In Practice

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The negative pledge and disposal restrictions: carve-outs and remedies for breach

KEY POINTS

- The negative pledge is frequently extended to include title finance or quasi security transactions.
- Exceptions to the negative pledge may include security for litigation costs, security for taxes or security to secure pension funding deficits and to reduce Pension Protection Fund levies.
- Where assets are disposed of to a subsidiary which has neither guaranteed nor secured the borrower, the effect of the disposal is in effect to subordinate the lender.

A simple loan agreement will set out the terms of the debt and interest provisions, repayment and acceleration events. That sort of agreement is often sufficient for intragroup or shareholder debt. Move away from that fact situation towards third party funding and the funder is likely additionally to require covenants. The purpose of many covenants will be to retain and preserve the assets in the borrowing vehicle and to ensure that those assets are available to meet the claims of the funder and that the funder's position is at least the same as all other creditors (save to the extent particular creditor classes may be preferred by law). The performance and value of those assets might be further periodically measured by reference to financial covenants.

The purpose of this In Practice article is to consider the negative pledge clauses and disposal restrictions found in loan agreements, the carve-outs to them and what options are available to a lender if those clauses are breached.

NEGATIVE PLEDGES

A negative pledge might commonly read: 'The Borrower shall not create or permit to subsist any security over any of its assets.' In the case of groups of companies, the clause would often be extended to include all group members (but a borrower might seek to limit this restriction to specified material subsidiaries or to obligors). The reference to "permit to subsist" ensures that the clause catches existing as well as future security.

Security is commonly defined as a mortgage, charge, pledge, lien or other security interest securing any obligation of any person or any other agreement or arrangement having a similar effect.

The final part of that definition is broad and arguably catches quasi security, being types of arrangement that enhance a creditor's protection against a debtor without creating a security interest (examples are described below). For that reason, borrowers may seek to limit the definition preferring the express restriction of quasi security which covers the same point in a more focused way, ie only prohibiting quasi security where it is used as a method of raising financial indebtedness. Equally the point can be covered by ensuring that the exceptions to the negative pledge are sufficiently widely drafted.

Since some types of quasi security can arise in circumstances where the arrangement or transaction has the effect of borrowing in a commercial sense even though the legal analysis is different, lenders will wish to ensure that the negative pledge does catch more than security that secures borrowings or guarantees of borrowings. Therefore the negative pledge is frequently extended to include title finance or quasi security transactions. The Loan Market Association introduced the specific concept of quasi security into its facility agreements in 2009. The following are some examples of such types of transactions:

- sale and leaseback arrangements, where typically a company wishes to acquire and make full use of an asset but has insufficient capital to do so. If so, the owner of the asset sells the asset to a bank or a financier for the purpose of raising funds and then takes back possession of the goods by way of a lease;
- invoice financing on a recourse basis: such transactions have the effect for the borrower of raising finance and puts the financier in a quasi secured position (because the debts have been assigned to it) even though the transaction itself does not amount to the creation of security; and
- arrangements under which money or the benefit of a bank or other account may be applied, set-off or made subject to a combination of accounts, can have the effect of reducing the assets available to a liquidator and thereby constitute quasi security.

The negative pledge clause is often linked with a *pari passu* clause:

> 'The Borrower will ensure that its payment obligations under the Loan Agreement shall at all times rank at least *pari passu* with all its other unsecured and unsubordinated liabilities (save as preferred by law).'

Such clauses do need to be watched because if, rather than referring to other unsecured liabilities the clause referred simply to liabilities to the lender ranking at least *pari passu* with all of the borrower's other liabilities, the clause would in effect be a disguised negative pledge.

A complete prohibition on creating security and quasi security would be inconsistent with the borrower being able to trade. Common exemptions to the negative pledge include:

- liens and similar rights that arise by operation of law and in the ordinary course of trade (sometimes lenders may require that these are discharged within a specified number of days or sometimes they are only excluded where they do not arise as a result of borrower default);
- netting and set-off arrangements in the ordinary course of banking arrangements;
- netting and set-off in hedging transactions;
- retention of title arrangements (possibly limited to where such arrangements are not entered into primarily for the purpose of securing financial indebtedness);
- security that is created or outstanding with the consent of the lender (sometimes a lender would require that the principal amount so secured will not be increased without lender consent);
- where applicable, security over goods or documents of title arising in the ordinary course of documentary credit transactions; and
- a *de minimis* whereby the borrower is permitted to create security (otherwise not permitted) up to a specified secured amount.

Other exceptions may be necessary dependent upon the nature and type of business of the chargor. For example, security for litigation costs, security for taxes or security to secure pension funding deficits and to reduce Pension Protection Fund levies.

DISPOSAL RESTRICTIONS

A disposal restriction would commonly read:

> 'The Borrower will not enter into a single transaction or a series of transactions (whether related or not) and whether voluntary or involuntary to sell, lease, transfer or otherwise dispose of any asset.'

Where a facility has multiple obligors, each obligor would probably be asked to agree to a similar restriction and the borrower might well procure compliance with it by all other subsidiaries. Clearly, there need to be exceptions to such a clause otherwise the company could not trade. A simple borrower perspective amendment might be to amend the clause so that it applies only to a substantial part of its assets (an unreported case *Commercial Union Assurance Co Ltd v Tickler*, 4 March 1959, indicated that cumulative disposals of 10% to 15% might be substantial). However, dependent upon the circumstances, that often would provide insufficient protection to the lender, particularly in the context of a secured facility because of the potential impact of such a permission on the fixed or floating characterisation of the security.

Common exclusions to a disposal restriction include:

- disposals made with the prior consent of the lender;
- disposals of trading stock or cash made in the ordinary course of trading of the disposing entity [for market value on an arm's length basis];
- intra-group disposals. However, there are some important considerations here. Where assets are disposed of to a subsidiary which has neither guaranteed nor secured the borrower, the effect of the disposal is in effect to subordinate the lender. Therefore, a lender would commonly restrict intra-group disposals to entities against which the lender has the same rights and security as it has from the disposing company. Additionally, where the disposing company has secured an asset, the permission to dispose of that secured asset may be conditional upon the acquiring company giving similar security;
- disposals of property or assets (other than shares, businesses, real property or intellectual property) in exchange for other property or assets of a comparable or superior type and value or the disposal of obsolete or redundant vehicles, plant and machinery;
- licences of intellectual property rights in the ordinary course of business on arm's length terms; and
- *de minimis* baskets in relation to assets disposed of in cash.

Where the loan is secured, careful attention needs to be given to permitted disposals to ensure that the disposal permission does not run the risk of fixed security over an asset being recharacterised as floating security.

WHAT OPTIONS ARE AVAILABLE IF THE NEGATIVE PLEDGE OR DISPOSALS RESTRICTIONS ARE BREACHED?

Breach of such provisions would normally amount to an event of default entitling the lender to accelerate the loan and, if it has security, to enforce its security.

Equally, the threat of acceleration can be used as a stick to bring the borrower to the negotiating table. The lender may use its bargaining position to demand further security and/or to vary the facility terms. These are the remedies that lenders are likely to adopt in the normal course.

If the lender has advance notice that its borrower intends to breach the negative pledge or disposals restriction it could seek an injunction against the borrower and, conceivably, against any other party involved, such as the party to whom security may be granted or to whom assets are to be disposed. The essence of joining in such other party will be to put them on notice that they will be facilitating a breach if they proceed, and this would normally be combined with a request for an undertaking to refrain from doing so.

Third parties taking security or taking an asset with actual knowledge that the security or disposal is in breach of the borrower's loan covenants could find themselves liable in damages for the tort of inducing a breach of contract. However, proving loss may be difficult unless one can point to a specific shortfall in security causing loss to the lender which is caused by the alternative security or disposal. ■

Biog box

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