Feature

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KEY POINTS
- Lenders (and borrowers) do not expect a negative pledge in an agreement for unsecured lending to need registration as a means of perfection and to ensure validity against competing creditors on insolvency.
- However, for the reasons outlined in this article, the author submits:
  - *first*, that an 'automatic security' clause creates a contingent right to security over the whole of the borrower's present and future assets, which is capable, if appropriately protected, of operating as a proprietary interest as against the borrower and third parties; and
  - *secondly*, that such an interest should be classified as a floating charge, and must be registered as such, if it is to be binding on other secured creditors and on any liquidator or administrator of the borrower.

Negative pledge with provision for 'automatic security' on breach: a form of floating charge?

This article considers, in relation specifically to land, whether and with what consequences an automatic security clause can be made, under English law, to create a proprietary interest binding on a third party who obtains security from a borrower contrary to a negative pledge.

INTRODUCTION

A lender ('L') making an unsecured loan on terms which include a 'negative pledge', ie an obligation by the borrower ('B') not to create or permit to arise any security interest over any of B's assets, may also include in the documentation a provision that if B creates or permits a prohibited security interest, L's loan to B shall be automatically secured on the assets subject to that security, rateably with the other obligations secured on them. An example of such a clause is given in *Encyclopaedia of Banking Law*, para K [2101]:

> '*Negative pledge* The Borrower will not, and will procure that none of its Subsidiaries will, create or permit to subsist any Encumbrance on the whole or any part of the respective present or future assets of the Borrower or any such Subsidiary [except for the following:
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> - encumbrances created with the prior written consent of the [lender];
> - liens arising by operation of law and securing obligations not more than 30 days overdue;
> - any encumbrance on any asset but only if simultaneously with the creation of such Encumbrance the obligations of the Borrower hereunder are equally and rateably secured by a comparable Encumbrance on other assets acceptable to the [lender], all in form and substance satisfactory to the [lender].]
>
> If the Borrower creates or permits to subsist any encumbrance contrary to the above, all the obligations of the Borrower hereunder shall be automatically and immediately secured upon the same assets equally and rateably with the other obligations secured thereon.'

The crucial sentence for present purposes is the final one. For discussion of how such a provision operates, see Wood, *Encyclopaedia of Banking Law* para F [3282]; Goode, Legal Problems of Credit and Security, 3rd edition paras 1-71 to 1-78 and 2-11 to 2-15; and Gabriel, *Legal Aspects of Syndicated Loans*, pages 82-90.

This article considers, in relation specifically to land, whether and with what consequences an automatic security clause can be made, under English law, to create a proprietary interest binding on a third party ('T') who obtains security from B contrary to the negative pledge. Provisions restricting creation of security by subsidiaries (not themselves parties to the agreement), or requiring matching security over *other* assets if prohibited security is created, will not have any proprietary effect. However, it is submitted, *first*, that the final sentence of the clause quoted above is immediately effective to create a contingent right to security over the whole of B's present and future assets, which is capable, if appropriately protected, of operating as a proprietary interest as against both B and T, and *secondly* that the interest thus created is to be classified as a floating charge, and must be registered as such if it is to be binding on T, and on any liquidator or administrator of B.

These conclusions differ fundamentally from those of Professor Goode and Mr Gabriel. Professor Goode considers (op cit paras 1-76 and 2-15) that under a 'security' which is contingent on the happening of an uncertain future event (other than a charge of B's after-acquired assets), L has contractual rights only, and not an equitable interest, both at the inception of the transaction (even if B already has the asset in question) and on the happening of the contingency; Mr Gabriel's view (op cit pp 89-90) is that L obtains an equitable interest when, but only when, the specified event occurs.

L's objective, to rank *pari passu* with T, will not be achieved unless, at the time the prohibited security is created, L has a proprietary right which is capable of being, and has been, made binding on T, notwithstanding that T has given value by making a loan to B, and has acquired a legal security interest. The issues are therefore:

- does L become entitled as against B to an enforceable charge on the happening of the event specified in an automatic security clause?

- If so, is L's contingent right to such a charge a proprietary right, capable of being binding on T, before the specified event happens?
- If so, how should that right be classified for the purpose of Companies Act 2006 ss 860ff, and what steps should L take to ensure that it will bind T?

WHAT ARE L's RIGHTS WHEN THE SPECIFIED EVENT HAPPENS?

If an agreement for a charge, or for any other interest in property, provides that the grantee's entitlement shall only arise on the occurrence of a specified event which may or may not happen, the agreement can be specifically enforced, it is submitted, after that event happens (if the other criteria for ordering specific performance are satisfied): see *Fry on Specific Performance*, 6th edition chapter XXII; *Jones and Goodhart on Specific Performance*, 2nd edition pp 22-23. Suppose, for example, that L said to B, and B accepted (complying with the relevant statutory formalities), that 'I am prepared to lend you £100,000, and will rely only on your personal covenant while you are unencumbered absolute proprietor of both Blackacre and Whiteacre; but if you encumber or dispose of either of them I am to be entitled to security over the other': once the money had been lent, it is submitted *first* that there would be no reason of principle or policy for refusing specific performance of B's obligation in respect of Blackacre on Whiteacre being sold; and *secondly* that there is no difference of principle or policy between such an agreement and a negative pledge fortified by a provision for automatic security to arise on the creation of a prohibited security interest.

Professor Goode asserts (op cit paras 1-76 and 2-16) that in the case of an agreement for L to have automatic security over assets which B charges to T in breach of a negative pledge, specific performance is not available because L provides no new consideration at that time. This objection, it is submitted, is unfounded. It is correct, of course, that obligations undertaken gratuitously will not be specifically enforced (*'equity will not perfect an imperfect gift'*) and that an obligation to make a loan, even a secured loan, will not be specifically enforced, in favour of either party, before the money is advanced: *Rogers v Challis* (1859) 27 Beavan 174 at 178-180. But it is submitted that neither of these principles applies where L actually makes a loan on terms that if a certain event happens, the debt shall be charged on identifiable property of B. As Mr Gabriel points out (op cit pp 86-87), by lending the money L provides consideration for *all* B's obligations under the loan agreement, including the negative pledge and the provision for automatic security if a prohibited security is created.

The authorities to which Professor Goode refers do not, it is submitted, support his proposition, or justify the distinction he draws between an agreement for security over B's after-acquired property, which is specifically enforceable and therefore effective to confer an equitable security interest on L when B acquires relevant property, (*Holroyd v Marshall* (1862) 10 HLC 191 at 211) and an agreement for security to arise on any other contingency, which is said to require fresh consideration. In both *Re Jackson and Bassford Ltd* [1906] 2 Ch 467 and *Re Gregory Love & Co* [1916] 1 Ch 203, [1914-15] All ER Rep Ext 1215, a director of the company gave its bankers security for its overdraft; the company agreed to give the director counter-security on demand; a demand was made and counter-security granted shortly before the company went into insolvent liquidation; and the counter-security was held invalid against the liquidator, as a fraudulent preference within the equivalent of Insolvency Act 1986 s 239. The effect of each decision was to thwart – very properly, if the comment may be permitted – an attempt by the company and the director to give the latter the benefit of security without disclosing it to outside creditors while the company continued to trade (compare *Re Jackson and Bassford Ltd*, loc cit at 479), and the correct analysis, it is submitted, is that if parties make an agreement to *grant* a security not immediately but on demand at a future time, they are to be taken at their word, and the insolvency 'hardening' period runs from when the grant is actually made. But it does not follow that under the general law, the security is granted for no consideration: the grant is, rather, performance of an obligation undertaken by the company in consideration of the director providing security for the overdraft, and (as Mr Gabriel points out, op cit pages 87-88,) in both the cases cited, the Court proceeded on the basis that as between the director and the company, the agreement for security was valid and enforceable. (*Re Jackson and Bassford Ltd* [1906] 2 Ch 467 at 479, penultimate sentence; *Re Gregory Love & Co* [1916] 1 Ch 203 at 211-212.)

It is submitted, therefore, that an automatic security clause in the terms quoted above does confer on L a right to security which is, at least, specifically enforceable as against B, in respect of the assets subject to the prohibited security, when that security comes into being in favour of T.

DOES L HAVE ANY PROPRIETARY INTEREST BEFORE THE SPECIFIED EVENT HAPPENS?

If an agreement is specifically enforceable, *'equity treats as done what ought to be done'*, and the party to whom an interest in property would be ordered to be granted is treated as already entitled to that interest. But if B has not yet created a prohibited security, L cannot obtain an order for equivalent security and cannot be treated as entitled to an equitable charge over any of B's assets, because he has no *present* right to require any property to be made available for repayment of B's indebtedness. Compare Atkin LJ's description of a charge in *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 431 at 449-450.

It is submitted, nevertheless, that L's contingent entitlement to a charge over ascertainable property belonging to B, on a specified event (the creation of prohibited security), is itself a proprietary right capable of being binding on T. A 'contingent, executory or future equitable interest in land' can be alienated: see Law of Property Act 1925 s 4(2); and it is suggested in *Megarry and Wade on Real Property*, 7th edition para 9-007 (a passage which appeared in the original authors' editions), that such interests should be regarded as interests in land, rather than 'mere possibilities'. Both authority and conveyancing practice, it is submitted, support

this conclusion. A contingent easement is in principle capable of binding successive owners of the servient land before the contingency happens: in *Dunn v Blackdown Properties Ltd* [1961] Ch 433, a claim, against a successor in title of the original grantor, to a right to use drains 'hereafter to pass' through certain land, failed not because that right was incapable of binding the grantor's successors, but because it infringed the rule against perpetuities. An option agreement exercisable only on the happening of an uncertain event (for example planning permission being granted) nevertheless creates an interest in the land which (if registered) is binding on the grantor's successors: see *Barnsley on Land Options*, 4th edition paras 2-059 and 2-060, and *Spiro v Glencrown Properties Ltd* [1991] Ch 537 at 543-544.

In *Williams v Burlington Investments Ltd* (1977) 121 SJ 424, the House of Lords held that a contingent right to a charge over unregistered land, registered as an 'estate contract', was binding on a mortgagee whose mortgage was created before the contingency happened. The sequence of relevant events was that the owner sold the land to a developer on terms making additional consideration payable on planning permission being granted, and the developer was to grant to the vendor, on request, a legal charge to secure such further payments; after completion of the sale, that agreement was registered against the developer as a Class C(iv) land charge, though not under the Companies Act 1948 s 95; the developer granted a legal charge to secure money borrowed from financiers, who knew the terms of the original sale agreement; planning permission was granted and a further sum became payable to the vendor; and the developer executed a legal charge in accordance with the sale agreement. The House of Lords held that the agreement did not have to be registered under Companies Act 1948 s 95 (because it did not create a *present* equitable right to a security), and that its registration as an estate contract under the Land Charges Act 1925 gave it, and the vendor's legal charge when granted, priority over the financiers' security. Therefore, it is submitted, the fact that the vendor's right to a charge was still contingent (on planning permission being granted) did not prevent it from being a proprietary interest when the financiers took their charge.

Professor Goode considers, however, that in *Williams v Burlington Investments Ltd* the Land Charges Act registration gave proprietary effect, and priority, to what would otherwise have been no more than a personal contract between the vendor and the developer: op cit para 2-15 and note 63, and *Commercial Law*, 3rd edition p 629 note 28, 'This is one of the exceptional cases in which a mere personal contractual right can produce a security effect by virtue of the statutory registration provisions.' But this, it is submitted, is not the effect of the Land Charges Act 1925, nor of its successor the Land Charges Act 1972. A land charge registration does not alter the intrinsic qualities of the matter registered: it operates simply as *actual notice*, under Law of Property Act 1925 s 198, 'to all persons and for all purposes connected with the land affected', of the matter registered and of the fact of registration. Failure to register a registrable matter makes it void as against the classes of purchaser specified (now) in Land Charges Act 1972 s 4(5) and (6), even if such a purchaser actually knows of it: Law of Property Act 1925 s 199(1)(i). The estate contract registration in *Williams v Burlington Investments Ltd* certainly preserved the priority of the vendor's contingent charge over the financiers' security, in that the vendor's right would have been avoided if it had not been registered; but that right can only have been capable of enjoying that priority on the basis that it was intrinsically, and independently of the registration enactment, an equitable proprietary interest which, apart from that Act, would have been binding on any successor in title of the developer other than a purchaser of a legal estate for value and without notice.

The same principle was and is applicable to registered land. Where a notice of a lease, land charge or restrictive covenant was entered on a registered title under the Land Registration Act 1925, ss 48(1), 49(1) and 50(2) provided that all persons deriving title under the registered proprietor were deemed to have notice of the matter registered, and s 52(1) provided in terms that a disposition by the proprietor took effect subject to all estates, rights and claims protected by registered notices, 'but only if and so far as such estates [&c] may be valid and are not (independently of this Act) overridden by the disposition'. Similarly under Land Registration Act 2002 ss 28 and 29, an interest affecting a registered estate is postponed to a registered disposition of the estate for value, unless it is protected by (*inter alia*) a registered notice, and by s 32(3), registration of a notice in respect of any interest 'does not necessarily mean that the interest is valid, but does mean that the priority of the interest, if valid, is protected …'. The rights of an occupier of registered land are only protected as 'overriding interests' so far as they are 'rights in reference to land which have the quality of being capable of enduring through different ownerships of the land, according to normal conceptions of title to real property': *National Provincial Bank v Hastings Car Mart Ltd* [1965] AC 1175, HL, at 1226-7, 1228, 1240 and 1261-2, approving the judgment of Russell LJ in the Court of Appeal, [1964] Ch 665 at 696. Under the 2002 Act, the same result follows from ss 29 and 132(3)(b) and Sch 3, protecting the priority of such of the matters listed in the schedule as are 'adverse right[s] affecting the title to the estate'.

There is a possible argument that no proprietary right is created by an agreement

"It is submitted that L's contingent entitlement to a charge over ascertainable property belonging to B on a specified event is itself a proprietary right capable of being binding on T."

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under which the grantee's entitlement depends on a further act of volition by the grantor: in *Pritchard v Briggs* [1980] Ch 338 the Court of Appeal held that a right of pre-emption does not, when initially granted, confer any proprietary interest, because the grantee has no enforceable right unless the grantor subsequently decides to dispose of the property; though the majority of the court also held (loc cit at 421D-E and 423A-C) that if a land charge is registered in respect of the agreement and the grantor does decide to sell, so that the grantee becomes entitled to an option to purchase, the priority of the option is protected by the registration. The decision has been criticised (compare *Megarry and Wade* 7th edition para 15-063), and has been reversed in relation to registered land (Land Registration Act 2002 s 115). It is not clear from the judgments whether the principle of *Pritchard v Briggs* applies only to an agreement that if the grantor decides to dispose of the property, the grantee is entitled to require the disposal to be made to him, or whether it also includes other contingencies dependent on the grantor's volition, such as the example given above of a right to security over Blackacre if Whiteacre is sold; it is submitted that the decision ought not to be extended beyond rights of pre-emption or first refusals.

On the assumption that *Pritchard v Briggs* is not applicable, it is submitted that the automatic security clause quoted above confers on L a security interest contingent on B creating a prohibited security, and that L's contingent interest is an equitable proprietary one, not merely contractual, which will be binding on T if it is appropriately registered. Any risk that *Pritchard v Briggs* extends to all contingent rights dependent on the grantor's volition, including a charge in favour of L if B creates a prohibited security, can be met, it is submitted, by providing in the automatic security clause that L's charge arises if B 'decides to create' other security: under that wording, L's charge will arise before any security is actually granted in favour of T, and on the reasoning of the majority in *Pritchard v Briggs*, L will then be entitled to priority over T if the automatic security clause has been protected by registration.

HOW SHOULD L's INTEREST BE CLASSIFIED AND HOW CAN IT BE PROTECTED?

While the negative pledge is observed, B can dispose of any of the assets potentially subject to the automatic security clause, and the disposal will remove them from the scope of the security. Recent decisions of the Privy Council and the House of Lords establish, *first*, that the *classification* of a security interest is not determined by the description the parties give it, but is a question of law turning on the effect of the particular rights and obligations created by the security document, (see *Agnew v CIR* [2001] 2 AC 710, at paras 31-32, and *Re Spectrum Plus Ltd* [2005] 2 AC 680, at para 141,) and *secondly* that a security under which the debtor can deal with the charged asset, and remove it and its proceeds from the security, until an event happens to terminate that freedom of disposition, is necessarily a floating charge, even if the parties describe it as a fixed one (*Agnew*'s case, para 32; *Spectrum Plus*, paras 107 and 138-140). It is submitted that an automatic security clause is therefore to be classified as a floating charge on all B's property, which crystallises, in relation to assets subject to prohibited security, on the creation of that security. If the analysis above is correct, an automatic security clause is within the principle stated by Lord Scott in *Smith v Bridgend Co BC* [2002] 1 AC 336, para 63:

> '… a charge expressed to come into existence on the occurrence of an uncertain future event and then to apply to a class of assets that cannot be identified until the event has happened would, if otherwise valid, qualify for registration as a floating charge.'

It follows that an automatic security clause should be registered as a floating charge under Companies Act 2006 s 860(1) and (7)(f).

If B owns unregistered land, registration of a floating charge under the Companies Act also operates as registration of a land charge: Land Charges Act 1972 s 3(7) and (8). If (as is now usual) B's land is registered, a Companies Act registration will not assist L as against B's successors in title, and the priority of an automatic security clause can only be protected by an entry on the Register of Title: Land Registration Act 2002 ss 26, 28 and 29.

Since L's entitlement is to share rateably in any prohibited security granted by B, who is entitled to sell or let the land free from L's rights while no prohibited security exists, it is submitted that the appropriate protection for L is a restriction (under ss 40 and 41 of the 2002 Act) providing that no charge is to be registered without a written consent signed on behalf of L. That will not impede any disposition which B is entitled to make; but if B creates a prohibited security, until registered it will operate only in equity and (if the analysis above is correct) L's right to a charge will have priority as first in time. If T applies to register the prohibited security, the restriction will enable L to require the making of entries recording the existence, and *pari passu* ranking, of the crystallised floating charge under the automatic security clause, as a term of consenting to T's application. If B acquires registered land after undertaking automatic security obligations to L, there will inevitably be nothing on the title to that land to protect L, so a charge by B securing a loan of the purchase money will take priority over L's security, as will any other prohibited security over the new land which is registered before L becomes aware of the acquisition and registers a restriction.

CONCLUSION

It is understood that lenders (and borrowers) do not expect a negative pledge, in an agreement for unsecured lending, to need registration under the Companies Act (or the Land Charges Act or Land Registration Act). But if it is desired to preserve the loan's *pari passu* ranking with other (non-preferential) creditors, by means of an automatic security clause operating on the creation of prohibited security, it is submitted that for the reasons given above, that result can only be achieved on the basis that a contingent security interest arises at the time of the loan agreement; and the registration consequences unavoidably follow. ■