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BORROWERS BEWARE...

A LENDER CAN HOLD ON TO ITS SECURITY EVEN AFTER A LOAN HAS BEEN REPAID IN LIMITED CIRCUMSTANCES

Some borrowers may worry about how and when security they have granted to a lender for a loan will be released. In virtually all cases this will happen when the borrower has repaid the relevant loan (plus accrued interest). This reflects the fundamental principle known as a borrower's "equity of redemption", i.e. that a borrower is entitled to recover from the lender an asset over which security was granted in favour of the lender free from that security once the secured liabilities have been repaid. A lender **cannot** exclude a borrower's equity of redemption. Nor can it somehow restrict the possibility of a borrower getting back its assets on repayment of the relevant loan.

But security documents often allow a lender to hold on to security even after a loan is repaid. If lenders habitually did this, refinancings of secured debt would become a lot more difficult. But it is very rare that it happens. A recent High Court case called *Re Industrial North West LLP (In Administration)* [2020] EWHC 3052 considered these issues, concluding that market standard drafting in finance documents did allow the relevant lender to retain its security to protect against a contingent liability and this was not "repugnant" to the borrower's equity of redemption, even though the lender's loan (plus interest) had been repaid in full.

The facts of this case were relatively unusual. But it is conceivable that the same or similar facts may arise more frequently in future as borrowers come under financial stress and secured lenders consider and/or exercise their acceleration and enforcement options. Read on to find out more.

BACKGROUND

Industrial North West LLP (INW) was established to acquire and develop land. Fairfield (F) lent approximately £60m to INW in April 2018 to finance acquisition and development costs pursuant to a facility agreement (Facility Agreement). The £60m facility was secured by an all asset security agreement entered into at the same time (Security Agreement).

The Facility Agreement contained a market standard clause (at clause 14.5) which stated that INW had to pay to F the amount of all costs and expenses (including legal fees) incurred by F in connection with:

- the enforcement of, or the preservation of any rights under, the Facility Agreement and/or the Security Agreement or the security package; and
- with any proceedings instituted by or against F as a consequence of it entering into the Facility Agreement and/or the Security Agreement, taking or holding the security package, or enforcing those rights.

The Security Agreement defined the "secured liabilities" in a customary fashion: all present and future obligations and liabilities (whether actual or **contingent** and whether owed jointly or severally or in any other capacity whatsoever) of INW to F under or pursuant to the Facility Agreement and/or the Security Agreement.

The Security Agreement also included a typical clause which required all security to be released following the date on which all the secured liabilities had been unconditionally and irrevocably paid and discharged in full – this is often defined as the "senior discharge date".

THE FACTS AND ARGUMENTS

INW went into administration in May 2019 following an alleged event of default and subsequent acceleration of F's facility. F's main security comprised five plots of land. The administrators sold three of them and in December 2019 repaid F's loan (and accrued interest) in full from the sale proceeds. INW's owner (M) had, however, already threatened legal proceedings against F for wrongfully terminating the facility and enforcing the security. The administrators sought directions from the Court about whether INW had a contingent liability for F's costs of defending the threatened litigation under clause 14.5 of the Facility Agreement and whether the Security Agreement secured that liability.

M argued that:

- INW had no contingent liability for F's costs of any future proceedings because clause 14.5 of the Facility Agreement could no longer be engaged following repayment of the loan
- even if there was a contingent liability for legal costs, that would be perpetual and so INW would never be able to exercise its right to redeem the security
- clause 14.5 only applied to the costs of proceedings already begun or to costs already incurred when the loan was repaid
- the continuation of the security after it had been enforced and the loan repaid in full would be oppressive, unfair and unconscionable

F argued that:

- clause 14.5 and the secured liabilities definition made it obvious that the parties intended for F to be secured for all the costs and expenses it incurred in connection with the financing transaction, including a contingent liability relating to the threatened litigation
- INW's right to redeem was not excluded or restricted as it could redeem by offering a reasonable amount of security for that contingent liability
- clause 14.5 was not imposed on INW by F in an oppressive or unconscionable manner

THE DECISION AND THE DIRECTIONS

The Court found in favour of F:

- the costs of defending the threatened litigation fell within clause 14.5 of the Facility Agreement. They would be incurred by F in meeting a claim brought by M as a result of F enforcing its rights under the finance documents, and that claim was likely as M was a "… a man willing to litigate even difficult claims..."

- that potential liability was a contingent liability within the definition of secured liabilities in the Security Agreement and, therefore, a secured claim
- that contingent liability would not be perpetual because M could choose whether to litigate or not and, if he did, the litigation would be heard and resolved so crystallising that liability
- there was nothing in clause 14.5 which suggested it only applied to the costs of proceedings already begun or to costs already incurred when the loan was repaid
- the wording of the finance documents meant that F did not have to release the security when the principal amount of the loan (plus accrued interest) was repaid if there were other outstanding secured liabilities. This kind of wording was not repugnant to INW's right to redeem. Nor was it oppressive for F to retain its security if no provision for contingent liabilities was made

COMMENT

Andrew Dodds, a partner in Stevens & Bolton's banking team, comments: "This is an interesting case for borrowers, lenders, insolvency practitioners and lawyers, confirming that a customary costs and expenses clause, as well as definitions of secured liabilities and senior discharge date, will cover contingent liabilities arising from the cost of threatened litigation in certain circumstances. Borrowers should take particular note here because if a lender (after much soul-searching) accelerates and a shareholder or other third party credit support provider threatens or seeks to challenge that acceleration, then the borrower may be on the hook for the lender's prospective or actual costs and have secured them. In addition, legal opinions delivered on finance transactions will generally include a qualification in which the relevant firm states that it expresses no opinion on whether any provision permitting the retention of security after payment would be effective. It remains to be seen whether the judgment in Re Industrial North West changes that – we doubt it given that each finance transaction being opined on will turn on how its documents are drafted".

KEY CONTACTS

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