

Article Information

Service: Banking & Finance

Sector: Financial Services

Off The Beaten Track: A Pathway to Raising Additional Equity

Borrowers who are seeking to raise additional equity may enter into “hidden mezzanine loans” with lenders while implementing springing securities. This approach would require each security document to be signed prior to financial close. The underlying intention is for:

- ***the securities to remain unregistered; and***
- ***the applicable charging clauses within the securities to remain inactive,***

until certain trigger events occur. In this instance, the mezzanine lender advancing the equity injection (usually in connection with a development project) would remain undisclosed to prior ranking lender/s. This article explores these equity structures and how lenders may utilise springing securities.

Understanding Preferred Equity and Springing Securities

Preferred equity is commonly used by project sponsors to fill the gaps of equity funding on a project, or to increase leverage. A preferred equity structure places a private lender in a priority position for repayment from any cash flow earned from a particular investment over others. Their preferred equity position places them behind the repayment of a senior lender (i.e. usually a major bank that holds the first mortgage) but before common investors or sponsors.

The following scenario explains how a preferred equity structure may be used. A senior lender (i.e. a major bank) funds the development of a site. A condition precedent to the \$70 million loan provides that the developer must demonstrate that they can contribute \$10 million of their own equity to the project. However, the developer does not have sufficient equity and may seek a preferred equity loan to raise this equity without consent or knowledge of the senior lender. In an attempt to circumvent breaching the negative pledge provisions of the senior loan and a breach of the financial indebtedness covenant without the senior lender’s consent, the mezzanine lender’s securities may be drafted on a springing basis and remain “hidden” (together with the mezzanine loan) from any prior ranking security interest holders. The “hidden” mezzanine loan and securities would still however breach the negative pledge and financial indebtedness covenants under the senior loan.

In practice, the mezzanine lender would hold onto security documents (i.e. mortgages and general security deed, among others) which are signed, but not dated and not registered with the relevant titles office and/ or on the PPS register. The charging clauses within these security documents will not take effect (and will not be registered) until a ‘Springing Event’ occurs.

What are Springing Events?

Some examples of Springing Events include:

- any mortgage in favour of the senior lender with respect to the property is released;
- all senior facilities made available under the senior facility agreement have been prepaid or repaid in full;
- an obligor defaults under the senior facility agreement or there is a default (however described) under any document entered into by an obligor in connection with the senior facility agreement; or
- an obligor defaults (however described) under a mezzanine finance document.

Benefits of Springing Securities

Following a Springing Event, a mezzanine lender is able to register the general security deed within 20 Business Days of the date of the Springing Event. It is important to note that the general security deed must remain undated until a springing event has occurred, at which the mezzanine lender will date the document and not be out of time for registration on the PPS register. However, some would argue that this does not rectify the security interest being registered out of time and the collateral would immediately vest with the Grantor prior to the appointment of liquidators.^[1]

The same would apply in respect of a real property mortgage, which you could register in New South Wales and Queensland as a second mortgage without the prior mortgagee producing the title deed to effect registration (refer to the link below for further information regarding the changes to the New South Wales title register).

A potential benefit of a springing security is that this approach may be used in an attempt to circumvent the negative pledge clauses in the senior finance documents (this is arguable, and caution will need to be exercised on a case by case basis). The underlying reason is that the security does not come into force until a Springing Event has occurred and the charging clause within that security comes into effect.

However, an argument exists whereby the security has been signed and there is an intention to charge the particular property (real or personal) of the obligor and thus could still be found to be in breach of the negative pledge clause in the senior finance documents as there is an intention to grant security from the time of signing the security.

Disadvantages of Springing Securities

The disadvantages of security springing mainly revolves around the ranking of the mezzanine lender's security interests. As a mezzanine lender, it is impossible to confirm with any certainty if the applicable obligor has granted any prior dated security (that remains unregistered) in favour of another secured party. Ultimately, this would affect the mezzanine lender's ranking at law and also in respect of equitable principles (whereby generally the prior dated unregistered security would prevail over the later dated unregistered security - equitable legal priority principles).

How the Cancellation of CTs and CoRD Consents affect Springing Securities?

The recent changes to the cancellation of Certificate of Titles (CT) and Control of the Right to Deal (CoRD) consents will change the way in which mezzanine lenders register their mortgages. As of 11 October 2021, there is no longer a need to request CoRD holder consents from the mortgagee on title (other than in respect of a Borrower's breach of any covenant to request such consent). As opposed to the old rules, where the ranking of the mezzanine lender's priority is based on agreed priority arrangements in respect of the senior lender's security. The new rules in New South Wales now depend on the unregistered party registering their mortgage the fastest (i.e. competing registered legal interests) to trump the legal priority of any other unregistered mortgagee. This means that if there are multiple mezzanine lenders in respect of real property, their priority in respect to their respective mortgages will depend on how quickly they can register their mortgage and perfect it following a Springing Event.

Key Takeaways

1. Borrowers who are seeking to raise additional equity may seek to enter into preferred equity/ hidden mezzanine loans;
2. The mezzanine lender's securities are often drafted on a springing basis in an attempt to avoid the negative pledge provisions of the senior finance documents. The mezzanine lender's securities will only take effect on the occurrence of a Springing Event;
3. A mezzanine lender will have no way of confirming with certainty if any other unsecured securities have been granted in respect of the same secured property (both real and personal property); and
4. The abolishment of CTs and CoRD consents means that the mezzanine lender's priority in respect of the secured property (both real and personal property) will depend on how quickly they can register their securities following a Springing Event.

Please read this article in conjunction with [Future of eConveyancing in NSW- Are you ready for the cancellation of Certificate of Titles and CoRD consents? How does this impact on second mortgages?](#) For further information relating to preferred equity structures and springing securities, please contact Banking and Finance Partner, Greg Conomos

[1] Personal Property Securities Act 2009 (Cth) s 267; Corporations Act 2001 (Cth) s 588FL.