

**SECURITY DOCUMENTS:
The Pitfalls of Charges, Mortgages & Personal
Guarantees**

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Seminar Notes for Delegates

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Introductory Note: The talk and these notes do not offer advice in relation to any particular transaction or individual situation. These should be discussed with a qualified legal advisor and for further information please contact Andrew Royce at:

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| Summary of Talk | Delegate Notes |
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| <p>SECURITY DOCUMENTS: THE PITFALLS OF CHARGES, MORTGAGES & PERSONAL GUARANTEES</p> <p>INTRODUCTION</p> <p>In the increasingly sophisticated and jargon filled world of banking the aim of today's talk is to try and give you an understanding of:</p> <ul style="list-style-type: none">• firstly, what the documents and terms are that the bank are talking about• secondly, what they cover, and• thirdly, what happens when things go wrong. <p>1. DESCRIPTION OF BANKING DOCUMENTS AND TERMS</p> <p>The banking industry seems to have come up with a completely new language to cover the weird and wonderful schemes that it was cooking up over the last few years to cover all the various different types of debt and debt package that it was creating in order to make more "profit".</p> <p>The rarefied atmosphere of those collateralised debt obligations etc. etc. is far removed from the day to day business banking that goes on, and looking at each of the more common phrases and words used, hopefully the following will be of help:</p> <p>(A) Facility Letter – the letter from the Bank setting out what they are going to lend you and on what terms.</p> <p>(B) On demand – this usually applies to an overdraft and means money can be called back whenever the Bank choose to do so.</p> <p>(C) Term Loan – this usually applies to a loan for a fixed term of, say, 5 years and means that provided the payments are made that the money cannot be demanded back by the Bank.</p> <p>(D) Debenture - this is a specific document that relates to companies only and is the form of security document given by a company to its Bank.</p> <p>(E) Charge – this is a document whereby an asset, book debt, plant, property is charged to the Bank which means that the Bank have</p> | |

effective control over it under certain

circumstances and it cannot be sold without their consent.

- (F) Mortgage – this is a charge granted either by an individual or by a company over a property.
- (G) Fixed – as regards the security documents, this usually relates to a fixed charge and relates to a specific asset, for example a piece of machinery with a certain serial number.
- (H) Floating – this usually relates to companies and, in particular, assets that flow in and out of a company and are only there for a short period of time, such as stock and book debts.
- (I) All monies due – this often appears in banking documents whereby any money that is owed by the person entering into the banking arrangement with the Bank is covered by that particular document, not just the current monies that are owed, and not just the monies owed by that individual in their own personal capacity.
- (J) Personal Guarantee – this usually relates to the financial security demanded by a Bank when they are lending money to a Limited Liability Company and they require the individuals who are involved with the business, usually Director-Shareholders, to personally guarantee performance by the company of those banking obligations.
- (K) Banker.

2. WHAT DO THEY COVER

What do all of these documents do and how are they all linked together.

If your business does not owe the bank any money then it is very unlikely that any of the above definitions will apply to you, as they relate only to bank generated documents.

However, if you owe the bank any money then some of the documents and scenarios mentioned above might well apply to you.

There is a distinct split between businesses that are run by individuals and businesses that are run through a limited liability company. The way in which the banking operations work for those two different legal personalities are looked at as follows:

(A) Individuals

If you are running a business either as a sole proprietor, or in a partnership, then you may well have an overdraft and this may or may not be covered by a Facility Letter.

An overdraft is that it is stated to be money that is repayable to the bank on demand without you needing to breach any of the terms of

your banking arrangement. It is therefore an area where business is most at risk from the vagaries of the banking system and can cause difficulties.

A more certain way to preserve your financial security with the bank is, and this is something banks are happier with, to have the money not by way of an overdraft but by way of a Term Loan. If, for example, there is a solid lump of borrowing within your overdraft, then an approach to the bank to convert it into a Term Loan will make them happier and cost you, usually, substantially less. An overdraft facility is something that should pivot around credit, it should not remain constantly in debit.

Once the debt is taken away from an overdraft into a Term Loan, then it is much more difficult for the bank, for example, in a fit of pique to close you down. You have to breach the terms of your loan repayable over a number of years for the bank to call all the money in. Providing you make your monthly payments, you should be fine, contrast this with the situation for an overdraft.

Individuals may also have in place a charge over certain assets, for example, plant and machinery, or book debts, but it is less common for individuals to have these arrangements.

Banks don't tend to view individual's interests in, for example, property leases unless they are for a long term, 90 years or more, as being an asset and there are difficulties in taking charges over book debts. But they happily take a mortgage of a freehold property.

(B) Companies

The picture that I always get people to imagine in their mind is that a Limited Liability Company is a ship. It is a separate legal entity to the people who are involved with it. It floats on the sea, the shareholders stand on dry land and in the event that the ship sinks, becomes insolvent, they lose their investment in the ship but none of their other assets on dry land. Usually the Directors manage to get in the lifeboats and are not sucked down with the ship, but there are exceptions to this when dealing with issues of wrongful or fraudulent trading.

Businesses will usually have a Facility Letter which sets out the terms of the banking arrangements between the Bank and the company and these are often on an annual basis, for which a fee needs to be paid for renewal of them. A Bank will usually require a Debenture over the company's assets and this will be in the Bank's standard form and they will not allow any variations or alterations to those documents. The Debenture will have a fixed charge over specific assets and will usually have a floating charge over the company's day to day assets such as stock and book debts. If there is any freehold property within the company then usually a specific mortgage is required by the Bank over that property and usually the mortgage will be an all monies due mortgage so that, for example, not only the borrowing specifically against that property is covered by the Bank's security, but any other money that is owed by the company by way, for example, of overdraft, factoring agreement, letter of credit etc. etc., is also capable of

being added to the cover provided by the mortgage.

As banks want more and more and more security for the meagre amounts that they are lending, the issues of Personal Guarantees become more and more important. Often the Bank will want a Personal Guarantee from a Director-Shareholder who is involved in the business and usually that Personal Guarantee should be limited to a fixed amount. That Personal Guarantee will be limited to, say, £10,000 but the ultimate amount claimed by the Bank will be, if the Guarantee is ever called upon, not just the £10,000 limit

but the interest accrued on that £10,000 from the date that they make the demand and also the costs that they have incurred since they made the demand.

Sometimes banks, not only in relation to companies, require a Personal Guarantee from the individuals Director-Shareholder, but they also require a charge, usually a mortgage, over that person's interest in their home. This has exercised the banks for many, many years, in particular when dealing with matrimonial home of the Director-Shareholder and dealing with that person's spouse. Banks have now evolved quite sophisticated procedures to be gone through to ensure that the problem cases that they had in the early 1990s concerning the inability of the banks to recover against the security of the property they thought, are overcome.

3. PROBLEM AREAS

(A) Facility Letter

I have experience of a Facility Letter having gone through seven versions of a draft from a major high street bank before they finally accepted my assertion that they were ending up going to lend my client £200,000 more than they actually wanted! Therefore, the moral of the story is always to very carefully check the terms of the Facility Letter to see that it exactly reflects the commercial deal that you have struck with your banker.

The other problem area that we have encountered, as a complete contrast to the above when there were surplus funds, the Bank deliberately placing obstacles in our way to ensure that the date by which the Facility Letter expired came and past, which meant the Bank was then able to renegotiate the terms on the basis of the movement of the libor to the Bank's advantage.

(B) On demand

As you have probably gathered from my previous comments, on demand money is something that the borrower has a substantial degree of exposure to complete irrationality from the Bank. Overdrafts should always therefore be viewed as a very risky source of borrowing and in an ideal world, only temporary, and should always be replaced by Term Loans.

(C) Personal Guarantee

The problems with this, apart from the issue of involving outside third parties in them, is whether or not they are appropriate for the

Bank. The Bank's attitude is that they are completely and utterly mandatory and they will not proceed without them, that may or may

not be the case and all depends upon the economic conditions, much tougher now than they were before. The strength of the balance sheet of the company must be the starting point for considering whether or not any Personal Guarantee is appropriate. The limit being put to the Personal Guarantee must be a realistic limit that is appropriate for the exposure of the Bank.

Banks always view Personal Guarantees as lasting indefinitely and are very reluctant to release them. My advice to clients is if the banking arrangements are put in place to protect the Bank at the

moment, then the Bank should accept a release mechanism provided that the performance of the business is as anticipated within the time period. This should be something that people giving Personal Guarantees are always reminding the bankers of, something that they have often, in my experience, amnesia about!

Another problem in relation to Personal Guarantees is obtaining confirmation from the Bank that if they say the Personal Guarantee has been released, that it has been released. My preference is to physically have the original document back and destroyed, but the banks seem quite precious about this and will fail to allow the document to be handed back to you. You should, at the very least, get a letter on their letter heading, signed by the appropriate signatory, saying that the Guarantee has now been released and is no longer effective.

(D) All monies due

This is something that the Americans call "all singing, all dancing" and it is the scope and range of it that you need to be aware of. An all monies due clause, for example, covers a joint venture arrangement with a third party, provided you bank with that bank. What happens if you are confident that your third party arrangements with another venture are with another bank and that bank merges with your bank is something that needs to be kept under review all the time.

(E) Banker

Finally, despite having a very jaundiced view of bankers, having dealt with them over the last 20 years and having had many heated discussions with them over the unfair provisions that they require to release some money to my clients, they are, unfortunately, a necessity and they do need to be looked after. We, as solicitors, for example were given guidance in October that we still had to continue to give undertakings, binding promises on us personally, to pay money to complete deals even if we were worried that the clearing house bank that we operated with was facing closure! That shows how fundamental they are to our system and how much of a problem that the whole system got into in Autumn 2008.

Therefore, although the moral is that they are a somewhat chastened bunch at the moment, you need to be on your guard when entering into any security documents with them to ensure

that they are not getting anything more than they are entitled to.

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