

# Security over Inventory and Plant & Machinery

## SECURITY OVER INVENTORY AND PLANT & MACHINERY

Inventory and plant and machinery (“Inventory” and “P&M”) are two of the most common asset classes to make up a borrowing base in asset-based lending deals after receivables. In this note we will look at the key considerations from a financier’s perspective in relation to each asset class, to ensure they are able to obtain effective security and don’t suffer diminution of the borrowing base.

## INVENTORY

### Floating security

While it is theoretically possible for a financier to obtain fixed security over Inventory, that would require that the security agreement restricted the borrower from utilising and/or disposing of its Inventory without the consent of the financier (and that the borrower complies with those restrictions in practice during the life of the facility). Due to the revolving nature of Inventory in most businesses, and a borrower’s requirement to deal with its Inventory on a daily basis, such control is likely to be impractical, not to mention burdensome for the financier to operate (either directly or through an appointed agent). As such, a financier will typically only require floating security over Inventory in England.

A financier with floating security over Inventory should be aware that in an enforcement scenario, its recoveries in relation to those assets will rank behind (a) fixed security holders over the same assets (although that is unlikely); (b) costs and expenses of the insolvency process; (c) preferential creditors and (d) an amount equal to the prescribed part. Financiers will therefore apply a reserve against the available facility to mitigate this leakage from their security.

## Retention of title clauses

A financier will often instruct their legal counsel to review the supply contracts entered into by the borrower with its suppliers before they agree to provide funding against its Inventory. The purpose of this is not to inspect each commercial term that the borrower has agreed with its suppliers, but instead to check that the borrower has unfettered title to its Inventory. The key thing financiers will be looking for in this regard are “retention of title” (“ROT”) clauses.

There are a number of different types of ROT clauses that might be included in a supply contract. A financier may come across a supply contract containing a basic ROT clause where the supplier reserves ownership of the goods supplied until the borrower has paid for those particular goods (a basic ROT clause); alternatively, the clause could reserve title until the customer has paid all amounts that may be outstanding between the supplier and the borrower from time to time (an “all monies” ROT clause). Both of these types of clause are considered effective under English law provided they are drafted correctly.

A financier may also find an “extended” ROT (EROT) clause, which purports to give the supplier rights, not only over the goods, but also over the sale proceeds of the goods once on-sold by the borrower. However, in a series of cases the English courts have held that an EROT clause creates a charge which will (for an English company) be void if not registered at Companies House and therefore the supplier would rank as an unsecured creditor behind any secured creditor (i.e. the financier). This is not the case, though, in some other jurisdictions where EROT can be effective.

The existence of a valid and effective ROT clause will impact on the ability of the financier to take valid security (as technically the borrower will not have valid title to the Inventory in question). This can be dealt with by excluding Inventory subject to a valid ROT clause from being eligible or imposing a reserve equivalent to the amounts owed to suppliers.

### Identification of assets

Unlike in certain continental jurisdictions, it is not necessary to identify the assets or their location in order to be able to take valid security. However, it is recommended that, either at day one or as an information requirement during the term of the facility, the financier has the ability to determine the location of the Inventory and whether it is stored in warehouse owned by the borrower or rented from a third party landlord.

### Landlord lien

If the borrower's Inventory is located in rented premises, its landlord will have a common law lien giving it a right to seize and retain any Inventory in the warehouse as security for the payment of any rent arrears owing by the borrower. Such a lien may also have a contractual basis in the lease.

Such a lien would make gaining access to the Inventory upon an enforcement much more difficult. In order to mitigate the risk of not being able to access significant borrowing base assets, the financier will either require a waiver from the relevant landlord or, more commonly, will apply a reserve so that there would be sufficient availability under the facility to enable the financier to discharge the rent arrears and gain access to the Inventory on an enforcement.

The reserve is usually set at three months' rent, although should be noted that in certain jurisdictions a landlord can have rights to payment over a longer period and so it may be appropriate to apply a larger reserve.

### Inventory in transit

Additional issues are raised by Inventory which is in transit, either between locations belonging to the borrower or, more commonly, in transit to the borrower. Financiers are less willing to lend against Inventory while it is in transit, particularly if the Inventory is travelling across borders. While an English law floating security should capture Inventory while it is in England and Wales, if it is in transit across borders, that may not necessarily be the case. There are also added difficulties associated with locating and taking possession of the Inventory if there is an enforcement event and the costs of third parties, such as hauliers and shipping agents, which may need to be met in order to release the Inventory into the custody of the financier.

This topic will be dealt with in greater detail in a separate note.

## PLANT AND MACHINERY

### Fixed/Floating security

While security over Inventory is likely to be floating (given the commercial difficulties in exercising the appropriate levels of control), it is in principle possible for significant items of P&M to be subject to fixed security.

In order for security over P&M to be fixed, the financier needs to exercise sufficient control over the assets in question. If the financier fails to do so, it risks the fixed security being re-characterised as floating.

To exercise control, the financier will need to restrict the borrower from dealing with the relevant P&M without the financier's consent. This can be achieved contractually by robust restrictive undertakings and a negative pledge restricting the borrower's ability to replace, move and/or sell the relevant P&M. The financier may also require the borrower to affix plates to the P&M which would identify it as being subject to security in favour of the financier.

However, if the borrower's P&M is of a type which needs to be replaced regularly and the borrower cannot operate its business if it has to obtain consent from the financier each time a replacement is needed, then the financier may have to accept that it may only have floating security and will have to instead apply suitable reserves.

### Fixtures

If the P&M is considered to be a "fixture" it would comprise a part of the real property on which it is located rather than being a standalone asset in its own right. Fixtures would then need to be secured along with the real estate. It follows, therefore, that P&M which has become a fixture in rented property would be owned by the warehouse/factory owner rather than the borrower, as title to anything attached to the land merges with the title to the land and so could not be secured in favour of the financier.

Whether something has been affixed to property so as to become a fixture is a question of fact. The answer partly depends on the extent to which the asset is attached to the land or building and also how it is affixed. The purpose for which the asset was annexed to the land or building is also relevant. However, this is a complex factual analysis and would need to be undertaken on a case by case basis.

### Landlord lien

Like with warehoused Inventory, any P&M situated in leased premises would be subject to the landlord's lien (whether under common law or on a contractual basis set out in the lease). As with Inventory, a financier will either require a waiver from the relevant landlord or will apply an appropriate reserve (to enable it to be in funds to discharge the rent arrears and gain access to the premises).

### Ownership

A final consideration is that P&M is commonly subject to hire purchase agreements. If this is the case then the borrower would not have title to the P&M and it should be considered ineligible for funding purposes. A financier should procure clear representations from the borrower as to the ownership of its P&M.