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# Negative Pledges in Commercial Real Estate Financings – Why Do We Need Them?

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Negative pledges are contractual constructs widely used in many financings − from simple mortgage loans to complex, large-scale real estate financing transactions − and, as a result, are often taken as a market standard inclusion in finance documents. That said, why do lenders insist we have them? Why are they necessary even in secured financings where the lender has the benefit of first ranking security? Why do lenders insist that they feature in the security documents even though the loan agreement has them? This article seeks to provide a wider understanding of negative pledges' existence and purpose.

**What is a negative pledge?**

A negative pledge is an undertaking granted by the borrower and, if applicable, obligors not to create, or permit to subsist, any security over any of its assets. The generally accepted European market standard construct of a negative pledge clause can be found in clause 22 (*General Undertakings*) of the Loan Market Association ("LMA") form of the real estate finance loan agreement, which goes further to covenant that the obligors "*shall not:*

- *(i) sell, transfer or otherwise dispose of any of its assets on terms whereby they are or may be leased to or re-acquired by an obligor;*
- *(ii) sell, transfer or otherwise dispose of any of its receivables on recourse term;*
- *(iii) enter into any arrangement 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; or*
- *(iv) enter into any other preferential arrangement having a similar effect,*

*in circumstances where the arrangement or transaction is entered into primarily as a method of raising financial indebtedness or of financing the acquisition of an asset.*"

**Why are negative pledges needed?**

Negative pledge clauses are important in lending transactions. As with other negative covenants in a loan agreement, they aim to give the lender control over the activities of the borrower by preventing it from, at the expense of the lender, creating security over its assets in favour and support of any indebtedness owed to other creditors.

A negative pledge covenant therefore becomes even more crucial for an unsecured lender because, in the absence of security, such lender would be vulnerable to the risk of security being created by the borrower in favour of another creditor, positioning it ahead of the unsecured creditor on the borrower's insolvency, which could have the effect of reducing the pool of assets available for the unsecured creditors. As such, a negative pledge covenant will assist the unsecured lender in preserving its priority upon a borrower's insolvency.

**Why are negative pledges required by secured lenders?**

Most European real estate financings are done on a non-recourse basis such that the security group is ring-fenced. However, regardless of whether a lender has first-ranking security, negative pledges should nonetheless be an important requisite for secured lenders for both priority and practical reasons. For instance, even if a lender has the benefit of a mortgage or fixed charge security, thus any further security granted by the borrower shall rank behind the

original security (assuming, of course, that it has been properly created and perfected), the new creditor may have rights to enforcement that may impede on the original lender's position, or obstruct a restructuring by refusing to agree to certain actions proposed by that original lender.

Furthermore, in circumstances where the secured lender has the benefit of a floating charge security, under English law such priority could be undermined by any subsequent fixed charge security, as a fixed charge will have priority over a floating charge, even if such floating charge was created earlier in time.

**Why do lenders require that the negative pledge covenant be featured in both the loan agreement and security agreements?**

As noted earlier, the LMA form of real estate financing loan agreement indeed has a negative pledge covenant in it, and it would be expected to remain as a feature of the loan agreement in any financing. However, the secured lender may also require a negative pledge covenant to be drafted into the security documents.

The reason for this is because under the Companies Act 2006 (Amendment of Part 25) Regulations 2013, almost all charges must now be registered, which means that the right of security granted by the borrower to a secured lender, together with details of its particulars such as the negative pledge covenant, can be noted on a public register available to all parties to view. A full and complete copy of the security document must also be submitted as part of the registration, with accessibility to a copy of the agreement being available to the public on request. This has significant implications in respect of notice to subsequent lenders or prospective creditors, and it greatly increases the likelihood that any subsequent creditor will have notice of the negative pledge.

Notice can potentially be achieved in two ways:

- (i) Actual notice: if the new creditor is informed of the negative pledge, or as part of their due diligence, the creditor reviews the charge register of the borrower at Companies House and identifies such negative pledge, then the new creditor shall have actual notice of it, and will therefore take its security interest subject to any security the original lender may have; and
- (ii) Constructive notice: if the new creditor does not have actual notice of the negative pledge, it is arguable that constructive notice is imputed to third parties by virtue of the registration of such security and noting of the negative pledge, the result of which is that it shall take security subject to any security that the original lender may have. However, it must be noted that there is some debate surrounding registration of security automatically giving rise to constructive notice, and so whether a party does indeed have constructive notice will depend on the facts of the scenario in question.

The borrower should not take issue with a negative pledge covenant being featured in both the loan agreement and the security document, but it is important for them and their counsel to ensure that the terms and obligations under the negative pledge clause in both the loan agreement and the security documents materially mirror one another.

**What if there is existing security granted in favour of a third-party creditor?**

Ultimately, the borrower needs to be able to continue its business effectively, and as such there may be instances where security will need to be granted − for instance, set-off or netting arrangements of credit balances that are often made in the ordinary course of the borrower's banking arrangements. It is therefore important for the borrower and its counsel to consider the negative pledge covenant carefully in the wider context of the transaction and include exclusions and qualifications where appropriate, as the default qualifications under the LMA are limited to the following:

- (i) security granted in connection with the transaction and finance documents (that is, security granted in favour of the lender);
- (ii) liens arising by operation of law and in the ordinary course of trading; and
- (iii) security that is released prior to the first drawdown.

If the borrower has any existing security, then the new lender will need to consider whether it is prepared to allow such security to subsist and remain in place during the life of its loan. This is important as any such security may prejudice the new lender's position. To the extent that the lender agrees that the existing security shall remain, such security would need to be expressly carved out from the negative pledge clause as "permitted security."

Furthermore, if the new lender is also taking security from the borrower, then it may wish to also consider putting into place a deed of priority or intercreditor agreement in order to govern the priorities of the security interest and

enforcement rights. This will need to be entered into between the borrower and the competing creditors, so will be a matter for negotiation at the time.

**What if security was created in breach of a negative pledge?**

It must be acknowledged that a negative pledge covenant is ultimately just a contractual obligation, and therefore in theory the borrower could in practice grant security notwithstanding such promise not to do so. Of course, a prudent borrower would, and should, comply with the terms of a negative pledge covenant that it has agreed to, but in a situation where a borrower does create security in breach of its negative pledge, it is worth noting the consequences of such actions for the borrower, original lender and new lender:

- (i) Borrower: a breach of the negative pledge clause would likely be an event of default under the finance documents, and typically this would trigger some fundamental powers for the original lender.
- (ii) Original lender: when an event of default has occurred and is continuing, the original lender will have the power to accelerate the loan and, if the loan is secured to enforce its security, such as its mortgage over the property. As alternative actions, in particular for unsecured lenders, it may also be possible to consider obtaining an injunction against the granting of security to a new lender, and if the new lender had notice of the negative pledge, then the original lender could bring a claim against it in tort for inducement to breach contract.
- (iii) New lender: a key issue will be priority. Ultimately, whether the new lender's security takes priority over the original lender's security, or vice versa, is dependent on a number of factors and thus must be considered on a case-by-case basis, such as:

    1. the nature of the security (*e.g.,* a fixed charge will take priority over a floating charge);
    2. whether the security has been perfected (security that has not been perfected may not be enforceable); and
    3. whether the new lender had notice of the negative pledge (if the new lender has notice of the negative pledge, then its security interest shall be made subject to the security of the original lender).

**Final thoughts**

Negative pledge clauses are a market standard covenant in any real estate financing, and so as a borrower the goal should be to negotiate in the right qualifications and exclusions to ensure that the negative pledge does not impede on its ability to run its business, as opposed to expending efforts to remove it. As a lender, however, it is important to understand why we have negative pledges and their effectiveness and limitations to ensure that the benefits and risks in light of the broader circumstances of the transaction are factored into the loan terms.