LECTURE 5

PURPOSE OF TAKING SECURITY

5.1. INTRODUCTION

As per Vinter Graham "the common view of security is that lenders take security over an asset in order to sell it if their loan is in default and to apply the proceeds against amounts outstanding under the loan". The way to take security over assets is one of the most important issues to lenders. As per Vinter Graham, lenders will be anxious to have a security package as a defensive opportunity, as well as offensive opportunity. The former is concerned with where the lender will have security and priority over the assets than a third party, and the latter is concerned with where the lender can be able to sell the assets taken as security for the purpose of enforcement of recovery of the debts.

For the lender to get the needed protection, it must take security and first ranking in terms of priority over the assets of the UJV. Such assets may include licenses, leases, any physical joint venture agreement, sales proceeds, and off-take agreement where necessary. Where a company is set-up as a holding company to the UJV, the lenders shall have first ranking security interests over the shares in that holding company. In that case, the shareholders loan is under subordination to the loan provided by the lenders.

Supposing that the holding company is set as a special purpose vehicle to enter into the subsequent UJV, it may advantage the lenders because the holding company will need only to provide security over all its assets to enable the lenders to enforce the security when necessary.

For the fact that lenders are not shareholders to the sponsors' benefits or shareholders' agreement, lenders may wish to ensure that sponsors inject the equity that the lenders relied on in financing the project.

Security over assets is realistic if it has ascertainable value and is freely marketable as well as where the lenders can exercise the rights without consent of third parties. This is relevant because a concession agreement for the exploitation of oil is taken as security today because the oil well is marketable; however, the equipment for the exploitation may deteriorate over time and become unmarketable as well as unascertainable value. Moreover, lenders may need the consent of a third party that supplied the equipment; or even consent of the host state before marketing it. This may defeat the rationale of taking security as an aggressive mechanism since the possibility of selling it to recover debt is defeated.

The effectiveness of the security taken by the lenders may depend on whether it achieved these purposes, namely :

(i) taking security for management purposes,

(ii) taking security as means of control on insolvency, and

(iii) taking security as a defensive mechanism.

5.2 TAKING SECURITY FOR MANAGEMENT PURPOSES.

Taking security for management purposes gives the lender rights to transfer the shares of the company to themselves, thereby using the assets without the project company. Under English law, a secured lender has the right to appoint a "receiver" over a company's business and asset, and to run the business so that debt is paid. S.72A (6) of Insolvency Act 1986 (IA 1986), allows the appointment of administrative receivers in certain exceptional cases including project finance. However, that has been restricted by S.72A(1) of IA 1986 which makes entering administration (instead of administrative receivership) the primary insolvency proceeding in England and Wales.

By appointing an administrator instead of administrative receiver, it may assist the company to return in business instead of outright insolvency. This may benefit a project company who defaulted on repayment even though the lender may have taken security over the asset. However, other jurisdictions like the U.S.A, and civil law jurisdictions do not permit management purposes, as remedy for enforcing security.

- **Effect of management control through shares**

Lenders can control the enforcement of security through taking security over the shares in the project company. The purpose will be to entitle the lenders to assume the rights of the shareholders on a default and replace the project company's management. By acquiring an enforceable share security, there is a high propensity that the lender will exert control that will put it as a 'subsidiary undertaking' of the lenders. However, the problem is that, under the statutory provision of FRS2 and S.405(3)C) of the Company Act 2006, there is exclusion of the consolidation of interests in the statutory accounts of a parent company where the interests are acquired through the enforcement of a security. Moreover, the security taken over shares in a project company by the lender, and which gave them control, will not give the lenders priority over other creditors of the project company.

However, the parties may draft the direct agreement to allow priority of share security over other creditors, thereby creating effectiveness in the enforcement of the security. Nevertheless, even if the only permitted way of enforcing share security is by judicial sales like in most civil law jurisdictions, the lender can mitigate the risk by the use of power of attorney by the charger to allow the secured lender to sell the shares where need be.

Supposing that the project company was incorporated in a jurisdiction that does not permit a secured creditor to run the debtor's business, or where the creditor's remedies with regards to the benefit of share security is restricted; the lender may increase the number of corporate groups that made-up the project company. The aim will be to use the added holding company to take security over the shares on an intermediate basis. The legal effect is that it will give the lenders the management control of the project company.

5.3. TAKING SECURITY AS MEANS OF CONTROL ON INSOLVENCY.

This is where the lenders exercise influence over the insolvency proceedings once commenced against the project company in the event of the company becoming insolvent. Where the lender ranks ahead of unsecured creditor, in the event of default the unsecured creditor will not be able to seek for the winding-up of the company. Because appointment of administrator is relevant during the insolvency proceedings, it means that, where the lender is in control of the assets in insolvency, it affords the lenders the opportunities to either sell the assets or manage it. As we shall see, the problem with this approach is that, in some jurisdictions the lenders may not have the right to appoint an insolvency practitioner of their choice.

"*Charge is a contract created under terms, indicating the availability of assets as security in respect of debt, or liability secured against the assets.*"

Where security was in form of a charge, the Courts usually determined whether the charge was floating charge, or fixed charge. In Re Yorkshire Woolcombers, the Court stated, inter alia, that the three characteristics of a floating charge are:

(i) it is a charge on a class of assets of a company, present and future;

(ii) that class is one which, in the ordinary course of business of the company would be changing from time to time, and

(iii) the charge contemplates 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 that particular class of asset.

- **Qualifying floating charge**

Under the English law of security, for the lender to achieve control on insolvency, a better option is for the lender to maintain a qualifying floating charge over the assets or proceed of the debtor. In the context of project finance, it will be favorable to the lenders under English law because of the applicable exceptions under which an administrative receiver may be appointed.

The logical argument is that where lenders exercise the right to appoint an administrative receiver instead of administrator, supposing that the borrower (in this case the project company in the exploitation of oil) defaults, the lenders may quickly enforce their security. This may frustrate or constitute repression on tens of companies that are involved in a typical unincorporated joint venture in the exploitation of oil. However, where there is room to appoint an administrator, it means that these companies may survive as a going concern. Following the above will encourage long-term lending, and protect the unsecured creditors because it reduces the lenders' ability to sell the assets of the company by ways of administrative receivership.

However, while it has been recognised that appointment of administrative receivership is no longer a major insolvency proceeding, for the fact that lenders can still choose who is appointed as administrator means that it will still benefit from its floating charges.

Consequently, lenders will be able to control the situation relating to the security. It is important that any security package for a project in England and Wales or granted by an entity incorporated within it includes qualified floating charges, whereas other jurisdictions do not operate charge over assets. This point is crucial when a lender is taking security over assets not within England and Wales because it may affect the way through which the lender will recover its loans where the borrower defaulted.

- **Lenders and the appointment of administrator**

The appointing administrator instead of administrative receiver has two effects. First, an enforcement freeze applies to any company in administration on and from the date of filing in the Court, the application for an administration order or a notice of intention to appoint an administration. The effect of this statutory provision is that the secured creditors lose control over the method and timing of the enforcement of their security. Secondly, the enforcement freeze prevents, inter alia, the enforcement of any security over the company's property, and the repossession of goods in the company's possession under a hire purchase agreement without the permission of the courts or (once an administrator is appointed) the consent of the administrator.

Legally speaking, loss of such control and the requirement of such consent is what the lender may be avoiding at the first instance because it may retard its speed of recovery of the debt.

The administrator has the statutory powers to dispose of property subject only to a floating charge. In effect, where a lender in the exploitation of an oil project has taken security charge over the proceeds or sales of the project company, the enforcement of the security through administration will have the same positive impact on the lender. Therefore, it serves the lenders in typical exploitation of oil projects to extend taking of security over the sales of the debtor.

Nevertheless, the administrator can also dispose of property subject to the fixed charge, but the problem is that the administrator requires a court order to be able to dispose of it. The general creditors' exercise of control to approve the administrator's proposals for achieving the purpose of the administration is beneficial to the creditor. The critical question is how can the lender exercise the Court order in another jurisdiction that does not have the concept of charge in its legal system? Administrator can only deal with the fixed charge assets with the consent of the secured creditors or leave of the court.[80]

Despite the fact that there are exceptions where administrative receivers can be appointed which included, inter alia, large project financing, contractual arrangements entered by the parties may offer the lenders a "step-in right". The effectiveness of enforcing the security through step-in rights will depend on 'direct agreement' that the lenders entered with third parties alongside the project company.

5.4. TAKING SECURITY AS DEFENSIVE MECHANISM

Lenders may also take 'fixed' security over the project company's assets in the jurisdiction of the project. The purpose is to have priority over the claims of other creditors so that in the event of default or insolvency, lenders may sell the assets to recover the debt. Lenders may wish to take as security over assets like:

(i) equipment, machinery, and other physical assets.

(ii) project site.

(iii) the project company's bank account.

(iv) the intangible assets – e.g intellectual property rights.

(v) insurance covers held the project company; and

(vi) security over certain rights of the project company

Where the lender has taken security in form of charge, the problem that may arise is whether it is a fixed charge, or in fact floating charge. The reason to draw distinction is that fixed charge ranks ahead of preferential creditors whereas floating charges does not rank ahead of preferential creditors. Moreover, reference to Sch.B1 para 70 of the IA 1986, assets secured by a floating charge can be disposed of, by the administrator without the consent of the charge holder (i.e lender); whereas Court's consent and approval is required before disposing of assets secured by a fixed charge. Therefore, lenders will prefer fixed charge in order to have higher influence over an administrator than the floating charge.

- **Risk assessment of fixed charge as security**

In the context of risk assessment of fixed charge as security, the only real criterion relevant when deciding whether a charge is fixed or floating is the degree of control that the charger has over the charged assets. The degree of control necessary to create a fixed charge is such that the charger cannot dispose of the charged assets without the consent of the chargee.

Legally speaking, in a hypothetical project financing the exploitation of an oil project, where the project company continues to use the money in the charged bank account, it cannot be a fixed charge even though the parties stated that it was a fixed charge. Consequently, the project company cannot obtain consent from the charger (lender) for every transaction it was to enter with the charged bank account. Thus, if the project company deals with the charged bank account, or the equipment and machinery, it will implicitly reduce the degree of control the lender has over the purported fixed charge. This will result in transforming fixed charges technically into floating charges.

It can also be argued that where the lender takes fixed charge as security over off-take contract, such charge will logically be construed as a floating charge since the charger (lender) cannot maintain complete control of the bank account where the money for the off-take contract is paid into. Thus, while a fixed charge may be workable over a concession agreement as security, it can hardly be workable for receivables like book debts opened for receiving proceeds.

Therefore, although the concept of fixed and floating charges is a realistic means of taking security in a project finance of complex projects like exploitation of oil, if the characteristics of fixed and floating charges bear its legal relevance; it could also mean that the concept itself is not free from limitations as narrated above.

5.5. SECURITY AND JURISDICTIONAL DIFFERENCES

Among the major risks is that there are comparative jurisdictional differences between England and Wales, and other jurisdictions in taking security through fixed charge and floating. Factors like the law governing the security documents, and the contract of the security could impinge on the security package.

For example, the law of the underlying contract of a share is usually the country of incorporation of the company and will then be the law that will govern the shares. The importance of this analogue is to draw a distinction between the jurisdiction where a project asset (e.g tangible assets and shares) and the law in the jurisdiction under which the assets were created (e.g intangible) when setting the security package for a project.

In some jurisdictions, the charger may need to grant the secured creditors the power of attorney before enforcing the security, whereas in England and Wales, if the charger appoints an attorney to act on its behalf; any action taken on behalf of the charger is binding on it. From the lender's perspective, it means that to enforce a security in some jurisdictions will be more difficult, especially where chargers need to grant power of attorney. The risk with that is that the charger may unnecessarily withhold such power of attorney to the detriment of the lenders. In contrast, since the appointment of a security agent as attorney of the charger is irrevocable, it means that lenders can easily enforce security under English law. Moreover, each charger may be required to provide power of attorney to facilitate enforcement of the security; the consequence is that the charger may operate to avoid judicial sale of the assets. In reality, the charger is in control and it will not benefit the lender.

While these are practical jurisdictional problems in taking security over assets in the perspective of lenders, peculiar ways to mitigate these problems is by referencing contractual dimensions, putting in mind project finance in a large exploitation of oil.