CURRENT ASPECTS OF UNSECURED LENDING
NEGATIVE PLEDGES

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I made some remarks earlier which may have seemed negative. They were negative in a way because my experience in unsecured lending generally has convinced me that we should not "kid ourselves" about what unsecured loan agreements achieve. I think they are extremely valuable but in themselves it is unlikely that they will determine whether it is a good credit or a bad credit. A bad agreement can certainly turn a good deal into a bad one but it cannot possibly work the other way.

But what I think a good negotiation does do is teach the banker and his lawyer a great deal about the borrower. If you go through the representations and warranties, the covenants, the events of default and so on, thoughtfully and methodically, and work out something which is appropriate for the particular deal, you will have achieved an agreement which you will never have to look at again.

But every single one is different. Every single one has got to be tailored if the thing is to matter at all. Now if the banker has chosen an absolutely outstanding credit risk it really does not matter. Most credit risks are not like that and if we are considering medium term lending things can change. So you have to look ahead a bit.

In the representations and warranties you should ask a lot of questions as a lender, finding out the facts against which you are lending, and recording answers. And you are doing the same thing to some extent in the covenants, whether they are the financial ratios or whatever. You are working out how the borrower works, how the lender wants him to work for the rest of the time and you are writing that down. In relation to events of default you are trying to define what it is that really matters, the things that really justify you in pulling the plug.

It is not non-payment that is a major concern - anybody can identify non-payment. It is the things that happen ahead of non-payment which are important. The agreement is worth something because it has made you think what it is you are really lending

against, what the real rationale of the deal is. The financial ratios are worth something; but do not believe that these will ensure you will get your money back. It is the same with negative pledges.

We were looking a moment ago at negative pledges. They are just promises, and if the borrower is not the sort who keeps his promises then he is going to breach his negative pledge and the chances are that you are going to find out too late and you will find as we have also heard that you have not got a security interest and you are sitting there crossing your fingers and hoping. But that does not mean that the whole thing has not been worthwhile. You can make it quite a bit better than nothing or just a bit better than nothing.

On the negotiation of a negative pledge it is very easy to be too clever by far. If you restrict any operating organization too far you will just have permanent events of default which cause trouble, particularly if it is a syndicated loan and your are the agents who are trying to keep the situation going. You don't want permanent events of default even if it is a single bank loan. You want the bank to have something that makes sense. So if you are negotiating a negative pledge you want to find out what actually happened in the borrower's organization. There will be some security interests which he will want to create - some which arise by operation of law and they have to be allowed; some which may be justifiable anyway. But after that there is an area where it is worthwhile saying "No more security" with or without one of those clauses!

Incidentally, just because I am not being negative, I have known of cases where the negative pledge has worked admirably. I was advising a syndicate of banks who lent money to a sovereign state in Europe; sovereign states are always a bit dicey because it is difficult to know where you get your money from and having a few battleship offered to you is not worth very much and where civil service assets consist of typewriters (and usually rather bad ones at that) and if the country is in trouble there is not much revenue coming from the taxation. But there is value in foreign exchange and above all there is always the gold. We discovered this foreign sovereign who had given quite a nice negative pledge had got his gold "stashed" in the vaults of the bank for international settlements in Geneva - the BIS. The agent bank came along to me and asked if this was a breach of the negative pledge. We asked the finance minister why his gold was "stashed" in the vaults of the BIS in Geneva. There was a long pause and he said: "Well, you have to put it somewhere haven't you". He said: "BIF have really excellent vaults". So we said: "Have you got no vaults with locks on them in your country?" "Well, we have got a few, but Geneva is a good place". So after more exchanges of telexes we decided to call their bluff. We sent a telex which effectively said: "Look, unless you move that gold out of the vaults of the BIS within 48 hours we are going to declare you in default". Within 24 hours we got a telex back

saying: "Do you know, we have found the most splendid vault down here in our own country and we will stash it away there".

The negative pledge achieved exactly what we wanted to in that case. They had hocked the stuff to the BIS and when they realised we were serious they unhocked it and moved it to their own country and eventually repaid the debt. It would be quite wrong to suggest that it was because of those little shenanigans over the negative pledge that the thing was repaid in the end. But the pledge can work and I have known it to work in the case of corporations where they were being reasonably co-operative borrowers and the lenders took an extremely tough line and stopped the lending.

The moral I am afraid is that an unsecured loan agreement is better than nothing. You can make it quite a bit better than nothing, but in the end it is whether the banker gets the fundamental credit decision right and what the management of the borrower does, rather than the terms of the unsecured loan agreement.

Now the point that I am going to make which the others are not going to make, is nothing to do with all of that. It is a question of comparison of approach towards negative pledges by looking at two different types of market - the bank lending market and the capital market. We have heard, and I think most people would agree, that the purpose of the negative pledge is that when the crunch comes, (and after all it is not until the crunch comes that any of this matters a damn) that somebody else does not get at the remaining assets first. That is what the mortgage is all about. In these unsecured loan agreements that we have been talking about, that you and I are involved in, we do not say to ourselves: "Well, there is a certain type of creditor who should always come first, because we are 'nice guys' and we like being in the back of the queue". We look after ourselves. We are lending our own money so to speak - our clients are - and therefore their interest is to make sure they get it all back if they possibly can.

But that philosophy does not seem to apply in the capital markets and in the London markets, and I think it happens elsewhere as well. It is nowadays almost universal practice for the negative pledges in bond issues to merely restrict mortgage in favour of debt relating to other types of marketable security. In other words the bond instrument says that the issuer cannot create, must not create a security which in effect "protects", other bond issues. Now that seems to me to be an absolute nonsense. When the crunch comes, why should the bondholder care what class of creditor is ranking ahead of him? What good does it do to know that all the other bondholders are sitting at the end of the queue? It is nonsense. I have tackled large numbers of people to try and find some rational explanation of this. I am afraid the only possible conclusion is this - on straight bank lending where you and I as lawyers are sitting on the side of the banker

lending the money, the banker is concentrating his mind, because the fact is that he is lending his own money, whereas when the capital market is putting together a bond issue the lead managers are not putting their own money in. Indeed one of their main objectives is to make sure they don't. They are going to produce a bit of paper which they propose to sell as soon as they possibly can and the only question going through their minds, is whether it is plausible enough to sell or to stuff into my client's portfolio or something.

This has led to what I think is really rather a disappointing difference in practices between the bank lending world and the capital market world. In bank lending we have negative pledges which can and do mean quite a lot and sometimes they work. In the capital markets we have negative pledges which mean very little indeed and which mislead people into thinking that they have got something. I think that in the capital markets there is a lot to be said either for scrapping negative pledges altogether, because they mislead people, or for having negative pledges that bite. But at the moment the difference between the two I think it is wholly unjustifiable and rather embarrassing.