will require special treatment. In the case of assignments of intangibles, a purported second "assignment" will simply take effect as a second ranking mortgage over the asset assigned in S1. Practitioners adopt a range of approaches to this issue. The easiest drafting option is simply to leave the S2 assignment clause worded as in S1. A construction clause may be added in S2 to clarify that any such second assignment will take effect as a fixed charge over the right or asset and will only take effect as an assignment if the relevant security interest created by S1 ceases to have effect at a time when S2 still has effect. However, some lawyers use variations on this theme; for

instance in S2 the chargor may purport to assign any residual rights it will have once the assigned contracts are re-assigned to it pursuant to the proviso for re-assignment in S1.

- To the extent that title documents have already been deposited with the chargee pursuant to S1, it makes no sense to require the same documents to be re-deposited; this requirement should be amended as appropriate. The chargor will also take care to ensure that no representations or undertakings imported from the S1 document are impossible to comply with.
- S1 will often have required the chargor to serve notices of charge and/or assignment on counterparties (eg account banks) promptly after execution. If so, S2 will often require notices to be served again, but the notice templates will require amendment to reflect the additional layer of security and also the handling of any assignments, as discussed above. Alternatively it may have been agreed that service of notices (eg to perfect an assignment of commercially sensitive contracts per section 136 of the Law of Property Act 1925) is not required until enforcement, in which case drafting changes will be minimal.
- Registration should be considered. If S2 is granted by a UK-registered company or LLP, section 859A CA 2006 effectively requires S2 to be registered at Companies House within 21 days using Form MR01. Failure to register will render S2 void against an administrator, liquidator or any other creditor of the company. Registration of security "confirmations" (discussed above) is not common; in practice Companies House usually rejects applications to register documents which do not include an express charging clause.
- In situations where S2 is granted by the new owner of an asset (where S1, granted by the old owner, has been left in place), section 859C CA 2006 allows S1 to be registered against the acquiring company using Form MR02 (for which there is no time limit). This facility is often missed in practice, but registration of S1 (and not just S2) against the new owner favours the chargee, as it should help ensure to the extent possible that third parties are fixed with actual or constructive notice of S1, being the security which is first in time (and therefore likely to be first ranking).

S2 GRANTED TO NEW LENDER

The above assumes that the chargee in S1 and S2 is the same entity. If S2 is granted in favour of a new financier, the situation is more complex. The new chargee will have to check the terms of S1 and related finance documents for prohibitions (and permitted exceptions) regarding the grant of new security. Most probably a negative pledge will prohibit S2 (and new security will trigger an enforcement event making S1 immediately enforceable) in the absence of consent from the incumbent chargee. Any such consent is likely to be conditioned upon the creation of a priority deed or intercreditor agreement to regulate priority of competing security interests and also the timing and manner of any enforcement. ■

Biog box

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