Feature

KEY POINTS

- Lenders on direct lending transactions should diligence borrower groups and their assets carefully when devising any recourse package.
- A one-size-fits-all recourse package is unlikely to be appropriate and lenders may need to adopt novel solutions to capture value within a group as recourse for a loan.
- Depending upon the cost-benefit analysis, certain types of recourse may be foregone in favour of others.

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Making the most of what you've got: how secured creditors can overcome common obstacles to recourse

This article is intended to be read alongside a March issue article ((2018) 3 JIBFL 173) in which Max Millington explored the trends in direct lending and noted certain unusual features encountered with such transactions, often in the mid-market, which limit a lender's ability to take comprehensive guarantees and security from the borrowing group. As Max mentioned, such transactions do not conform to those contemplated by LMA leveraged documentation. Participants on direct lending transactions should understand these risks and the possible ways to mitigate them.

A BRIEF ANALOGY

According to *Porter's five forces*, there are five forces that determine the competitive intensity and attractiveness of any market: competitive rivalry, supplier power, buyer power, threat of new entry and threat of substitution. It is beyond the scope of this article to explain what those forces are in any detail, but by analogy we suggest that there are four forces which may determine the success or failure, or the effectiveness of, any recourse package. They are as follows:

- The robustness of the legal documents, in particular the ability of a creditor to accelerate its debt and invoke its ancillary rights at the appropriate time.
- The availability of an enforcement methodology, ie the availability, either under contract or at law, of a means to realise assets or recover a debt.
- The absence of other creditors, secured or unsecured, with competing claims or alternatively, where they exist, of suitable restrictions on their rights.
- Recourse to relevant assets, in particular the availability of assets against which a creditor can recover the monies owing to it.

It is worth keeping each of the above forces in mind as we explore below some of the anomalies which can appear in direct lending transactions.

THE ABSENCE OF A HOLDING COMPANY STRUCTURE

Certain borrowers, especially in real estate finance, organise their businesses with multiple companies under the common control of one or more individuals. Such structures are often established in the expectation that security will not be available from the other companies and that any lender limits its security to the assets of the relevant special purpose vehicle alone.

Obtaining cross-guarantees and security from other companies in such structures is possible but the corporate benefit analysis is more rigorous. We recommend that companies only offer security for companies under common control, but not part of the same corporate group, in return for remuneration or other benefits commensurate with those a third party would expect for providing equivalent security. Where there are no solvency issues and the default risk is low, a director may conclude that they can approve any guarantee and security if sanctioned by a shareholder resolution. A careful analysis should still be undertaken to determine whether the transaction results in a distribution.

SILO STRUCTURES

Sometimes a borrower employs a conventional holding company structure but wants to raise finance secured on a limited asset pool only. This is common in asset-based lending structures. In this model, the lender's security is limited to the special purpose vehicle's assets, with the parent company providing security over that entity's shares (perhaps on a limited recourse basis) and possibly also a parent company guarantee sometimes limited by amount. If the borrower has multiple asset pools in separate "silos" secured in favour of different lenders, complications may arise on enforcement if that impacts the operation of the performing asset pools, or where multiple lenders seek to enforce different silos which are administered by a common head office function. Intercreditor disputes can be extremely complex.

Lenders must be clear what enforcement remedies they have and confident they can collect on secured assets without the parent company's co-operation, particularly where the parent wants to continue running businesses in performing silos and without triggering any process or priority disputes with lenders which enforce over other non-performing silos.

MULTIPLE INDEPENDENT SECURED CREDITORS

Conventional documentation and industry practice envisages a refinancing of all existing debt. In practice, many borrower groups are messier, and corporate structures may contain debt which parties are unwilling to refinance. Intercreditor arrangements will be required – sometimes these can be agreed relatively easily, for example where specialist asset-based lenders, or perhaps franchisors or dominant suppliers, co-exist alongside cash-flow or real-estate backed lenders. At other times, intercreditor negotiations can be nightmarish. A common problem is where acquisition finance is used to acquire a target where the existing debt is not refinanced. Parties should not underestimate the potential complications, and a refinancing of the whole group is usually

the most pragmatic option, even where financially unattractive for the borrower.

MINORITY INTERESTS AND JOINT VENTURES

Obligor groups may contain non-wholly-owned entities which are joint ventures, because of a local law requirement for more than one shareholder, or for some other reason. They may still be subsidiaries, but it may be difficult or near impossible for such entities to grant guarantees or security without other shareholder consent. Even where the borrowing group can grant security over its shares in such entities (which joint venture agreements often restrict), a lender should think carefully before choosing to get into bed with other shareholders upon enforcement. Potential purchasers are unlikely to find the prospect of purchasing the group's interest in such entities attractive.

Ideally, where common security principles are agreed at the outset of a transaction, borrowers should avoid any requirement for guarantees or security from or in respect of minority interests or joint ventures. Guarantor coverage requirements should be limited to group members alone, so excluding minority interests. These can be difficult arguments to win, especially where the relevant entity is profitable with substantial assets, but a lender should be accommodating where it gives little or no weight to such entities in its credit analysis.

UNLIMITED COMPANIES

Unlimited companies are rare but do occasionally appear where groups look to avail themselves of the flexibility such vehicles enjoy in relation to, for example, share capital reductions, redemptions and share buybacks. Problems for shareholders of unlimited companies can arise however because of the unlimited nature of the liability of their members.[1] Lenders should avoid taking security over the shares in an unlimited vehicle, unless persuaded by a perceived requirement to obtain a qualifying floating charge (see further below). Where such security is taken, a lender should if possible take an equitable as opposed to a legal mortgage over such shares, and undertake a thorough solvency analysis before transferring legal ownership into its own name or a nominee upon enforcement.

INSOLVENT COMPANIES

Any company in the zone of insolvency is a potential bear-trap when taking guarantees or security given the greater risk that any such recourse will be vulnerable to challenge as a preference, transaction at an undervalue or as an invalid floating charge. Moreover, where a company which grants security enters into administration and gains the benefit of a moratorium, this will suspend a secured creditor's ability to enforce its security over that company's assets unless the administrator consents or a court order permits otherwise.[2] The moratorium does not apply to certain interests, including security under a financial collateral arrangement, nor does it have extra-territorial effect, so that it will not limit a creditor's ability to take enforcement against the assets of a company located outside England and Wales.[3]

THE RISKS WHEN RING-FENCING ASSETS

Assets may be ring-fenced and kept apart from a lender's security net for various reasons, including because of the inability to give security over certain assets (for example, leasehold or intellectual property interests which cannot be charged without the consent of the landlord or registered IP owner) or to comply with the regulatory regime to which a borrower is subject.

Lenders should understand the implications of carving assets out of the security net when purporting to take all asset security, as it may jeopardise whether they hold a qualifying floating charge with the ability to appoint an administrator using the out-of-court route. A qualifying floating charge must extend to the whole or substantially the whole of the company's property and this is less likely to be the case the more one excludes assets from a floating charge.

To address such concerns on an Asset Based Lending transaction, a lender may ask for the receivables to be legally assigned to it on enforcement in addition to a security assignment of such receivables. Third party consent may be required to effect any such legal assignment. Even then, such rights may prove relatively meaningless where the receivables arise from a regulated activity, so that acquiring legal ownership of the receivables also requires the purchaser to have the relevant regulatory permissions too. Exercising rights under a related share charge to transfer ownership of the receivables seller may offer little practical solution, since if it is a regulated entity that will likely prompt a change of control notification for which a related permission is also required.

In practice, lenders need to size up the pros and cons associated with having security over some (but not all) assets only. It may be that certain assets do not represent a company's property (for example, monies in an account held on trust for third party beneficiaries), in which case that should not affect the floating charge analysis. Even without a qualifying floating charge, a lender can still seek to appoint an administrator using the court route. Whilst still reasonably quick, it is more expensive than the out of court route and relies on the court being able to list a hearing in short order.

DEFERRED CONSIDERATION

Many fast-growing companies backed by private equity investors pursue an ambitious path to growth by adopting a "buy and build" strategy. Deferred consideration or earn out arrangements commonly feature in such acquisitions. Lenders should be informed of such arrangements and if such payments fall due during the life of the loan, permitted payment exceptions should be introduced to allow the borrower to make them when due. Given the cash leakage these payments entail, lenders may want to re-visit any permitted acquisition criteria to ensure any deferred consideration or earn-out payments fall within acceptable parameters. Intercreditors with deferred creditors can be heavily negotiated and tend to focus on whether the deferred payments are made from cashflow the lender is relying on in its credit assessment, or whether the payments are already ear-marked for the seller and the borrower is effectively obtaining a cashflow advantage from the deferral.

THE INVOLVEMENT OF NATURAL PERSONS

Natural persons can feature in any number of ways – whether as directors who give personal guarantees, as owners of, or occupiers in, a property that is being financed, or as a lender to the borrower itself either as a director, shareholder or otherwise.

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Individuals who are asked to grant guarantees or security or waive their rights will need to be independently advised. Additional issues arise where the registered shareholder of a company is an individual, as any security taken over their shares will not need to be registered under the Bills of Sale Act 1878. A lender with only an equitable mortgage or charge over such shares may consider filing a stop notice to protect against a *bona fide* purchaser for value without notice of such lender's interest acquiring a better title.

RELATED-PARTY CREDITORS AND OTHER STAKEHOLDERS

Recourse can be inhibited where related-party creditors or other stakeholders have claims against the obligor group or of its assets. Examples might include:

- sums owed to any company which acts as the group's treasury function;
- the transfer of legal title to property to an affiliate and its leaseback to the occupying affiliate; and
- shareholders who inject funds to cure a financial covenant default or who purchase the external debt and become a lender of record.

Such issues require the lending team to assess who the other creditors or stakeholders are and what contractual restrictions should be imposed to limit their impact. Where assets are sold to related parties, a lender will want reassurance that the sale takes place on arm's length terms to avoid any transfer at undervalue resulting in value leaking out of the obligor group. Subordination arrangements with parties who acquire claims against the obligor group should ideally be entered into, although a lender will have little choice but to accept that trade creditors continue to be get paid in the ordinary course. A lender concerned that persons related to the borrower may acquire the bank debt might include appropriate sponsor voting disenfranchisement provisions in the loan documentation.

NON-OWNERSHIP OF MATERIAL ASSETS

Lenders should be mindful of material assets owned or occupied by persons outside the obligor group. Examples include property interests where the freehold title is owned by a third party but an obligor has occupation as lessee. Similarly, intellectual property rights may be registered in the name of a third party owner but licensed to an obligor under a licence agreement. Lenders should diligence assets to capture security over whatever valuable interests are owned. In the previous examples, this might be achieved by taking a security assignment over the IP licence and a charge over the leasehold title. Conversely if an obligor retains legal title to properties leased to third parties, security assignments of the rental agreements can be taken, with rental proceeds credited to a specified account over which the lender takes security. It is worth noting in passing that the existence of a freezing order should not ordinarily inhibit the enforcement of security over assets subject to such order provided such enforcement is not used to aid or abet the breach of such order.[4]

PROBLEMATIC PENSION SCHEMES

Lenders should understand the risks associated with taking security over shares in companies with pension deficits. Specifically, under the Pensions Act 2004, the Pensions Regulator can issue a contribution notice to the company and any persons connected or associated with it requiring such persons to make good such deficit. A lender will be an associate of the company if it is the registered holder of shares of that company with the right to exercise, or control the exercise of, one-third or more of the voting power at a general meeting of the company.

Loan documentation should where appropriate contain representations and warranties which give lenders comfort that such groups have sufficient reserves/assets to meet contingent pension liabilities if crystallised during the life of the loan and, where group companies have a defined benefit occupational pension scheme, that no financial support or contribution notice has been issued by the Pensions Regulator. Any lender that plans to enforce any share security over a company with a pension deficit may seek clearance that the Pensions Regulator will not exercise its anti-avoidance powers.

Pension scheme trustees will not take too kindly to a secured lender gaining prior-ranking claims ahead of them. They may agree to enter into a priority arrangement but as a compromise retain their own security and require any schedule of pension contributions to be revised as they consider appropriate.

PUBLIC COMPANY CONCERNS

Public companies cannot give financial assistance for the purchase of their shares or shares in their holding companies. This includes guarantees and security in support of acquisition financing. The restriction is usually overcome by having the target re-register as a private company which then gives the required collateral.

OVERSEAS LEGAL CONSIDERATIONS

In preparing this article we have solely considered the English law structural issues which can arise on a direct lending transaction. Additional complications may arise where the obligor group includes foreign subsidiaries. Lenders should ensure that any foreign corporate guarantees adhere to any local capital maintenance rules and any security interests granted to a security agent contain appropriate parallel debt wording. Lenders taking security over shares in jurisdictions such as Germany also need to be alive to the risks of equitable subordination.

SUMMARY

This article is intended to illustrate some of the difficulties in obtaining a full recourse package in a direct lending transaction. Lenders should be mindful of such risks whenever undertaking a credit analysis on a proposed transaction. A cost-benefit analysis which assesses the relative merits of taking or not taking the recourse in question is always recommended. ■

1 Section 3(4) Companies Act 2006.
2 Paragraph 43(2), Sch B1, Insolvency Act 1986.
3 *Harms Offshore AHT "Taurus" GmbH & Co KG v Bloom and others* [2009] EWCA Civ 632.
4 *Taylor v Van Dutch Marine Holding Ltd and others* [2017] EWHC 636 (Ch).

Further Reading:

- Current and anticipated trends in direct lending (2018) 3 JIBFL 173.
- Some practical points in relation to the granting of floating charges (2016) 6 JIBFL 366.
- LexisPSL: Banking & Finance: Taking security over shares.