CURRENT ASPECTS OF UNSECURED LENDING
NEGATIVE PLEDGES

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It was a dark and stormy night.

It may not have been, it may have been a warm and sunny afternoon. All we know was that it happened sometime in America between the Wars. Some American, he might have been an investment banker looking for new ways to sell his deal. He may have been a lawyer dreaming of merchant bankers' fees, thinking up new jargon to dazzle his colleagues. But someone, somewhere, thought up the term "negative pledge". Now that man, whoever he is, has an awful lot to answer for. Not only his obvious crime for what he did to the language - it used to be a rather beautiful thing - because his sins paled if you compare them with later crimes such as "negative growth" and "negative cash flow" for decline and insolvency. But by inventing a term which seemed to give something which had no substance a substance which it did not have, he has I think created a frame of mind in a lot of bankers, at least in this country, that allows them to think, when they are getting a "negative pledge" out of borrowers, putting in a document a "negative pledge" or setting out in an information memorandum that they are getting a "negative pledge", that they are getting something tangible. And what I will try and do in the next ten minutes is show that no matter how hard you try, all you have at the end of the day is a promise. I will also try and look at what happens when that cynical breed of men with their low opinion of human nature, the banker's lawyers, try to devise some method to try and give some sort of teeth to it to prevent breaches of negative pledge. I have on other occasions spoken for an hour and a half on this topic so today is your lucky day!

The way to assess the worth of these things is to look at what happens when they are breached. What enforcement rights you have got? Say the borrower has given you an undertaking that he won't create any, or suffer or permit to exist, any security interest over any of his assets, and he goes off and he does it. He is in desperate straits, he does not really worry about the covenants he has given to you or your clients as bankers and he gives a charge over a parcel of shares to a merchant bank recently arrived in the country. What can you do?

Well you can sue him, but you are an unsecured creditor and if he has gone broke, and you have discovered that all effective assets of the company have gone to other banks, the ability to sue is of no greater worth than the covenant to repay, whatever that was ever worth. You can accelerate the loan - but that is effectively closing the door after the horse has bolted, because the assets that you were hoping to have access to because of your negative pledge are now all locked up with his new merchant banker.

So you need to look at what other remedies are around and obviously the nearest target, and the deepest pocket, you can find is that of the banker whose charge it was that breached that negative pledge.

Now if you can prove that he knew about your negative pledge, which is highly unlikely as a practical matter, you may be able to sue him for inducing a breach of contract. In that case your damages should be the difference between the amounts that you would have received in the insolvent winding up of the borrower had all of the assets been available for all unsecured creditors and the amount that you actually received because the assets were given by way of security to another lender.

You may, if you find about it before hand, obtain an injunction. You can either obtain an injunction against your borrower to stop him doing what he is going to do (though he is not exactly going to telegraph to you the fact that he is going to breach your loan agreement) or you can try and obtain an injunction before the fact against the other banker to try and stop him taking his charge. Again he is not going to telegraph his actions and will in any event try and demonstrate innocence of knowledge of your negative pledge.

So the best you can do is to try and exploit the sorts of principles that were talked about in the first instance decision in Lloyds Bank Limited v. Swiss Bank Corporation [1972] 2 All ER 853, a case which went on to greater things and other principles in the Court of Appeal and the House of Lords. And this principle was not taken up in the higher courts. But there in the lower court Brown-Wilkinson J. who was the judge at first instance effectively dragged out the principle of De Mattos v. Gibson [1858] 4 De G & J 276 in relation to a roughly analogous situation to say that, if the new lender effectively did have knowledge of the negative pledge, you could restrain that new lender from exercising his security - so in effect that asset that would have been secured to him becomes subject to the overall winding up of the company and available for all unsecured creditors - including yourselves.

However, that in most practical circumstances is a bit fanciful. It will be very difficult, as I say, to find any situation in which there will be another bank or financial institution knowingly involved in a breach of your negative pledge. You may find him guilty of misinterpreting your negative pledge, if he is trying to do something to get around it in the way I described earlier, but in most cases those types of remedies will not be available to you. Your difficulty, despite the fact that you have this marvellous sonorous clause, will be that you are there with the rest of the run of the mill unsecured creditors, the telephone company and the like, begging for assets from the liquidator while all the prime assets have been charged in the dying days of the company to other creditors.

Well, what can you do about it? Is there some way in which you can say that by taking this negative clause - which effectively says that the borrower shall not create or suffer to exist any security interest - you yourself have a security interest or the right to one, in priority to or to rank equally with the new creditors? There is very little to go on in this area in English or Australian law. There are some American decisions - which in the Australian context I think would be very difficult to follow. Even trying to understand some of the reasonings behind them is difficult. I do not think they would be applied here.

There are four different situations which you can look at when you are talking about negative pledges.

(1) You can have the straight ban of the type I described above. There was one amazing case in the States which said that a ban on pledging an asset effectively constituted a charge over that asset (Coast Bank v. Minderhout 38 Cal. Repts. 505, 392 (1964) perhaps attributable to admissions made by counsel). It is very difficult to see how that could be followed here.

(2) The second type of clause you might have is to have a ban on creating security over assets unless the borrower gives you an equivalent security over other assets. The difficulty with that clause is that it is too vague to be enforceable by specific performance, and it may indeed give greater weapons to the armoury of the new lender in trying to prove that he had no knowledge of the fact that he was inducing a breach of your contract, because he can simply say though he knew we had a negative pledge, and he knew he was taking a charge, he did not know that the taking of the charge would necessarily cause a breach of our negative pledge, because it was quite open to the borrower to give us an equal ranking security at the same time.

(3) Similar problems apply to the next clause which is the one that says: "You won't give security over any asset unless you give us equal ranking security over the same asset or allow us to participate in that security". Again there are American cases which have led to the conclusion that somehow you are able to take a charge over that asset (see Gilmore, Security Interests in Personal Property, 1965, chapter 38). The facts in one of those cases shows an interesting

reflection on corporate morality in the '20s which is perhaps reflected now. The trustee for an unsecured bond issue, with a negative pledge contained in the trust deed, lent further money to the issuing company in its own right and took security itself, in clear breach of the negative pledge over the assets of that company. Again for specific enforcement purposes any such obligation is vague. It is very difficult to see how it could in any way in Australia give rise to any security.

(4) So the last type of clause is the only clause which might at first sight give you any sort of hope. And that is a clause which says: "If you the borrower give a charge then automatically you will be deemed to have given us an equal ranking charge on the same terms to us". And again there is an American decision - this time more easily understandable from our point of view - in favour of that creating some sort of security interest (Connecticut Co. v. New York, New Haven & Hartford Railroad 94 Conn. 13, 107 ATI 646 (1919)). But all sorts of problems arise under Australian law.

The first and most difficult is the requirement of registrability - that type of clause is clearly an agreement to give a charge, an agreement to give a charge for the purpose of the Companies Code is included in the definition of a "charge". If the ultimate security which you are trying to enforce fell within the various headings in s.200 then you would have a problem of non-registration.

The second possible problem is one of stamp duty. There have been a couple of cases (United Realisation Co. v. IRC [1899] 1 QB 361, Williams v. Burlington Investments Ltd. (1977) 121 SJ 424) where agreements to give a charge have been held to be a mortgage. But in this case, as the creation of the charge is subject to a contingency, it is very difficult to see how it could fall within the normal idea of a presently constituted charge. It would be normally difficult to see how you could say that there was any present intention to create a charge. Any document containing such a clause would probably not be a stampable instrument. But if it didn't create a charge now, if you didn't create some sort of security interest but only purported to create a security interest some time in the future, again, you have problems. And those problems relate to the fact that at the relevant time you may have a charge being given which constitutes a fraudulent preference. There are a number of English cases - Jackson v. Bassford Limited [1906] 2 Ch. 467, Gregory v. Love and Co. [1916] 1 Ch. 203 - which have held that agreements to give a charge subsequently can quite often lead to a fraudulent preference if those charges are given after the insolvency of the borrower.

The third problem in this area is the lack of value. If you want to take an equitable security at the relevant time you have got to show valuable considerations, not only an agreement to give an advance, but an advance actually made at the time or subsequent to the giving of that security. You can't rely on past consideration. So you may also find that the charge that you have tried to bring into existence is ineffective.

The next problem, even if you have managed in some miraculous way to get through those hurdles is the issue of priorities against holders of legal and equitable charges which take without notice of your security.

I guess the final problem would be uncertainty of obligation. You would have to go into great details about what type of security you would have, how it would secure your own obligations, how it would rank against the other people in order to be able to make it effective.

And after all that there is a philosophical problem - you have gone into this entire transaction on the basis that you are not taking any security and you have tried to establish a clause under which effectively you do. If you succeed then I suppose you are no longer lending unsecured and you may have caused problems for the borrower in relation to all his other negative pledges.

One solution to the problem that I have seen - I don't understand how it can work but it has appeared in a number of respectable documents - is a clause that purports to impose a trust on the new financiers who take security in breach of the obligation. I find it difficult to see how this works if the other lenders do not have any knowledge of it.