

~ LENDER'S LIABILITY DURING ASSET TAKEOVER ~

When a lender takes security over different types of assets, it will potentially incur a range of different types of liabilities: pensions and environmental liabilities being the most significant. A lender is likely to have been granted a complete security package by a borrower in return for making a facility available to the borrower.

More recently, lenders have experienced the greatest returns from an enforcement of their security to be from the sale of the shares of the borrower company (i.e. through the enforcement of a lender's rights under a Charge over Shares granted in its favour) rather than from the sale of individual assets.

In this article, we consider the various liabilities that may stem from taking security over shares and from taking security directly over the actual asset (such as land or vessels), and the procedures that lenders ought to be instigating to protect themselves from such liabilities.

1. Pensions Liability

The Determinations Panel of the Pensions Regulator (the "Pensions Regulator") in relation to the Box Clever Pension Group Scheme has reopened the debate on whether lenders are exposed to any employer-related risks, and may be liable for any shortfall in the scheme, when taking security over shares.

This issue arises where a borrower, as a part of its security arrangements with a lender, transfers shares in a company by way of legal mortgage to the lender (or its nominees). English law documents that create security over shares typically expressly deal with the circumstances in which the person giving the security and the lender can exercise voting rights in respect of the shares subject to such security.

The lender, by being entitled to exercise voting rights in respect of such shares, is potentially liable under the Pensions Act 2004 as being "connected" or "associated" with an employer in relation to an occupation pension scheme.

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Potential lender liability when taking security over an asset If so, the Determination Panel can potentially issue a financial support direction to the lender by virtue of which it will be liable, as well as the company whose shares have been mortgaged under the debenture (i.e. employer), to put in place financial support for the defined benefit pension scheme while the scheme is in existence.

1. A person is deemed to be an associate of a company (i.e. employer) if it is entitled to exercise, or control the exercise of, one third or more of the voting power at a general meeting of that company or another company that has control of it. The Determination Panel concluded that voting rights pass to a lender when the following two conditions are met:

(a) an event of default occurs and the lender has exercised its rights under the facility agreement; and

(b) the lender has given notice to a company/provider of the security that it intends to exercise voting rights in respect of the shares.

In response to a request from the Financial Markets Law Committee Working Group on the Pension Act 2004, the Pension Regulator confirmed that even if voting rights have vested in a lender under a debenture, lenders were unlikely to be targets of a financial support direction where they have not in fact exercised voting rights in respect of the relevant shares.

2. Liability as a Shadow Director

A shadow director is a person in accordance with whose directions or instructions directors of a company are accustomed to act.(1)

The case of Triodos Bank NV v Dobbs [2004] EWHC 845 (Ch) establishes that a lender is unlikely to be considered part of the corporate structure of a company when acting in defence of its economic interests. However, sometimes provisions of documents which create security over shares in the company do not expressly deal with the circumstances in which the lender can exercise its voting rights in respect of such shares making it difficult to distinguish between commercial pressure which lenders may apply, particularly in distressed circumstances, and instruction upon which directors are accustomed to act.

The consequence of a lender being held to be a shadow director of a company is that it may be liable to make a contribution to the assets of the company if it knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation (i.e. it has been carrying on wrongful trading).(2)

3. Environmental Liability

3.1 Taking security over land or over the shares in a company that owns land.

In respect of environmental liability in particular, a lender may be affected in two ways:

- (a) Environmental liability could reduce the creditworthiness of the borrower either by significantly reducing (in some cases to nothing) the value of the security or by adversely affecting the borrower's business;
- (b) liability can, in certain circumstances, fall on the lender (or a receiver appointed by it under its debenture) when enforcing security.

3. Lenders can potentially be liable for historically contaminated land under the Environmental Protection Act 1990 (the "Act"). The Act covers liability for contaminated land and is administered either by the relevant local authority or the Environment Agency depending on the type and significance of the land and contamination in question.

The local authority has powers to serve a remediation notice which requires the relevant persons to carry out remediation works on contaminated land. Loan documentation typically includes, amongst others, provisions concerning the carrying out of environmental reports, the reporting of the incidents or investigations, and power to require the borrower to carry out remediation at the borrower's cost. By virtue of such provisions a lender holding security over the relevant land (or even in the shares in the company owning the land) might be regarded as "knowing permitters" of pollution under the Environmental Protection Act, or to have secondary liability as an owner or occupier, if they fail to require or carry out remediation works.

3.2 **Taking security over a vessel**

It is highly unlikely that under English law lenders can be held liable for pollution caused by a vessel if such vessel is in the mortgagor's possession, i.e. it is not in possession or under the control of the lender. The same position exists in the European Union and similar provisions apply in the U.S. A lender can, however, be liable if it takes possession of a vessel and that vessel causes pollution.

However, if a lender wishes to be absolutely certain that there is no possibility of lenders' liability unless the lender takes control over or possession of a vessel, then, ideally, inquiry would be made of the laws of the territorial waters of the countries (outside the EU) the carrier will be sailing through or passing by and that the law of the flag. If a lender does take possession of a vessel (especially a tanker) careful consideration should be given to its potential liability for pollution and appropriate insurance put in place.

4. **Procedures for protection from liability**

In order for a lender to avoid being exposed to any employer-related risks – in particular where pensions liability is a potential concern - when taking security over shares, it is advisable for a lender (or its legal team) to consider revising the terms of standard form security documents to make it clear that in the case of a legal mortgage of shares, voting rights do not pass to the lender until it has given written notice of its intention to exercise their rights.

As a general rule, a lender should always carry out careful due diligence and consideration of the potential risks when looking to take security from a charger company or group that has defined benefit pension schemes that may have significant deficits. At the start of any lending transaction involving land or other assets such as vessels which could potentially cause environmental damage, lenders should carry out full due diligence, insist that insurance is in place adequately covering borrower and itself from third party environmental liability and carefully consider how they enforce their security so they avoid potential liability.

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