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Safeguarding guarantees and security as the deal evolves

Using a traffic light approach, we consider the sorts of amendments which might impact on "day one" security.

WHEN MIGHT AMENDMENTS PRESENT A PROBLEM?

We are frequently asked to advise parties to loan finance transactions on the steps to take when secured debt is amended or extended. In our experience, loan facility extensions are becoming increasingly common in the mid-market, as lenders will often commit to a loan with a specified term with a view to extending the scheduled maturity at a later date. This may be because the origination or credit team at the relevant lending institution was not willing to initially extend credit for the longer period or that such team may have been willing to do so, but with the credit made available after the initial period being on different terms – a term out facility replacing a revolving credit facility, for example. Alternatively, it may be because the borrower did not want to incur the cost of upfront fees on longer-dated debt which it may or may not ultimately use.

It is equally common for the quantum of a facility to be increased over time as the borrower's needs evolve. To a greater or lesser extent, this may have been part of the initial "plan". Provisions regarding additional advances may be pre-baked into the facility agreement (by way of an uncommitted / accordion facility). Alternatively, the additional debt may require amendments to the documentation. This may entail a logical "scaling up" of the same project (e.g. increasing the quantum of a subscription facility to reflect an increased borrowing base as a result of further fund closes or continuing to fund the construction of an office block under a development finance facility). Equally however, it could be that funds are required for an entirely different purpose which was unlikely to have been contemplated by the parties when the original documentation was signed.

Often amendments will be made simultaneously to other commercial terms, such as the margin and/or fees or the purpose of a facility. Financial covenants may be reset or an amendment may be required to permit an action that might otherwise have been prohibited under the terms of the original documentation.

If secured debt is amended substantially, there is a risk that the original guarantee and security package will not extend to the amended debt and so there is increased risk of challenges by competing creditors. Understanding that risk and deciding how to act on it appropriately in the commercial context is critical for lenders and borrowers alike. For lenders, a proportionate response is also a key client care issue when the topic is broached with a valuable borrower client.

THE EXTENT OF THE SECURED OBLIGATIONS

At the smaller scale of corporate lending, it is common to see "all monies" guarantees or security which typically cover all a borrower's present and future indebtedness to a particular institution. This is distinct from guarantees or security where the guaranteed / secured obligations are defined by reference to the original facility documentation, as amended from time to time. Where all monies guarantees and security have been taken, amendments or extensions to the underlying indebtedness are unlikely to pose a problem. This is because, by their nature, they cover "all monies" owing to that institution rather than being tied to a particular debt obligation which is now the subject of an amendment or extension.

However, such all monies security is likely to be unattractive to borrowers – not least, because convincing a lender to release it upon repayment of the facility it was initially intended to secure can be problematic. Likewise, security agents will not want to be responsible for collateral realisations relating to debts outside the main credit facility, nor will they (or other creditors which benefit from the same security package) want to find out that debts outside the main credit facility are secured by the security granted to support amounts owing under the main facility agreement.

Consequently, on larger scale financings (such as those documented using Loan Market Association documentation) all monies security is rarely seen. By definition, this means that the security will not extend to a substantially different debt obligation.

FIRST PARTY AND THIRD PARTY SECURITY

It is important to distinguish "first-party" security (i.e. security granted by a borrower solely for its own debt) and "third-party" security. The latter can include security granted by an obligor both for its own obligations and for the obligations of other obligors (i.e. not simply security granted by an entity that is not itself an obligor). First-party security is, generally speaking, more likely to be found to extend to subsequent amendments. On the other hand, third-party security (in the wide sense used here) is more likely to either be discharged by variations to the principal debt or, as a matter of interpretation, found not to apply to the loan documentation as amended. The legal principles at play here are complex and derive from long standing caselaw. A key point to note, however, when seeking to establish whether third party security remains intact is that there are two separate considerations. It is necessary to consider both:

- the *scope* of a surety's[1] obligations (i.e. do the words used in a guarantee or security contract demonstrate sufficiently clearly that the parties intend the surety to be bound by the amended obligations?) and

- the *possibility of discharge* (on the basis that even where a guarantor / chargor appears to have already consented to all manner of variations, this may not cover amendments which go beyond the parties' reasonable contemplation).

The so-called "purview" doctrine may limit the extent to which it is possible (even with state of the art drafting) to avoid the need to re-take security. There is considerable debate both in caselaw and in textbooks as to the nature and effect of this doctrine and it remains a grey area.

RELYING ON BOILERPLATE PROVISIONS

Both guarantees and security documents typically contain copious boilerplate wording which purports both to define the scope of the surety's obligations and to ensure (so far as possible) that future events will not cause those obligations to be avoided. The latter are often referred to as "savings" or "indulgence" provisions.

[1] A "surety", in this context, is someone who promises to support the debt of another; a guarantor or chargor whose liability is triggered upon the default of a principal debtor.

Whilst the transaction documentation may, on its face, appear to extend credit support to a loan facility as amended or varied from time to time, there are limits on how far facilities may be amended or varied without the need for guarantees to be confirmed and security retaken. The law in this area is uncertain and it may not be possible to entirely contract out of the purview doctrine referred to above.

THE IMPACT OF 'CAPS'

It is common for recoveries under a guarantee or a charge to be capped. For example, a director's exposure under a personal guarantee could be capped at £100,000. Alternatively, a third party chargor might insist that its exposure be limited to the proceeds of sale of the charged assets. One might assume that, given this limited exposure, the credit support might less likely be affected by variations to the underlying debt. This would be incorrect, as material changes to the secured or guaranteed obligations could increase the possibility of a default thus putting the surety in a worse position.

DOES CASELAW PROVIDE A USEFUL PRECEDENT?

It is helpful when considering the effect of an amendment to debt documentation to look for a legal precedent. Unfortunately, most of the cases on this topic simply do not relate to corporate borrowing with credit support provided by a stack of operating company subsidiaries. Instead, cases involve credit support for a wide range of commercial enterprises including property developments, construction contracts or vessel charterparties. Some of the core cases date from the nineteenth century and few are based on LMA-style documentation. One of the lead cases frequently quoted in legal analysis of this topic relates to a guarantee for the safe return of a flock of sheep! Cases frequently turn on unusual facts and disputes often relate to poorly documented amendments to small bilateral facilities or defects in the boilerplate, which LMA-style documentation should – to a large extent – avoid. Nevertheless, they are often quoted out of context.

When secured debt is amended, each deal is different and there is no one size fits all approach to preserving the security package. It is difficult, for instance, to derive a rule of thumb as to the amount of additional debt which may be incurred without impacting on security.

UNDERSTANDING THE RISK – THE TRAFFIC LIGHT SYSTEM

Using a traffic light approach, we consider the sorts of amendments which might impact on "day one" security. There will not always be a clear cut answer to the question of whether new security is required. Note also the assumption here is that the guarantee and security package is not "all monies" and that it adopts the boilerplate currently used in LMA facility documentation.

Red flags	Amber	Green light
Significant risk that the existing security package is vulnerable to challenge.	**Proceed with caution.**	**Security unlikely to be affected by amendments. Guarantee and/or security confirmations may be advisable.**
• A very large increase in the debt amount, not expressly contemplated in the original documentation (e.g. not provided pursuant to an uncommitted facility). • Very substantial extensions to the scheduled maturity of a loan. • Wholesale refinancing of an existing facility agreement. • A change in purpose or other substantial variation affecting commercial terms, not contemplated by the original loan documentation. • A tranche of additional debt is provided directly by a new lender, in a manner not contemplated by the original loan documentation. • Any case where the surety is in financial difficulties or the solvency of obligors is in doubt.	• Significant increases in the amount of debt. Caselaw provides little guidance as to the exact "tipping point". • An increase to debt amount over and above an express accordion or capped facility extension amount. • Term debt is substantially prepaid; subsequent amendments increase a facility back to (or beyond) the original amount. • Material extensions to the scheduled maturity. • Multiple changes of substance (e.g. increased debt, re-pricing, revised maturity, capitalisation of unpaid interest). One item alone might seem insignificant, but when combined, the effect could be to significantly increase the burden on the surety. • Re-setting financial covenant ratios (e.g. allowing additional debt under an uncommitted facility, the amount of which is defined by reference to a covenant formula). • Boilerplate provisions (LMA standard amendments clause or Obligors' Agent wording, for example) suggest that an amendment is allowed, but objectively this may not have been in the original contemplation of the parties. • Changes made to an extent or in a way not provided for in the clauses governing changes to lenders or obligors. • Changes made in a manner not contemplated by express provisions on procedures for waivers and amendments. • The surety is an individual (especially where the individual is directly involved in the borrower's business). • The guarantor has no financial interest in the transaction or commercial motive. • A new agreement reschedules existing indebtedness.	• First party security – i.e. borrower has granted the security for its own debt (within reasonable limits). • All monies security. • Additional debt made available under an accordion / uncommitted facility (or pursuant to a similar option to request further borrowing, set out in the original documentation). • Increases to the debt amount otherwise expressly contemplated in finance documents. For instance, where an intercreditor agreement (to which the surety is a party) provides for senior headroom of 10 per cent this could form part of the factual matrix showing that such increases were "contemplated". • Limited increases to the debt amount or to debt maturity (although it is difficult to discern a rule of thumb here). • Minor amendments to correct errors in documentation. Waivers granted to avoid a "technical" default. • Non-commercial changes in debt documentation (e.g. updating legal representations). • Tweaks to amortisation schedule (e.g. bringing the final maturity of a shorter tranche in line with a longer one). • Multiple advances and repayments under a revolving credit facility (without increasing overall facility amount). • Other amendments expressly contemplated by bespoke drafting of the guarantee or security documents.

WHAT WAS IN THE CONTEMPLATION OF THE PARTIES?

Security will often fail in situations where a court finds that, in substance, an amendment is so substantial that it could not be described as amendment to the existing deal, but rather as a new obligation – something outside the contemplation of the parties at the time the original documentation was entered into. A court will examine the surrounding facts at the time security was granted. It is therefore potentially in the interests of both borrower and lender to include in the original facility documentation tailored references to the sorts of amendments which could be made over the life of the facility.

For instance, the "guarantor intent" clause used in LMA facility documentation lists a range of potential amendments which are said to fall within the scope of the guarantee. The issue is that, in our experience, this provision is not always adapted to the likely course of the deal and nor is it always replicated in third party security documentation. If such clauses are drafted with care to reflect likely future amendments, as opposed to trying to capture any amendment any party could possibly wish to make at some point further down the line, a court is more likely to give them their intended effect.

UNDERSTANDING HOW CHALLENGES COULD ARISE

When deciding on the best course of action in the context of an amendment to secured debt, it is important to remember that the security documentation is likely to be tested when the surety is financially stretched (possibly insolvent) and that it could be challenged by anyone with a competing interest in the assets in question; for instance an out-of-the-money junior creditor. In such disputes, any ambiguity in the documentation may be construed against a secured creditor.

The economics of mounting a challenge could prove to be relevant. For instance a junior creditor might not think it worthwhile to challenge a 30 per cent. increase to a £200,000 facility. At the other end of the scale, a 30 per cent. increase to a £2bn facility made without fresh security (wiping out the value of junior creditors) might be analysed closely by multiple stakeholders and their advisers, since the cost of challenging the amendment could be small relative to the potential outcome for stakeholders lower down the capital structure. On most deals, an intercreditor agreement would scope permitted senior debt increases (aka "headroom") more closely, but this example shows how bigger numbers could affect the likelihood of a challenge.

INSOLVENCY CLAWBACKS UNDER ENGLISH LAW

Where fresh credit support is granted to secure an amendment, there is a risk that this new transaction may be set aside by a court on the application of a liquidator or administrator if the credit support provider then goes into administration or liquidation within a certain prescribed period of time (see below). It is often assumed that this risk only applies to new security, but it should be noted that a guarantee or security confirmation, to the extent that it varies or amends an existing guarantee, could also be vulnerable to challenge. The Insolvency Act 1986 includes various heads of challenge, the most common being those listed below.

A "transaction at an undervalue", which may include the grant of security or a guarantee, is a transaction entered into for no consideration or for consideration that is significantly less than the consideration provided by the company. Under section 238 IA 1986, a liquidator or administrator can apply to the court for an order restoring the position to that which it would have been in the absence of such a transaction. It is a defence to a claim if the company entered into the transaction in good faith for the purpose of carrying on the business of the company, and there were reasonable grounds for believing that the transaction would benefit the company.

A company grants a "preference" where it does something, or allows something to be done, that puts a creditor in a better position than it would otherwise have been in if the company went into insolvent liquidation or administration. This could be the case if a company granted security for an existing unsecured debt. However, the court will only make an order restoring the position to what it would have been if the company was influenced by a desire to put that other person in a better position. This desire to prefer is presumed where the parties are "connected" (for example, a company grants security to its shareholder) and the onus is on the company to show that there was no such desire to prefer.

In addition, floating charges may be challenged by an administrator or liquidator if granted in the lead up to a company's insolvency, except to the extent of any valuable consideration (being money, goods or services supplied or a discharge or reduction of any debt or interest). No application to court is required.

The court will not make any order unless, at the time of entering into the transaction at an undervalue, granting the preference or giving the floating charge, the company was unable to pay its debts, or became unable to pay its debts as a consequence of the transaction (except in the case of a floating charge made with a connected person). Inability to pay debts is presumed in the case of a transaction at an undervalue in favour of a connected party.

There are time limits on the availability of these remedies. The relevant "hardening periods" prior to the onset of administration or liquidation for the above heads of challenge vary depending on whether the counterparty is a connected person.

IA 1986 →	**s238 Undervalue**	**s239 Preference**	**s245 Floating charges**
Connected person	2 years	2 years	2 years
Not connected	2 years	6 months	1 year

HOW TO HANDLE GUARANTEE AND SECURITY DOCUMENTATION WHEN DEBT IS AMENDED

When debt documentation is amended, it is important first to review those provisions of the original documentation that expressly address amendments and variations and those which set out the scope of the guarantee or the secured obligations. Check whether the documentation includes drafting which follows the LMA format (many smaller bilateral facilities do not). Widely worded anti-avoidance boilerplate may give the impression that substantial amendments would not impact on credit support. However, it is important also to consider whether the proposed variations fall within any of the specific provisions which address the scope of the guarantee or secured obligation or otherwise figure in the green list above. If so, this would suggest that the proposed amendments are likely to fall within the purview of the original documentation. Consequently, whilst it would be prudent to obtain express consent to the amendments / confirmation that the existing guarantees and security remain unaffected from guarantors and chargors, no additional documentation need be taken in relation to the original security package (**S1**).

If the proposed amendments are more significant and figure in the red list above, new security will be required, although S1 should not be released, so as to retain the benefit of hardening periods in the event that there is a dispute but the court decides S1 was not impacted by the amendments. Amendments in the amber list fall between the two extremes – they would not *necessarily* fail to be covered by S1, but caution is advised.

As mentioned above there are key differences between first and third party security. Where a borrower has granted security for its own debt, the "purview" doctrine is not relevant. Nevertheless, as a matter of construction, it will still be necessary to show that the secured obligations extend to the amended or varied debt and also to be mindful of other stakeholders who may be adversely impacted as a result of substantial amendments.

RETAKING SECURITY AND CONFIRMING GUARANTEES

When amendments are made to debt documentation, it is usual to obtain confirmations from guarantors that their guarantee obligations extend to the amended debt. This is a relatively easy step. Security providers will often also be required to confirm that S1 extends to the amended debt. Such confirmations are often inserted into the amendment documentation. In recent years, some lenders have increasingly asked law firms documenting amendment and restatement documentation to give a legal opinion confirming that S1 extends to the amended debt. Given the legal uncertainties discussed above, it would be difficult for a law firm to give an unqualified opinion for anything in the red and amber list above. This does not necessarily mean that S1 will not survive the amendments, only that there is an element of uncertainty.

In cases where the borrower group contains multiple companies, it is often argued that the confirmation referred to above could be made by the parent company entity (as "Obligors' Agent") on behalf of multiple obligors. However, because the ability of a surety to delegate authority to consent to material amendments is a subject of legal uncertainty, the prudent approach for a lender will be to require obligors to sign up individually to any amendment documentation which makes material amendments to the guaranteed and/or secured obligations (even some of those in the green list above).

If the amendments are so significant 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. It is best not to document such arrangements in the form of an amendment to S1. One reason for this is that it could be difficult to register the amended security at Companies House. It is best to base the second ranking security on the S1 documentation. Whilst a lender may wish to err on the side of caution, borrowers will understandably be reluctant to incur the time and expense of having repeat security documentation drafted, executed and registered. Nevertheless, English law repeat security is relatively painless compared with the formalities for (re)taking collateral in some foreign jurisdictions.

Click here to read our article on practical issues to consider when registering charges at Companies House.
Click here to read our article on drafting pitfalls when preparing second ranking security documentation.

FOREIGN LAW ISSUES

Whilst the English law analysis revolves heavily around concepts of materiality and what was in the contemplation of the parties at the time of the original documentation, the starting point for the analysis in other jurisdictions can be very different. It will be necessary to consult with local counsel as to whether fresh security is required or, if new English law security is taken, whether local registration formalities are necessary. In particular, reliance on the Obligors' Agent clause in an English law document may not be possible to the extent that obligors are incorporated in other jurisdictions.

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