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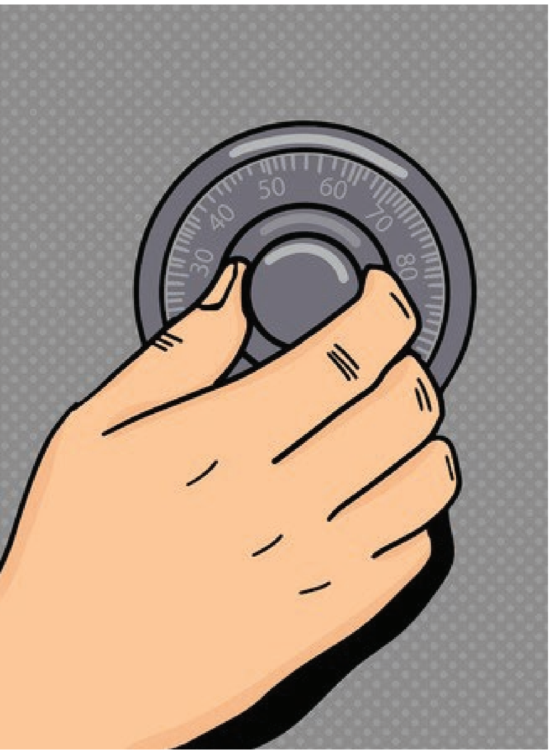

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fresh ideas...

Bank Security Explained
A Basic Guide

After last month's bulletin (some said rant but no offence) regarding bank lending and personal responsibility we received quite a lot of feedback. Most was based around misconceptions of how lender security works with suggestions that we need to drill down and provide some detail. Given that books have been written on this subject any brief summary will, of necessity, only skim the surface.

I should also point out that I am going to talk about a variety of security arrangements in very general terms and borrowers should always seek independent advice to ensure they fully understand their obligations.
So, without further ado, here goes!

Mortgages
The one bank security we are all familiar with. The borrower offers a piece of real estate they own or are buying as security for a loan. Default on the loan and the lender can sell the property to recover the money owed.

Charges Over Specific Assets
A charge over an asset is really just a mortgage over a specific item of value other than real estate. In fact, some lenders refer to taking security over a leasehold motel as a mortgage over the lease. Again, this instrument allows a lender to sell the charged asset to recover a default loan.

Company Charges
Back in the day these were broadly referred to as Fixed and Floating Charges (FFC). The object of the exercise was to take a security over a company's balance sheet. Given that assets such as cash and debtors are very fluid while machinery and equipment is less so this instrument was designed to capture a range of business assets. More recently with the implementation of the Personal Property Security Act (PPSA) the FFC has been replaced with a similar arrangement called a General Security Agreement (GSA). The description of this arrangement is best summarised as a security interest over a company's present and future acquired assets.

Guarantees
As the name suggests the guarantee is taken by a lender from a person or entity that is not the borrower. Lenders do this for numerous reasons. The most common is where the borrower is an incorporated entity and the guarantee is being sought from the people who either control that entity or benefit from its operations. As such a lender would ask for the personal guarantees of the directors, shareholders and any adult beneficiary of any trust for which the incorporated entity acted as trustee.

It is also quite common for lenders to ask for guarantees from entities on who's income there is reliance for debt servicing. If the borrower has multiple business interests across various incorporated entities then those entities may well be asked for their guarantees. Ultimately the lender is looking at who controls cash flow and hence debt service capacity.

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It is important to note that most personal guarantees where more than one guarantor is involved are documented as being joint and several. This means that all guarantors are guaranteeing the full amount of the debt and the lender can go after any guarantor for the full amount regardless of the actual share that person may have in the business. Essentially the joint promise by the guarantors creates a single obligation upon all of them.

In some instances, guarantees can be limited to the individuals share of the total debt. This is most often seen in partnerships where different investors have a variety of equity percentages.

Third Party Security and Cross Collateralisation

This is a very common situation in management rights transactions where a couple are the purchasers. Typically, the unit is purchased in a single personal name with the business acquired by a company with a sole director being the other partner. It is usual for the company to be acting as trustee for a discretionary trust with the couple as primary beneficiaries. The lenders will take a mortgage over the unit, a charge of the management and letting agreements, a GSA over the company and personal guarantees from both individuals. All security is cross collateralised so in effect all security serves to secure all debt.

In this instance, the two primary assets (unit and rights) are linked and cannot be dealt with individually. Also, there is clear commercial benefit for the individuals in terms of the security they are providing. That's important because without demonstrated commercial benefit a lender will generally not take a security from a third party. This is particularly the case where a borrower is seeking to use a relative's house as supporting security. Unless that relative is receiving a commercial benefit and has a level of ownership and control over the business the lender will not accept the security.

Of course, if the ultimate owner of an asset is essentially the same party taking out a loan all is well. A director of a company can offer an asset they own in their personal names as security for that company's debt, that's fine.

BTW - Don't even think about parachuting your 90 year old parents into your company as directors and then using their home as security. No one, least of all the banks and your finance broker, want to be on 60 Minutes as your elderly folks are tipped out on the street after your business goes bust!

Asset Protection

When purchasing or starting a business, it's always a good idea to consider strategies around protecting your assets from future legal action. This may take the form of acquiring the business in an incorporated entity unrelated to the ownership of personal assets such as the family home and ensuring the owner of the home and the director of the company are different people. It is important to understand that asset protection strategies do not extend to lenders in terms of security arrangements. If the lender has your unlimited guarantee then either directly or indirectly you are putting your personal assets on the line.

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no surprises...

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The management rights purchase structure I have described above is a good example of asset protection in terms of the managers unit being owned by an entity other than the business owner. Should a guest sustain an injury and sue the resident manager the unit is owned by a separate entity and thus would usually be out of scope in terms of any legal action.

Deeds of Consent and Rights of Entry

This security is seen most often in leasehold motel transactions and management rights transactions outside Queensland. The document is essentially a tripartite agreement between a landlord or owners corporation (OC), the owner of the business and the lender. If the motel freehold is mortgaged the landlord's bank also gets involved.

The effect of this arrangement is to compel the landlord or OC to notify the lender of any defaults under the lease or agreements, allow the lender to move to remedy the default and if necessary step in and operate the business.

In Queensland the BCCMA includes lenders rights and responsibilities so no Deed of Consent and ROE are required albeit a financiers interest notification is provided to the Body Corporate by the lender.

Limited Recourse Lending

Essentially an arrangement where the borrower does not offer security which would allow a lender to pursue a range of otherwise standard debt recovery remedies. Typically, this will be no personal guarantees or cross collateralised security with the lender simply taking a mortgage or charge over the asset being financed. Limited recourse is not popular with lenders for obvious reasons and can sometimes suggest that the borrower is not confident in their capacity to meet their obligations.

However, on occasions there are commercially viable reasons for such a security structure and lenders will consider such requests on their merits. Lower loan to valuation ratios and higher interest rates will apply.

Summary

Each of these security arrangements could fill several volumes so please take this very much as a high-level overview. Read your specific loan documents carefully, understand your obligations and seek independent legal advice.

Most importantly, if you mortgage a property, offer a business as security or provide your guarantee understand that your worst case scenario is loss of the specific assets you have pledged and more broadly the loss of other assets in which you have an interest. It's really that simple.

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