**KEY POINTS**

- Covenant to pay clauses in security documents provide important clarification as to the nature and scope of a chargor's liability to pay.
- There are a number of pressing commercial reasons why a chargor may wish to limit its personal liability under a covenant to pay. It is possible to limit a chargor's personal liability under a covenant to pay but careful drafting may be required to achieve that goal.
- The omission of a covenant to pay from a security document is not necessarily fatal to the security but its omission may lead to some undesirable consequences.

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# Covenant to pay clauses in security documents: why are they needed?

Covenant to pay clauses are commonplace in security documents. This article addresses why such covenants are necessary, the circumstances in which a chargor may wish to limit its liability under the covenant (and how it can effectively go about doing so), and the potential consequences of not including a well-drafted covenant to pay in the security document.

## SOME REASONS WHY A COVENANT TO PAY IS TYPICALLY INCLUDED IN SECURITY DOCUMENTS

Generally, a loan agreement to which the charge typically relates will set out the key commercial terms as between the lender and borrower. The charge typically deals with the security. Ideally, the loan agreement and charge will be drafted so there is no inconsistency between the two documents. If an obligation to pay the lender is contained in the loan agreement it might be asked why the same or similar obligation should appear as a covenant to pay in the security document at all, at least where the borrower is also the chargor (cf. a third party chargor, or non-recourse chargor where liability is limited to the value of the secured assets).

First, it provides the chargee with a more generous limitation period. In the absence of a covenant to pay, the secured debt is only a simple contract debt to which the six-year period of limitation will apply under s 5 of the Limitation Act 1980 (simple debts). Where the debt is a covenant the applicable period of limitation for payment of the principal sum secured is 12 years pursuant to s 20 of the Limitation Act 1980 (recovery of monies secured by mortgage or charge) if the charge is under seal or otherwise executed as a deed. A right under the covenant to pay survives the chargee's exercise of its power of sale: *West Bromwich Building Society v Wilkinson* [2005] UKHL 44.

Second, the covenant should clarify when the cause of action for the covenant to pay arises. Under s 20(1) of the Limitation Act 1980, no action should be brought to recover any principal sum of money secured by a mortgage or other charge on property after the expiration of 12 years from the date on which the right to receive the money accrued. The terms of the mortgage or charge will determine the date when "the right to receive the money accrued" within the meaning of s 20(1) of the Limitation Act 1980.

- A well-drafted covenant to pay will typically specify an obligation to pay on a fixed date or on demand.
- Covenants to pay are usually expressed as payable on demand. Where the loan expressly specifies a fixed date for payment, care should be taken not to convert inadvertently the loan into a demand loan by imprecise drafting in the covenant to pay. A well-drafted covenant to pay clause should provide that "the Company will pay or discharge the Secured Liabilities on demand when due"[1] so as to avoid this risk.

In the absence of a properly drafted covenant to pay, there is a risk that the time for the purposes of limitation may run from the time the charge is granted: *Bradford Old Bank v Sutcliffe* [1918] 2 KB 833, CA.

Third, it clarifies the scope of the obligation that is in fact being secured. It is beyond the limits of this article to deal in detail with issues as to the construction (or interpretation) of the scope of the secured obligation but common issues include:

- whether the scope extends to the contingent liabilities of the borrower under a guarantee;
- whether the scope is limited to liabilities owed by the borrower to the lender (or includes any after-acquired debts of the borrower assigned to the lender by a third party);
- whether (conversely) the scope includes debts owed by the borrower to any subsequent assignee of the charge;
- whether the scope extends to obligations arising from any variation to the loan facility; and
- whether the scope includes the costs and expenses of enforcement.

Fourth, if the mortgagor is under no liability to pay, it may be difficult to make a valid demand for payment or exercise a right to foreclosure over the land. The mortgagee also runs the risk in seeking to foreclose or possess land (and in so doing destroying the equity of redemption) of having its conduct challenged as unconscionable.

Fifth, in the context of a syndicated loan or a securitisation transaction, the Security Trustee holding the various security interests created on trust for the various creditors will typically insist on a covenant to pay so as to establish a direct relationship between it and the chargor.

Sixth, there are commercial instances where a third party or non-recourse chargor (possibly inadvertently) may assume all of the borrower's personal obligation to pay. The common law starting point is that in the *complete* absence of a covenant to pay (and the absence of any basis for implying such a covenant from the security document or the surrounding circumstances), the chargor will have no *personal* liability to pay at all: *National Provincial Bank Ltd v Liddiard* [1941] Ch 158. In those circumstances the chargor can either pay off the monies owed by the borrower or, if it does not, run the risk of having its property

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seized by the chargee. However, a covenant to pay may be implied into a security document by the court. For example, it is potentially arguable that a covenant to pay will be implied by an admission of liability in the third party or non-recourse charge deed. However, such an implication will likely (but not certainly) be readily rebutted where the chargor puts up its property as security for a loan to a third party: *Fairmile Portfolios Management Ltd v Davies Arnold Cooper* [1998] EGCS 194; *Re Midland Bank Ltd's Application* [1941] Ch 350. Moreover, certain statutory provisions provide for an implied covenant to pay. For mortgages created before 13 October 2003, a covenant to pay was implied pursuant to s 28 of the Land Registration Act 1925. Although s 28 of the Land Registration Act 2002 does not include a similar provision the Land Registration Rules 2003, rule 103 prescribes the use of form CH1 where the parties can elect to incorporate similar covenants to pay the principal sum charged and interest: the risk of an inadvertent election to incorporate such covenants is all too real. In an abundance of caution, and in order to ensure that personal liability is limited, it is probably more prudent to draft a provision expressly addressing limitation on personal liability rather than relying on a complete absence of a covenant to pay to achieve that result.

## WHEN MAY A CHARGOR WISH TO LIMIT ITS LIABILITY (AND HOW TO ACHIEVE SUCH LIMITATION OF LIABILITY EFFECTIVELY)

As noted above, there are a number of other instances when the chargor may seek to limit its liability:

- The secured liability may be so extensive that the chargor may wish to limit its potential liability: charges are often drafted to assume a cross-guarantee structure in which there are multiple chargors and each chargor guarantees all obligations of all the other chargors, and grants security in respect of that comprehensive guarantee.
- A third party or non-recourse chargor (eg a parent company granting a share charge only) may wish to limit its liability.
- When signing on behalf of a limited partnership, a manager may wish to see its potential liability limited.
- Some foreign companies may not be permitted to cover the full amount since to do so may constitute unlawful financial assistance or breach corporate benefit rules.

It is generally advisable, where there is an absolute covenant to pay, to avoid express clauses that purport to exclude personal liability since such exclusion clauses will likely be held to be repugnant to the covenant to pay and be given no effect. In the case of *Watling v Lewis* [1911] 1 Ch 414 the court considered the following provision:

> "And the said defendants as such trustees **but not so as to create any personal liability on the part of them or either of them** hereby jointly and severally covenant with the said Henry John Wyatt Watling that … [the defendants] … will pay the said principal sum of [£2000] now remaining due in respect of the said indenture … ." [emphasis supplied]

The court held (at p 424 of the report) that the attempt to exclude personal liability would be repugnant to the covenant to pay:

> "The result is, I think, that first there is a covenant to pay the money and to indemnify, and then the parties have attempted to qualify that covenant by using the words the effect of which, if effect is to be given to them, would be to destroy the personal liability. That being so, the words that they have used can have no effect at law and the liability remains."

Generally, therefore, it would be advisable, in instances where the chargor wishes to restrict its liability under a charge, for such restriction to be expressed in the covenant to pay as a limitation, rather than exclusion, of personal liability.

## POTENTIAL CONSEQUENCES TO THE SECURITY WHERE THE COVENANT TO PAY IS ABSENT OR DEFECTIVE

Some of the consequences of not having a covenant to pay contained within the security are commercially undesirable but not necessarily fatal to the security (or its intended aims). By way of example only:

- If the 12-year limitation period for payment of the principal sum secured runs from the date of the security rather than the date of the demand that may not be an issue for many commercial securities.
- Section 103 of the Law of Property Act 1925 provides that the power of sale under a charge can only follow a notice requiring payment under s 101 of the Law of Property Act 1925. However, since the provisions of s 103 of the Law of Property Act 1925 are often expressly excluded, the lack of clarity as to whether, and when, a mortgagor can request payment from the mortgagor may not be fatal.
- If there is no covenant to pay in a mortgage over land, it may be that the mortgagee can enforce its security by relying on an "event of default" provision in the mortgage that often gives rise to an express right to foreclose or take possession.
- The restriction in the ability of a chargee to pursue any shortfall after the sale of the secured property may not matter where the commercial deal is for a non-recourse security where recovery is limited to the sale proceeds of the secured property in any event.

## CONCLUSION

Generally, covenants to pay within security documents perform a number of commercially and legally important functions. They provide valuable commercial certainty to both the chargor and chargee; and also clarify the obligations between them where otherwise the common law may lead to unintended and commercially undesirable results for one or both of the parties. Poorly drafted covenants to pay or the absence of a covenant to pay while not necessarily fatal to the effectiveness of the security can lead to serious consequences for the parties. ■

1 See eg *Butterworth's Encyclopaedia of Forms and Precedents*, vol 10(2), [780].