

THE NEGATIVE PLEDGE

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In General

Banks have traditionally used a device known as the negative pledge ("Negative Pledge") in lending documents. The Negative Pledge is an agreement whereby a borrower-pledgor promises a lender not to place a lien on pledgor's property. The Negative Pledge is most often utilized as one of the standard provisions in a loan agreement or other loan document such as a guaranty ("Covenant Negative Pledge") or a separate agreement relating to a particular parcel of real property owned by a borrower or guarantor ("Specific Negative Pledge").

The purpose of this article is to explain the limitations of the Negative Pledge as a lending tool. The article emphasizes that Negative Pledged debt is very little different from any other type of unsecured debt. The Negative Pledge does not transform unsecured debt to secured debt.

A Negative Pledge is a promise not to encumber certain property. It should be distinguished from an agreement creating a security interest or lien. The Negative Pledge does not provide for foreclosure and realization on collateral security, the proceeds of which could then be used to satisfy a related credit extension. Therefore, the Negative Pledge, unlike a mortgage or security agreement, provides no lien or security to the creditor.

Since the Negative Pledge is an agreement from a borrower or guarantor to a creditor, it will not prevent a different creditor from taking a lien or security interest in collateral in violation of the borrower-pledgor's covenant in the Negative Pledge. Nor will a Negative Pledge prevent a judgment lienor or a trustee in bankruptcy from jumping ahead of the lender of the Negative Pledge on the creditors' rights priority spectrum.

Presumably a breach of a Negative Pledge would give rise to a default under the loan documentation and/or possibly a separate cause of action by the lender-grantee for violation of the Negative Pledge. It is questionable, however, whether such a breach, and a separate legal action arising from such a breach, would add to a cause of action for the loan default. In fact, such a separate cause of action for a breach might be illusory because the very breach has placed the pledged asset out of the reach of the lender grantee and into the hands (as security) of a third party creditor. Lender's enforcement action based on any such breach or default additionally could trigger a cross-default under the newly secured creditor's loan

documents and thereby prompt such newly secured creditor's realization upon the property given as security.

The Specific Negative Pledge as a Mortgage

Despite the fact that the Negative Pledge is not itself a security device, some creditors utilize a Specific Negative Pledge as the functional equivalent of a mortgage, filing it with the land records to notify other creditors that there should not be any further encumbrance of the negative pledged property. Prior to the July 1, 2001 revisions of the Uniform Commercial Code, notice of a Specific Negative Pledge could be filed as a UCC-1 financing statement with the land records, and indexed against the negative pledged real property to give notice of the Specific Negative Pledge.

In the mid 1990s, the New York State Department of Taxation and Finance ("Tax Department") by regulation expanded the definition of a mortgage to include a Specific Negative Pledge of real property for purposes of the New York State mortgage recording tax. 20 NYCRR 641.6(b)(9). This regulation requires the payment of mortgage tax upon the recording of a Specific Negative Pledge because the Tax Department considers a Specific Negative Pledge to be a mortgage for mortgage tax purposes.

While a Specific Negative Pledge does not create a lien and does not possess the security attributes of a mortgage since it cannot be foreclosed on to realize on collateral, it is arguable whether the Tax Department regulation is enforceable. However, until there is a successful challenge, the regulation continues to be effective and must be complied with, since, if it is not, potential liability for mortgage tax would complicate the debtor creditor relationship.

Whether or not Negative Pledges that are contained in a Covenant Negative Pledge are to be considered similar to Specific Negative Pledges for purposes of the Tax Department regulation is another question. Since the Covenant Negative Pledge does not describe a specific parcel of real property, it does not possess an essential requisite for recording. Therefore, such Covenant Negative Pledges should not properly be considered mortgages for purposes of the Tax Department regulation. It should be noted that the Tax Department regulation specifically provides that the Negative Pledge is considered a mortgage only if it is actually recorded in the proper real property records.

The adoption of Revised Article 9 of the UCC also impacts the analysis of the Specific Negative Pledge. Generally, revised Article 9 has done away with all county filings, except for filings against fixtures and timber. Thus, an attempt to make a county UCC filing indexed to specific real property in support of a Specific Negative Pledge likely should be rejected by the county filing office, since such a filing is not against fixtures or

timber. Filings at the state level may still be made, however, most title companies performing real property searches routinely search county real property records but would not customarily check state UCC filings. Therefore, the efficacy of a Specific Negative Pledge filed at the state level and providing notice may be questioned for this reason.

Conclusion

Specific Negative Pledges do not afford a lender security for extensions of credit and have been traditionally advised against by lenders' counsel. In light of the regulations imposing a mortgage tax on Specific Negative Pledges, there is little reason to take a Specific Negative Pledge and, to the extent that a borrower is aware of the Tax Department regulation, could present serious issues relating to liability for mortgage tax that could cause additional controversies in an enforcement action. If the mortgage tax must be paid, there would seem to be no reason not to instead take a mortgage and pay the tax. However, if a Specific Negative Pledge were taken, it should be recorded and mortgage tax paid in order to comply with the Tax Department regulation.

Our continuing advice concerning Specific Negative Pledges is not to utilize them as a substitute for secured debt. They afford no security to a lender and are as costly as a mortgage to record. Additionally the value of their warning and therefore deterrent effect on competing creditors is questionable.

Some Related Concepts:

Tortious Interference: Affirmative Negative Pledges and Double Negative Pledges:

A discussion of a claim of "tortious interference" for breach of contract for violation of a Negative Pledge is beyond the scope of this article but should be evaluated by the secured creditor, who has actual or constructive notice of the Negative Pledge, and which takes a lien or security interest in violation of same. Tortious interference, in the common law of tort, occurs when a person intentionally damages the plaintiff's contractual or other business relationships. Tortious interference with contract rights can occur where the tortfeasor convinces a party to breach the contract against the plaintiff, or where the tortfeasor disrupts the ability of one party to perform his obligations under the contract, thereby preventing the plaintiff from receiving the performance promised. This tort occurs when one party induces another party to breach a contract with a third party, in circumstances where the first party has not privileged to act as it did and acts with knowledge of the existence of the contract. Such conduct is termed tortious inducement of breach of contract.

The Negative Pledge discussed in this article should be distinguished from what commentators sometimes call an "affirmative negative pledge" which, in addition to the pure

negative pledge, also has an affirmative element of either requiring that if the pledgor gives security in violation (knowingly or otherwise) of same, it will equally and ratably secure the negative pledge grantee, or creating an exception to the Negative Pledge allowing for encumbrance if the instrument granting the encumbrance by its own terms gives equal and ratable security in the property to the negative pledge grantee.

A Double Negative Pledge is an agreement whereby a borrower agrees to both abstain from granting liens on assets to any other existing or prospective lender (negative pledge), and abstain from offering any current or prospective lender an agreement not to pledge (double negative pledge). The double negative pledge keeps the assets free and clear and positions the financial institution holding such an agreement with the opportunity for gaining a lien position (only upon being granted by borrower) should deterioration in the borrower's financial condition warrant it. A double negative pledge does NOT provide the lender with security.

*This article is not intended to provide legal advice for a specific transaction. If you require further information on any matter contained in this article or would like to discuss a specific transaction, please feel free to contact either **Mr. Goetz** or **Mr. Hoffmann** at (516) 296-7000.*