

# SECOND RANKING SECURITY UNDER GUERNSEY LAW

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There is no doubt that second ranking security can be taken under the Security Interests (Guernsey) Law, 1993 (the Law). The process can, however, be somewhat involved and there is often some confusion about the mechanics of doing so.

The Law envisages the creation of multiple security interests in the same collateral, and states that priority between security interests in the same collateral is determined by the order of creation of those interests (although nothing prevents a secured party from postponing its rights). Issues arise, however, from the mechanisms by which multiple security interests can be created over the same collateral under the Law as security may only be taken under the Law by way of control, possession or assignment.

As security by control (under section 1(5) of the Law) relates only to account security where the account bank is also the secured party, it is unlikely that second ranking security will be created under this section.

## Second Ranking Security

In order for second ranking security to be taken over securities (under section 1(3) of the Law) or a policy of life assurance (under section 1(4) of the Law) by way of possession, the certificates of title to those securities (or life assurance policy as the case may be) must be held by the second ranking secured party or some other person on its behalf (other than the grantor or some person on behalf of the grantor). By virtue of the first ranking security interest in those securities the certificates of title (or life assurance policy) required in order to create the second ranking security interest will, however, already be in the possession of the first ranking secured party.

Similarly, in order for a second ranking security by assignment of title to be taken (under section 1(6) of the Law), the title to the relevant collateral needs to be held by the second ranking secured party or some other person on its behalf (other than the grantor or some person on behalf of the grantor). Again, by virtue of the first ranking security interest in that collateral, the title to that collateral will already have been assigned to the first ranking secured party and cannot be assigned twice.

## Options Available

Consequently, in order to take second ranking security under the Law by possession or assignment, there are three real options:

Firstly, the senior secured party could be joined as a party to the second ranking security interest agreement to agree that it holds the certificates of title (or policy document) in the case of possessory security, or title in the case of security by assignment, for itself and, subject to the security interest of the first ranking secured party, the second ranking secured party. This is often difficult to achieve in practice as the senior lender is rarely prepared to accept this additional obligation when there is little incentive for doing so.

A second and more simple approach is possible where a single security interest can be taken in favour of a single secured party, and that secured party is prepared to act as security trustee for the various secured creditors to exercise and enforce the security interest and apply the proceeds of sale of the collateral in accordance with the terms of a security trust. In many cases the senior security will be being taken by a security agent for the senior lending syndicate, so it is not particularly onerous to amend the security trust so that, once the senior parties are paid out, the security trustee will distribute any remaining proceeds of sale to the second ranking secured party. This is often a more flexible approach which can be more easily adapted to the commercial requirements of the parties and the security trust instrument need not necessarily be governed by Guernsey law.

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Lastly, a second ranking security may be taken by way of taking security over the “equity of redemption”, being the rights of the grantor of the first ranking security to have any proceeds of enforcement not required for the discharge of the first ranking security interest returned to it. This is not strictly second ranking security but first ranking security over different collateral and only comes into existence when the first ranking security has been enforced, but the commercial effect is very similar to true second ranking security. The mechanism has not been tested in the courts and there is a possibility that, to the extent the doctrine applies in Guernsey, it might be argued that a security interest of this type might constitute a clog on the equity of redemption (and is therefore invalid).

#### **Enforcement of the Law**

Upon enforcement, the Law provides expressly that a secured party must apply the proceeds of sale in discharge of any prior security interest before discharging its own and then must pay, in due order of priority, those secured parties whose security interests were created after that of the enforcing secured party.

Enforcement of a Guernsey security interest may only be carried out once. The Law does not envisage

multiple partial enforcements but does provide for and envisages that the holder of a lower priority security interest has the same ability to enforce as do the holders of prior security interests. A junior secured party might, therefore, trigger enforcement of a first priority security interest before all the relevant secured debts had become due and so the prior ranking secured party could be prevented from requiring such debts to be discharged. This might prove to be in the junior secured party’s interests as it would leave more of the value in the collateral available for meeting its own secured liabilities.

The consequence of this is that great care needs to be taken in drafting security interest agreements where security interests of differing priority are to be taken. It also points to the importance, in a first ranking security interest agreement, of covenants against the creation of other security interests in the secured collateral without the consent of the secured party. In addition, to ensure protection of a senior lender in an enforcement situation, it is wise to ensure that suitable intercreditor provisions are put in place to prevent premature enforcement by a junior secured party.

It is worth noting, in passing, that the Jersey security interests law is currently similar to the Law in most respects and the same principles and issues arise there. Jersey is, however, introducing a new Security Interests (Jersey) Law 2012 in the course of next year which includes specific priority provisions so the position there will shortly be fundamentally different.

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