KEY POINTS

- We are not aware of any reported English case law where a lender has successfully relied upon a security reinstatement or conditional discharge clause to restore its security where a redemption payment has been clawed back in insolvency.
- Such provisions have little practical application and in most instances are overlooked on subsequent security releases.
- Rather than having to persuade a court to rely upon such a provision, lenders should be vigilant when releasing their security at the time of redemption.

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Security reinstatement provisions: worth the paper they are written on?

When I first agreed to pen this article, one of my esteemed colleagues remarked that he was surprised I had agreed to take this on. And when the Editor asked me a very straightforward question – "do security reinstatement provisions work?" – and I responded by saying "honestly, I have no idea", the omens were not encouraging. Undeterred I enlisted the support of some colleagues at home base. The outcome of our collective efforts follows.

TAKING A STEP BACK …

The danger faced by many of today's lawyers (myself included) is that unless we are careful, we can become hooked on our precedents. And that way only chatbots and artificial intelligence lie. But if we found ourselves stranded on a desert island without our handy bibles and faithful precedents, tasked with drafting a security document for a loan, what essential provisions might one include in an English law security document?

For me the following clauses represent essential features of any security document:

- a covenant to pay tied to a description of the secured obligations;
- the charging provision itself outlining what security is granted over which assets;
- a negative pledge and non-disposals undertaking;
- an enforcement clause dealing with when the security becomes enforceable; and
- the chargee's powers upon enforcement.

Even if one gets those core components right, it is still possible to overlook some constituent features of any security instrument. By this, I mean documenting the security in the correct form and ensuring that it is executed correctly. In recent times we have come unstuck on a couple of occasions with HM Land Registry in particular; extra care must be taken to ensure that the electronic execution of any legal charge over real property complies with the relevant HMLR guidance.[1]

Beyond the above there are always some "nice to haves" that will find their way into your average security instrument. Perhaps, for example, a covenant to release, a further assurance clause, a provision setting out the lender's right to appropriate secured assets to the extent they constitute financial collateral within the meaning of the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) and maybe a provision dealing with assignment and transfer of the parties' respective rights and interests. These are each useful but not necessarily essential.

And that's it. Although security documents have been elongated over the years, arguably they need nothing more than the core elements that I touch on above. Most of the commercial undertakings and boilerplate provisions can be dealt with in the wider loan agreement which is where the client's focus should be. I recall one partner at my former employer expressing the view that if you were taking up a client's time with lengthy discussions around the contents of a security document, you should take a long hard look at yourself!

Anyway, I digress. My main point is that security reinstatement provisions would not be included in my "must have" list of essential security provisions. And yet security reinstatement provisions continue to feature in many security precedents that cross our desks.

So, it is only right that we should give these provisions some proper consideration. Am I missing a trick?

THE THEORY BEHIND SECURITY REINSTATEMENT CLAUSES

One usually comes across a security reinstatement clause (also sometimes referred to as a conditional discharge provision) towards the end of a security document just when one's attention is starting to wane.

Such a provision (sourced from our precedent debenture) might read as follows:

> "Any release, discharge or settlement between a Chargor and the Security Agent shall be deemed conditional on no payment or security received by the Security Agent in respect of the Secured Obligations being avoided, reduced or ordered to be refunded pursuant to any law, and despite any such release, discharge or settlement the Security Agent may retain this Debenture and the security created by or pursuant to it, including all certificates and documents relating to the whole or any part of the Charged Assets, for such period as the Security Agent deems necessary to provide the Security Agent with security against any such avoidance, reduction or order for refund."

The logic behind these provisions is to protect a lender in a situation where it releases its security upon repayment of a loan where that payment is subsequently clawed back in the insolvency of the payer (the obligor). This is a possibility if one considers the anti-avoidance provisions found at Pt VI of the Insolvency Act 1986. For example, s 239 of the Insolvency Act 1986 provides as follows:

> "(2) Where the company has at a relevant time … given a preference to any person, the office-holder may apply to the court for an order under this section. (3) … the court shall, on such an application, make such order as it thinks fit for restoring the position to what it would have been if the company had not given that preference."

In such circumstances, a lender might (so the theory goes) find itself in a position whereby the obligor's indebtedness has not in fact been repaid (because the lender has had to return the payment to the insolvency office-holder for application amongst the obligor's creditors generally). Moreover, if the lender has released its former security based on that previous payment, it has gone from being a secured to an unsecured creditor. In the insolvency of that obligor, the lender will therefore find itself ranking pari passu with other unsecured creditors for the sums which it has repaid. An unenviable position and one which security reinstatement provisions are designed to avoid.

DO SUCH SECURITY REINSTATEMENT CLAUSES WORK?

Is there any evidence that such reinstatement provisions work? Remember the object of these provisions is to effectively reinstate the security in the form that it existed before the lender released that security on the strength of an obligor's payment. And sadly, the truth is that we cannot find any reported cases where a lender has successfully re-instated its security based on a conditional discharge provision along the lines set out above.

So, in the absence of any authoritative guidance, I have considered some hypothetical scenarios which I now turn to below.

SCENARIO 1: NO SECURITY REINSTATEMENT CLAUSE AND UNCONDITIONAL SECURITY RELEASE

In this scenario the borrower repays its secured debt in full and the lender releases its security in full at redemption. Form MR04 is filed with Companies House to confirm that the debt for which the security was given has been discharged in full and the Registrar updates the company's charges register to mark the status of that security as satisfied. The repayment is subsequently clawed back in the insolvency of the debtor. In the absence of a security reinstatement clause, can the lender's security be reinstated?

Without a court order to this effect (and it is difficult to see how a court might be persuaded by a lender that its security should be reinstated), we cannot see on what possible basis the lender's security could be restored. The commencement of such insolvency proceedings would also make it difficult to take replacement security. So, this is the worst-case scenario that presumably resulted in some clever insolvency lawyer drafting a security reinstatement provision in the first place.

A sensible approach which focuses the minds at the point of repayment (which is the one taken by the Loan Market Association (LMA) in its template security documentation found in the Real Estate finance section of its members' website) is to tie the security agent's covenant to release to the end of the "Security Period". This term is defined as follows:

> "Security Period means the period beginning on the date of this Deed and ending on the date on which all the Secured Liabilities have been unconditionally and irrevocably paid and discharged in full."

As drafted, this is an objective test but one to which we often see lenders' lawyers attempting to add a subjective element (ie specifying that the lender or security agent must be satisfied that the secured liabilities have been so discharged). The point here is that the LMA documentation provides that the security will only be released once the liabilities have been unconditionally and irrevocably discharged in full. If there was any question mark as regards the obligor's solvency at the time of redemption, then a concerned lender might seek to rely upon this wording to withhold its security release until it is satisfied that the clawback risk has in fact passed. This is I acknowledge a rather hopeful statement – how many lenders in receipt of repayment funds diligence the borrower's solvency at that time?

SCENARIO 2: CONDITIONAL RELEASE SUBJECT TO SECURITY REINSTATEMENT PROVISION

In this second scenario, a lender releases its security but its deed of release is expressly subject to the conditional discharge provision in the underlying security instrument. Form MR04 is filed with Companies House to confirm that the debt for which the security was given has been satisfied in full and the Registrar updates the company's charges register to mark the status of that security as satisfied. The repayment is subsequently clawed back in the insolvency of the debtor. Can the lender still invoke its (former) security?

In theory this sounds like a better scenario for the lender than scenario one above but for the practical implications. Firstly, most borrowers (and especially the advisors to any incoming lender that is refinancing the outgoing debt) will strike out any qualification in a deed of release that makes the release subject to a security reinstatement provision. Even if a lender were to successfully negotiate a release in this way (something which is pretty much unheard of as most borrowers will look for a "clean" release), the likelihood is (as here) that the chargor then goes on to record that release at Companies House and other relevant registries. Of course, the lender would (correctly) argue that the deed of release operates as the effective release document (not the Form MR04) but they would nonetheless likely find themselves having to apply to court for rectification of the charges register.

SCENARIO 3: UNCONDITIONAL SECURITY RELEASE WITHOUT REFERENCE TO CONDITIONAL DISCHARGE PROVISION IN UNDERLYING SECURITY DOCUMENT

In this third scenario, a lender with a security document that contains a reinstatement provision releases its security in full upon redemption but without qualifying its release

by reference to that provision. Form MR04 is filed with Companies House to confirm that the debt for which the security was given has been satisfied in full and the Registrar updates the company's charges register to mark the status of that security as satisfied. The repayment is subsequently clawed back in the insolvency of the debtor. Can the lender still invoke its (former) security?

This is the most common scenario that lenders are likely to find themselves in – ie their security document contains conditional discharge wording, but when it came to redemption the lender gave a clean release (releasing its security in full without reference to the conditional discharge).

Which of the security document and the release trumps the other? The prevalence of the security instrument over a release in the event of any conflict (or vice versa) is rarely (if ever) specified. Stepping back, there appear to be two ways in which the reinstatement provision can operate: either the "existing/old" security is only ever conditionally released such that if the condition for full release is not satisfied (ie there is a clawback of the payment made to the lender) the existing/old security continues; or there is a conditional grant of new security, such grant occurring at the same time the existing/old security is granted but with the condition to its effectiveness satisfied at a later date (after the release of the existing/old security, at the point in time where the repayment of the debt is clawed back). Whether either approach results in an effective reinstatement in the situation envisaged would depend on an analysis of the terms, both express and implied, of the release.

A typical deed of release releases the security interests constituted by the security document but does not otherwise bring to an end the arrangements between the parties under the security document and does not, in our experience, specifically override the security reinstatement provision. As the arrangements set out in the security reinstatement provision are expressly designed to address exactly the scenario that the parties now find themselves in, it seems arguable that it could be an implied term of the release that it remains at all times subject to the security reinstatement provision. Concerned chargors could in theory specify that the release expressly supersedes the security reinstatement provision.

SOME TRAILING THOUGHTS

And finally, some further thoughts (in no particular order of importance):

- Security reinstatement clauses address the hypothetical risk of a redemption payment being clawed back. But that is one feels a very low risk – how many businesses on the brink of insolvency decide that they will pay off their secured lender in preference (for example) to other creditors. One can see the potential attraction in doing so – it obviously clears a major roadblock and might then open up other restructuring options (for example, a moratorium might become more meaningful as financial creditors are unaffected by a moratorium under Pt A1 of the Insolvency Act 1986), but still overall the situation these clauses purport to address seems to be a very remote one.
- It seems to me that a more likely occurrence is that a lender releases its security upon redemption but in doing so overlooks that some of the secured liabilities have not in fact been discharged. For example, a security agent on a leveraged financing releases the transaction security upon discharge of the senior and mezzanine debt but the hedging liabilities are overlooked. In that situation, the security no longer exists and the hedging liabilities would then be unsecured. In such circumstances the security reinstatement provision does not apply – no payment or security has been avoided, reduced or ordered to be repaid – but it emphasises my earlier point that security holders need to satisfy themselves at the time of redemption that they can in fact release their security, and if they get that assessment wrong they should bear the consequences.
- Security reinstatement clauses carry less importance on a redemption exercise funded by third party debt. If a borrower discharges an existing secured loan as part of a refinancing with one or more new lenders, then it seems to me that the chances of that payment being clawed back are much lower because it has been funded with third party funds.
- If a lender insists on keeping its security reinstatement clause, then a borrower might reasonably insist that the security can only be reinstated during that period when a repayment might be challenged under insolvency legislation. The so-called "hardening period" during which a transaction with a corporate entity can be challenged as a transaction at an undervalue or as a preference to a connected person, for example, is the period of two years ending with the onset of insolvency.[2] To extend a reinstatement provision beyond that period seems like overkill. But even this assumes that the relevant obligor can operate successfully without new secured indebtedness during that intervening period.
- What happens if security is successfully reinstated based on a security reinstatement provision – is the original Companies House filing still good? Or is the reinstated security somehow "new" security and a new 21-day filing period starts to run? It seems to me that what is reinstated is old rather than new security, as how could a lender take new security in such a situation without it being an unlawful preference.
- And finally, I note that the Loan Market Association contains a reinstatement provision of sorts in the guarantee provision of its template loan documentation and in its shareholder security agreement found in the Real Estate Finance section of its members' website. This provision reads as follows:

> "If any discharge, release or arrangement (whether in respect of the obligations of any Obligor or any security for those obligations or otherwise) is made by a Secured Party in whole or in part on the basis of any payment, security or other disposition which is avoided or must

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> be restored in insolvency, liquidation, administration or otherwise, without limitation, the liability of the Chargor under this Deed will continue or be reinstated as if the discharge, release or arrangement had not occurred."

The rationale for including the above language in the shareholder security agreement as opposed to the other template security documents is likely much to do with the fact that the shareholder is acting as a quasi-guarantor. But the wording is also more accurate. Importantly, there is no attempt in the LMA security document to reinstate the security once it has been discharged. To me, that is simply an accurate reflection of what would happen in practice. In other words, if as a lender you have agreed to release your security, it is difficult to see how you can subsequently have that security back. But equally the liability owed to that lender should I think be restored. That is, I think the most likely position for a lender to find itself in – ie unable to claw its security back but a continuing (unsecured) creditor all the same. ■

1 See HM Land Registry Practice Guide 82: electronic signatures accepted by HM Land Registry (https://www.gov.uk/government/publications/electronic-signatures-accepted-by-hm-land-registry-pg82/practice-guide-82-electronic-signatures-accepted-by-hm-land-registry)

2 See s 240(1) Insolvency Act 1986.

Further Reading:

- Covenant to pay clauses in security documents: why are they needed? (2020) 4 JIBFL 245.
- Enforcing security: the challenges (2009) 4 JIBFL 187.
- Lexis+® UK: Banking & Financing: Q&As: How can I ensure security and guarantees remain effective on a refinancing?