LETTERS OF OBLIGATION

Guidance Notes for Use

Letters of Obligation continue to be used regularly in the settlement of property transactions and in recent years a number of "standard" provisions have appeared in most letters of obligation granted by solicitors. The Law Society Conveyancing Committee produced an approved style of "classic" letter of obligation for Sasine transactions in 1995. The Registration of Title Practice Book provides styles of letter of obligation for first registrations and transfers of registered interests in the Land Register. Yet there are still instances of time spent between solicitors negotiating the terms of standard letters of obligation. There appears to be some inconsistency within the profession on the terms of a letter of obligation in some commercial security transactions or in lease transactions.

The Group has studied most of the usual permutations of Letters of Obligation with a view to producing a series of Letters which take into account the typical interests and requirements of the seller/purchaser; landlord/tenant; assignor/assignee and lender/borrower, and their respective solicitors in the majority of transactions. Alistair Sim of Marsh has confirmed that the content of these styles and the contents of this Guidance Note meet the criteria for "classic" letters of Obligation for Master Policy purposes. A standard form undertaking granted in the context of a share purchase transaction is, potentially, a "Classic" undertaking

Master Policy cover for Letters of Obligation

The Master Policy will indemnify a firm of solicitors (Clause INSURANCE 2 of Master Policy Certificate of Insurance) against loss arising from the firm having to honour any personal undertaking (other than a personal financial guarantee) or letter of obligation given by the solicitors in the ordinary course of their practice as solicitors.

What is a "classic" Letter of Obligation?

Source: "The Importance of Being Classic" by Alistair Sim JLSS April 2001

If an undertaking conforms to the definition (in the Master Policy Certificate of Insurance) of a "classic" letter of obligation, the impact of any claim arising out of the firm having to honour the undertaking will be neutral in two respects so far as the firm is concerned. There will be a Nil self-insured amount contribution payable by the firm towards the settlement of the claim. The amount paid by the Master Policy insurers will be disregarded for the purposes of the firm's Master Policy premium discount/loading ie. there will be no impact on the level of the firm's Master Policy premium.

The definition of whether or not an obligation will qualify as "classic" revolves around compliance with Special Condition 3 of the Master Policy Certificate of Insurance. This in turn revolves around the context in which the undertaking is given, the content of the undertaking, any qualifications which are attached to the undertaking and the observance of appropriate risk management controls to minimise the risk of a claim arising.

Letters of Obligation granted in a variety of situations will qualify as "classic" for the purposes of Special Condition 3 when given in appropriate circumstances, which Special Condition 3 defines as any situation involving "the disposal for onerous consideration of any interest in property of any description or the granting of security over any such property by a client of that solicitor". This will therefore include undertakings given in landlord/tenant, assignor/assignee and lender/borrower

transactions as well as sale/purchase transactions, including share/corporate sale/purchase transactions.

Appropriate undertakings include clear property and personal searches, and executed/recorded Discharges, and also to give undertakings in, or substantially in, the styles of letter of obligation set out in the Registration of Title Practice Book. These will be treated as "classic" provided they are couched in appropriate terms and are subject to appropriate qualification (i.e. limited so that it is effective for no more than 14 days from the date of settlement).

The minimum risk management controls which have to be observed are:

- a search must have been carried out "immediately prior to settlement" (which in practice will mean dated not more than 3 days prior to settlement*) including in Sasine cases a search in the Computerised Presentment Book, and the search must be clear (Note: Insurers will require to see the clear searches in the event of a claim);
- the granter of the letter of obligation must have control of sufficient funds to pay the loan (and must know the identity and whereabouts of the party entitled to the redemption money) before giving an undertaking to deliver a discharge of a standard security;
- the granter of the letter of obligation must have made proper enquiry of the client regarding any outstanding security or other matter which might adversely affect the search (Note: in the event of a claim, Insurers will require evidence of such enquiry having been made and it is therefore prudent for the position to be documented in writing); and
- the granter of the letter of obligation must be unaware of any other security or matter which might adversely affect the search.

*Note that the Council of Mortgage Lenders Handbook now specifies 3 **working** days.

1 PSG Letters of Obligation relating to Sasine Transactions.

1.1 For standard transactions the period of time for continuation of the Searches and time limit for recording the Disposition (or Assignation) must not exceed **fourteen** days to comply with the Master Policy. The Law Society reverted to this period for letters of obligation granted on or after 1 November 2010.

1.2 A period of **one year** has been specified for delivery/exhibition of the search. This appears to co-incide with standard practice of the majority of the profession and is an achievable period for the professional Searchers. There should not therefore be any justification for a longer period than this, nor from a practical point of view should there be any reason for a purchaser to insist on a shorter period.

1.3 A six month period is allowed for delivery of a duly recorded discharge to allow ample time for the longest backlog in the Sasine Register.

1.4 Any obligation by the Seller's solicitor, other than delivery of searches, and, where there are sufficient funds available, delivery of a recorded discharge, would be non-classic and any claim under the Master Policy in respect of such a non-classic obligation would be subject to the double deductible (or double excess). All non-standard obligations ought therefore to be given **on behalf of the client**.

2 Obligations relating to Company and Charges Searches

2.1 The allowance for delivery or exhibition of a Charges Search has been specified at **three months**. This will allow a sufficient period for the professional searchers to provide the Search.

2.2 A **thirty-six day** continuation period has been provided to allow for a combination of the period of 14 days after settlement, by the end of which the disposition or assignation has to be recorded, plus the period of 22 days after the date of completion/settlement, during which a charge created by the Seller or assignor immediately prior to the date of completion/settlement would normally appear in the Charges Register

2.3 There is strictly speaking no need to qualify the statement that the Searches must disclose no prejudicial entry, as is sometimes seen, with wording to the effect that this includes no notice of winding-up, striking-off, liquidation, receivership or administration procedures, as these would clearly be prejudicial and therefore clearly included within the general terms of the obligation.

3 PSG Letters of Obligation relating to First Registrations

3.1 The letters relating to First Registration in the Land Register follow the format laid down in the Registration of Title Practice Book, which are accepted by the Master Policy insurers as classic provided the 14 day period is specified and the necessary steps to minimise risk have been taken before granting the letters.

3.2 Given the increasing possibility that the parties to the transaction choose to dispense with a hard copy Land Certificate, and opt instead for an electronic version, in line with the Keeper's push towards "dematerialisation", the latest versions of the Letters of Obligation dealing with First Registrations and Registered Interests now provide an option for the parties to refer to the updating of the Title Sheet in such circumstances, rather than the issuing of a Land Certificate.

4 PSG Letters of Obligation relating to Registered interests

The letters relating to Registered Interests in the Land Register also follow the format laid down in the Registration of Title Practice Book.

5 PSG Letters of Obligation relating to Security Transactions

5.1 In loan transactions where the Borrower is also purchasing the Property, the Seller's solicitors will be granting a letter of obligation in favour of the Borrower's solicitors, which they should ensure is also in classic terms, to enable them to grant a letter of obligation to the Lender's solicitors in classic terms.

5.2 A period of three years has been suggested as a suitable length of time by the end of which most Land Certificates in First Registration transactions will have been issued. However, given that this is a matter outwith the control of the solicitor granting the undertaking, the proviso "(or as soon as received thereafter)" should qualify this undertaking. While this may be seen by some as an open-ended undertaking and therefore of questionable worth, it should be borne in mind that this is also coupled with the undertaking at paragraph (4) of this style not to withdraw the Borrower's application for registration except with the Lender's consent, and the Keeper has a statutory obligation to register following application subject to any appropriate requisitions.

5.3 In circumstances where the Borrower is also purchasing the property, the Lender's solicitors will also look for a clear Charges Search against the Seller, as well as the Borrower. Such undertakings are given on behalf of the client only, but the Borrower's solicitor should ensure that they have a similar obligation from the Seller's solicitor to produce the Search.

6 PSG Letters of Obligation relating to Lease Transactions

6.1 *Are they appropriate*? Although most landlords' solicitors don't at the outset offer obligation letters, tenants often ask for them. This is a reasonable request even where the lease is not registerable. In theory, when the tenant takes entry, it has a right to be satisfied on the landlord's title.

6.2 *When should they be granted*? In practice, however, life is not as simple as that. Most lettings tend to be effected and entry taken under missives with the actual lease being signed later, sometimes well after entry. As a result:-

(a) Where the letting is to rest on missives, letters of obligation can only be granted at entry but this would not be appropriate in most other situations since the obligation would fail to meet the classic test.

(b) Where there is a separate lease, the recommended approach is for obligation letters to be granted when the lease itself is signed or, in the case of a 20+ year registerable lease, either when it is delivered to the tenants for registration or alternatively when the landlords stamp and register. The relevant missives ought to spell this out.

In those cases, regard should be had to the fact that, immediately following entry and prior to the grant of the lease, many tenants will incur significant expenditure on shop-fitting and other items. The prudent lawyer ought therefore to insist on seeing clear updated interim reports at entry to ensure that the landlords' title at that point is clean and this should be a contractual provision in the missives. In order to reduce the period of risk, such prudent lawyer should also insist on a short timetable being written into the missives for the production and execution of the Lease by both parties. Strict contractual timetables should also be applied where the landlords are to stamp and register the Lease.

Further, the issuing solicitor should, for his own protection, obtain and exhibit updated interim reports at the time he is to grant the obligation letter and it would also be helpful if this was written into the missives. The Insurers require that the issuing solicitor must obtain clear interim report prior to granting the letter of obligation and Insurers will require such reports, or copies, to be retained on file.

6.3 *In what terms*? Where the lease is to be registered in the Land Register, the obligation letter follows the general format but, where the Lease is not registerable, the obligation should be to produce clear updated reports for the period from the date of the latest update to the date the Lease is first signed by all parties (being a mutual contract it does not require delivery) with any related charges search being updated a further 22 days later.

7 Letters of Obligation relating to transactions by Receivers

In the case of a sale by a Receiver, the question of whether any letter of obligation is to be granted is a matter for negotiation in each case, and is becoming increasingly rare. Any letter of obligation which is agreed to be granted will normally be (a) on behalf of the Company in receivership only and (b) in terms which expressly exclude any liability on the part of the receiver.

8 Implications for undertakings in High Value Transactions.

8.1 When **receiving** an undertaking from another firm at settlement of a high value transaction, arguably consideration ought to be given to the adequacy of the granter firm's Professional Indemnity Insurance. All that may be safely taken for granted is that a firm of solicitors will have the minimum compulsory Limit of Indemnity (currently £2,000,000). In certain cases, it may be considered appropriate to require confirmation/evidence that the granter firm's cover is at least £x.

8.2 When **granting** an undertaking in a high value transaction, it should be borne in mind that there is the potential for a claim exceeding the firm's compulsory (Master Policy) Limit of Indemnity (currently £2,000,000) and the firm needs to consider the adequacy of its cover. It needs to be remembered that cover is on a "claims-made" basis and that may mean that cover needs to be maintained at a particular level for as long as the undertaking is extant. It may be worth checking that, in the event of a claim in excess of the Master Policy Limit of Indemnity, the firm's Top-Up insurers would not apply an individual loading to the firm's future Top-Up insurance premiums to reflect the amount reserved and ultimately paid by Top-Up insurers in settlement of the claim.

This Guidance Note refers only to the **minimum/essential** risk management controls which **must** be complied with in order that the undertaking is (potentially) a "classic". Other additional risk management controls which, although not requirements of Special Condition 3, may serve to further reduce the risk of a claim arising include making enquiry of the client regarding any impending insolvency or threat of inhibition, as well as ensuring that no part of the property has already been sold! This is not an exhaustive list however, and any additional enquires which it is appropriate to make will depend upon the individual circumstances of the transaction and the client.

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