THE NEGATIVE PLEDGE CLAUSE

An investigation into the remedies available to the original lender with special emphasis on the tort of interfering with contractual relations

I. INTRODUCTION

The negative pledge clause has always been a clause of immense significance in domestic as well as in international finance. In international finance the negative pledge clause has a dominant position in almost every loan agreement, but also in other areas of international finance, for example in the issuance of various debt securities such as eurobonds and medium term notes, it plays an important role. Its application in domestic finance has mainly been in relation to the issuance of debentures where the inclusion of the negative pledge clause in the debenture instruments seeks to prevent the creation of subsequent fixed charges to the detriment of the floating charge granted in favour of the debenture holders. The internationalisation of finance has however also meant, that even domestic loan agreements nowadays often contain negative pledge provisions along with other clauses originally only found in the area of international finance.

Although the negative pledge clause is widely used, its application is not without difficulties. Throughout the years there has been some controversies about which undertakings by the borrower are prohibited, the scope of the prohibition and finally exactly which remedies that are available to the creditor in case of a breach of the clause. This controversy can partly be explained by inadequate and inappropriate drafting. The use of terms like “encumbrance” not having a strict meaning does beg the question of exactly which undertakings that are prohibited.[1] On the other hand the ingenuity of debtors when it comes to raising secured finance in adverse financial conditions, inevitably must have some effect on the way the clause is drafted. From the solicitors perspective a rigid and complex negative pledge clause is often the preferred alternative as to a clause which eventually turns out to be inadequate when it comes to protecting the interests of the lender.

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P Gabriel *Legal Aspects of Syndicated Loans* (Butterworths London 1986) p. 82.

Another possible factor that has been contributing to the controversy is probably the fact that some lenders, if not all, seek to extend the scope of the clause beyond what was original contemplated when the borrower faces financial difficulties. The rationale behind this is not difficult to conceive; while market conditions and the strength of the borrower might have prevented the taking of the security in the first place, there is no reason for not trying afterwards to enhance ones protection vis-à-vis the other creditors. Although understandable this position sometimes leads to some far-fetched arguments, which are not exactly improving the common understanding of the negative pledge clause. Attempts to enlarge the scope of the clause retrospectively through the use of equivalent and the automatic security clauses can cause further problems as to understanding and ascertain the effects of the clause.

While most of these controversies can be solved by either interpreting the contract or by applying ordinary contract law, some controversies still remain. One of those is the remedy available to the lender in case of a breach of the clause. It is evident that the negative pledge itself does not constitute a security[2] meaning that any protection offered to the lender must either be based on a contractual basis with the borrower or must rely on the principles of tort law. Generally speaking breach of a covenant and certainly breach of the negative pledge clause is an event of default and thus will normally result in the acceleration of the loan. In the unlikely circumstances that the lender ex.ante is aware of a threatening breach of the covenant the use of a prohibitory injunction might also be of some assistance. Those are the remedies available against the borrower.

However, as it is often the case those remedies are useless against a debtor who is facing serious financial difficulties, making an acceleration nothing more than a step towards a rescheduling and possible massive write down of the debt. Correspondingly the use of an injunction as a mean to prevent breach of a negative pledge is more theoretical than practical; by the time the lender acquires knowledge of the breach the security will almost inevitably already have been

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RM Goode *Legal Problems of Credit and Security* (Sweet and Maxwell, 1988) p.19.

handed over and perfected. Unless the granting of security is in favour of an existing lender for existing debt, thus possibly being a preference and thereby being voidable, the original lender will seldom have any adequate remedies against breach of the covenant.

Even though most borrowers honour their commitments[3] the question remains whether the lender has other more auspicious alternatives. One alternative might be to focus on the new lender taking the security in breach of the covenant. In this connection one might consider whether the action undertaken by the new lender could amount to being an interference with contractual relations between the original parties and whether such interference actually can give rise to an action for damages on the original lenders behalf. Another possibility may be to seek other kinds of contractual protections against such breaches, eg by the inclusion of the aforementioned equivalent and automatic security clauses.

This essay will focus on the first of the two alternatives. In order to structure the discussion in a proper way, the paper is divided into two parts consisting of a total of five sections. An introduction is found in section I. Section II comprises an introduction to the negative pledge, its content and its structure. A section on the various aspects of enforcing the clause is found in section III with the primary focus on the remedies available against the borrower. A brief introduction to the economic torts is however found in the end of the section. In the second half of the essay section IV contains an analysis of the tort of interference with contractual relations and its application in regards to negative pledge clauses. A conclusion is found in section V.

Due to the word limitation of the essay it is stressed that the introductory remarks about the clause, which set the ground for the following discussion, are quite concise. Readers who desire a more fundamental and thorough discussion of the clause and its content are referred to the literature stated in the bibliography.

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In relation to international borrowers see PR Wood *International Loans, Bonds and Securities Regulation* (Sweet and Maxwell, 1995) p. 38.

Furthermore it should be noted that the essay will focus on negative pledges in commercial finance and their enforcement in a commercial context. World Bank, EBRD[4] and commercial bank loans to sovereign borrowers are thus excluded from this essay.

Finally it should be noted that although negative pledge clauses are frequently included in issues of eurobonds and medium term notes, the purpose and the content of the clause is somewhat different, hence not all observations in the following will apply with equal strength to such situations.[5]

II. THE NEGATIVE PLEDGE COVENANT – AN OVERVIEW

1. The Purpose of the Clause

The negative pledge covenant[6] performs a number of different functions, depending on the circumstances where it is applied. Although some of the functions are identical in different contexts one can derive advantages from differentiating between its functions in unsecured and secured finance.

(a) Unsecured Finance

In unsecured finance the main function of the negative pledge clause is to ensure, that the pool of assets available to a lender in a possible insolvency does not deteriorate substantially over time.

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4 European Bank for Reconstruction and Development.

5 The typical negative pledge in eurobonds issues will thus not per se prohibit the creation of security interests, but will require that the bonds be equally secured. Furthermore the restriction of the negative pledge will normally only apply to indebtedness evidenced by similar securities, thus eg bank loans are excluded. Furthermore domestic borrowing might be excluded. The reason for this somewhat different approach is due to the fact that bondholders are not that concerned about the debtor's encumbrance of his assets, but more with the way a secured, but otherwise identical, bond issue will affect the price of the outstanding unsecured bonds. For an example of a typical eurobond negative pledge clause see Allen & Overy *Legal Aspects of Eurobond Issues – Investment Risk* (London 2002) p. 17.

6 A covenant can be defined as a promise made in a deed. Commonly it is however also used as meaning a promise or obligation of any kind whether made under seal or not. In banking and finance law the expression is used to describe obligations of the borrower in a credit facility other than the obligation to repay the debt. The term negative pledge covenant and negative pledge clause will be used interchangeable in this essay.

Although an evaluation of a debtor's cash flow projections over time probably is the most important element in the credit rating of the borrower, a potential creditor will also want to know which assets are available for a forced distribution in a worst case scenario. Since it is a dominant feature of most insolvency regimes that secured assets can be separated from the insolvent estate of a debtor and thus not being available for the ordinary creditors, the debtor's ability to create security interests in his assets has to be restricted in some ways.

The inclusion of a negative pledge clause in the finance agreement is one way to ensure the availability of the assets. The negative pledge clause has always played a special role in international finance as opposed to domestic finance. This is not due to the fact, that international finance necessarily differs substantially from domestic finance or that international lenders have special needs for protection. It is more due to the predominance of unsecured lending in international finance as opposed to domestic finance. A predominance caused to a large extent by the difficulties related to the obtaining and the administering of security on a transborder basis. It should thus be remembered, that while the governing law of the finance agreement to a large extent can be decided by the parties themselves, this is not the case when it comes to security. The applicable law will here normally follow from the *lex situs* doctrine. Since there until now, even within the European Union, has been virtually no harmonisation of security law a creditor opting for security will have to comply with local laws.[7] If the assets are located in numerous jurisdictions the compliance with local security laws can be onerous.

Besides preserving the pool of assets the negative pledge also indirectly inhibits excessive borrowing by the debtor.[8] It must namely be assumed that companies wanting to raise finance beyond a certain leverage point can only do so on a secured basis.

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Some harmonisation of the member states' security laws is found in the Financial Collateral Directive 2002/47/EC. The narrow scope of application and the limited substance prevents it however from having any substantial impact on the way lending business is conducted across the EU.

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PR Wood *International Loans, Bonds and Securities Regulation* (Sweet and Maxwell London 1995) p. 34.

By restricting the debtor's ability to furnish security, the amount of additional finance is also restricted. In that respect the negative pledge will however also often be supported by more specific financial covenants, eg leverage ratios and borrowing limits.

Where a debtor has numerous creditors, all having substantial stakes in the debtor's business, the negative pledge serves a third more subsidiary purpose; namely to enhance equality between the creditors. As long as all creditors are secured or all are unsecured there is no problem with equality but once some creditors are secured and others are not an imbalance with possible detrimental effects arises.

Should the debtor experience financial difficulties only the unsecured creditors facing a risk of non or only partial fulfilment of their claims will have an incentive to work out a rescheduling. The secured creditors will on the contrary, given that their claim is fully secured by a perfected and non-voidable security, have no incentive to participate in such a rescheduling. A potentially more valuable sale of the debtors business as a going concern will thus be jeopardised by the piecemeal sale of assets by the secured creditors. The inclusion of a negative pledge in the finance agreement should prevent this.

(b) Secured Finance

In relation to secured finance the negative pledge serves a somewhat different function. While some of the motives for the use of the negative pledge apply with equal strength in relation to secured finance other motives differ. The main concern for the secured creditor is the existence of junior security interests. The existence of a junior security broadly speaking gives rise to two distinct problems as Mr. Wood points out.[9]

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[9] PR Wood *International Loans, Bonds and Securities Regulation* (Sweet and Maxwell, London 1995) p. 38.

First of all, the lender cannot advance additional funds with the benefit of the original security without the junior security holder's consent, thus making rescheduling more difficult. Secondly, the junior security holder in most jurisdictions will be able to enforce the security independent of the senior security holder, which can create problems if the enforcement takes place at an inconvenient time and the senior security holder is not prepared to pay the junior creditor out. Even though a subordination agreement might mitigate the problem, it will not solve it completely. Thus the need for a negative pledge even in secured finance agreements.

Another application for negative pledges in secured finance is in relation to the preservation of priority in connection with floating charges. Since the very essence of the floating charge is the company's continuing authority to dispose of its assets in the ordinary cause of its business, the debenture holders are potentially endangered since the company might sell or encumber the very assets covered by the floating charge. As long as the creation of eg a fixed charge is deemed to be 'in the ordinary course of business' the fixed charge will have priority over the floating charge. Since the term 'in the ordinary course of business' has been interpreted quite widely in case law, it is evident that debenture holders seeking to prevent such situations must restrict the debtor company's authority to encumber its assets.[10] The inclusion of a negative pledge in the debenture is one way to restrict the company's authority. A subsequent holder of a fixed security with notice of the restriction would thus not gain priority over the floating charge in the event of crystalisation.

The use of negative pledges in debentures as a way of restricting the debtor company's authority to encumber its assets seems to be quite common in jurisdictions that recognise universal charges such as the floating charge.[11] However, the problem remains, that only an encumbrancer with notice of the negative pledge would be affected by it.

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[10] See on the interpretation of 'in the ordinary course of business' RM Goode *Legal Problems of Credit and Security* (Sweet and Maxwell, London 1988) pp 84-85 with references to case law.

[11] WJ Gough *Company Charges* (2nd edn Butterworths London 1996) p. 221.

Without notice of it, the encumbrancer would still gain priority over the floating charge. The problem hereafter is how to put potential encumbrancers on notice as regards the negative pledge clause.

One solution apparently often adopted seems to be the inclusion of the negative pledge in the particulars to be filled in accordance with the Section 395 of the Companies Act 1985. By including the restrictions in the particulars filled one avoids the problem that the registration of a charge is not notice of the contents of the charge instrument itself.[12] This ensures that potential encumbrancers searching the register would be on notice of the restrictions with the aforementioned effects. If they however do not search the register, they will not be on notice thereby gaining priority over the floating charge since there can be no constructive notice of matters which are not required to be filled at the Registry.[13]

Whether there can be an inferred knowledge on behalf of the encumbrancer as to such restrictions is doubtful.[14]

2. General Structure and Content

The structure and content of the negative pledge covenant can be described in terms of a) the obligation it imposes on the borrower, b) the scope of this obligation and c) any exclusions necessary to make it commercial viable.

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12 RM Goode *Legal Problems of Credit and Security* (Sweet and Maxwell, London 1988) p. 41 with references to case law.

13 Ibid. p. 43

14 Ibid.

(a) Obligation

In its basic form the negative pledge is an undertaking by a borrower not to provide security for other lenders typically given to a creditor in connection with entering into a finance agreement. Even restricted to corporate credit facilities the variations of the clause are immense. First of all the clause can be varied as to which kind of security is covered. The bulk of the negative pledges in corporate credit facilities cover both future and existing security. The reason for including existing security is seldom the desire of the creditor to have the debtor discharge existing security interest. The inclusion of existing security rather seems to perform some kind of investigatory function; the lender would like to know whether there exist any security interests on the debtor's assets, which for some reason have remained undisclosed. Since breach of a covenant in general and certainly breach of the negative pledge covenant always is made an event of default, the debtor has a clear incentive to inform the creditor about the security interest and request a waiver.[15]

(b) Scope of Obligation

In relation to the types of security covered by the negative pledge the trend seems to be to include all conceivable types of security and preferable all other types of transactions having the effect of security. This is normally achieved by either using general terms like "encumbrance"[16] or just "security interest" or by listing a number of specific security types, like mortgages, charges, pledges etc. The advantage of the former approach is that the clause has a wider scope, ultimately to be determined by the courts, thereby offering the lender more protection against various attempts to

15 Breach of a covenant does not necessarily imply that the loan as such is called in. In syndicated loans, where the negative pledge covenant originated from cf. PR Wood: *International Loans, Bonds and Securities Regulation* (Sweet and Maxwell, 1995) p. 5), the acceleration of the loans is sometimes conditional upon the Majority Banks calling the default.

16 According to Mr. Gabriel the term 'encumbrance' is normally used in connection with land law and its meaning differs depending on the circumstances. After citing and discussing case law, Mr. Gabriel argues that in relation to loan finance, the term encumbrance must be in the nature of a security or a proprietary claim, cf. P Gabriel *Legal Aspects of Syndicated Loans* (Butterworths London 1986) p.82.

bypass the covenant. On the other hand the general approach does reduce the predictability of the clause, leaving it to the borrower to seek waivers whenever a contemplated transaction might theoretically infringe the negative pledge covenant.

The trend nowadays seems to be a combination of the two options, where the existence and creation of security interest is prohibited followed by an exemplification of some, but not necessarily all security interests which are covered by the clause. A special problem in this connection is the presence of quasi-security transactions, which although not within the narrow definition of security have the same effect as security. Examples of such quasi-security transaction are financial leasing, sale-and lease-backs, title retention and repurchase agreements. While such transactions in some jurisdictions might be re-characterised as constituting security, the safest approach is probably to include transactions having the effect of security within the ambit of the negative pledge clause.

Another problem with the interpretation of the security actually covered by the clause is the one that arises when some of the debtor's assets are situated in different jurisdictions. It is generally recognised that the applicable law when it comes to security is *lex situs*, thus making the physical location of the security a pivotal point. In cases where the *lex situs* differs from the governing law, the question arises which transactions actually constitute a breach of the clause. It is quite evident that one cannot simply apply the English definitions of eg a charge to the relevant overseas transaction. Comparisons between various security interests are inherently difficult.

Furthermore it is not even certain that a comparable security exists in the jurisdiction in question. While this will probably not be of any concern to the lenders the opposite situation would. Although there seems to be no firm authority on how to solve this problem it is submitted that a liberal construction of the negative pledge clause is called for. Since the very essence of the negative pledge clause is to prevent the creation of a class of assets which a unavailable to the ordinary creditors on an insolvent liquidation, it is submitted that those transactions which by the *lex situs* are treated as being security interests should be captured by the negative pledge clause. This would apply whether or not the transaction would be classified as a security interest under English law.[17]

(c) Exclusions

Since the negative pledge clause as a matter of drafting has a very broad scope it is necessary to introduce some exclusions, if it is not to hamper the day to day operations of the borrower. While the number and ambit of the exclusions vary on a case to case basis, one would normally find one or more of the following exclusions: 1) Security created with the consent of the Majority banks, 2) Liens arising by operation of law given that they are discharged within a specified period – typically within 30 days, 3) security on, after acquired assets to secure the finance necessary for the acquisition and 4) a *de minimis* amount covering various kinds of security.[18]

3. Drafting Structures

Even though the functions of the negative pledge clause are roughly the same in different kind of transactions a number of different variations exist, even if one excludes those that only differ as to which transactions are within the ambit of the clause. The main difference evolves around whether the clause is drafted in a negative or – although a bit self-contradictory – an affirmative manner.

(a) The Strict Negative Pledge

This clause will only consist of the normal undertaking not to furnish security to any other creditor. No further guidance on the effects of a breach of the clause will be mentioned in the clause itself,

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17 RC Tennekoon *The Law & Regulation of International Finance* (Butterworths London 1991) p. 93.

18 PR Wood *International Loans, Bonds and Securities Regulation* (Sweet and Maxwell London 1995) p. 36-37. For a more extensive list see p. 464-469. See also Loan Market Associations Recommended Forms of Primary Documents regarding exclusions to the negative pledge.

but will of course be mentioned in the event of default clause. Unless the lender waives the clause, no security can be given to a new lender, even if equivalent security is given to the original lender.

(b) The Affirmative Negative Pledge

The second type of clause is the, although a contradiction in terms, so-called affirmative negative pledge clause, which not per se prohibits the creation of security interests over the debtor's assets, but which requires as a pre-condition that the original lender is given equal security. A negative pledge clause most often encountered in relation to bond issues.

(c) The Equal Security Clause

The equal security clause differs from the strict negative pledge in that it not only restrains the borrower from granting security to subsequent lenders, but also requires the borrower to give the original lender equal security, should he breach the first prohibition. What constitutes equal security will normally not be specified in the clause as such and neither will it be specified whether the security is to be created on the same assets or some other assets belonging to the debtor.

It should be noted that the equal security clause is somewhat different from the affirmative negative pledge, although it occasionally is seen to be treated as the same clause. While the affirmative negative pledge gives the borrower a right to create security interests as long as the lender will receive an equal security interest this is not the case with the equal security clause. Even if an equal security is offered to the lender he is not obliged to give his consent to the creation of the first security interest. Any furnishing of security would thus constitute a breach of the negative pledge clause and give rise to various remedies, cf. section III.

(d) The Automatic Security Clause

While the equal security clause only contains a promise by the borrower to furnish security to the original lender should the clause be breached, the automatic security clause takes it a step further. The automatic security clause will thus specify that in the event of a breach of the clause the lender is deemed to be equally and rateably secured on the same asset as the secured creditor is. The difference between the two variations should be noted; the equal security clause only requires the borrower to furnish equal security in favour of the original lender, while the automatic security clause implies that no further action is required by the borrower should he breach the prohibition.

In essence the cause seeks to create a contingent security interest where the contingency is the breach of the negative pledge covenant. From a theoretical point of view this should circumvent any problems the equal security clause might suffer from such as the debtor's unwillingness to grant the equal security, problems as to identifying equal security and matters of priority.

The automatic security clause is however not without its flaws as it shall be seen in the following sections, even when it is taking into account that the problems associated with lack of registration within due time, might be mitigated by the intervention of equity.

III. ENFORCEMENT OF THE COVENANT

1. Enforcement in Relation to the Borrower

Although this essay is primarily concerned with the remedies available to the original lender against a new secured lender, one should briefly consider the available remedies against the borrower. In principle there are four different remedies available to the lender although not all are equally viable.

(a) Acceleration and Damages

First of all a breach of the negative pledge will be an express event of default in almost every loan agreement whether bilateral or syndicated[19], although it should be noted that under most syndicated loan agreements this remedy is subject to the discretion of the majority banks. The majority banks, often defined as the holders of 2/3 of the participations, could thus waive any of the borrower's obligations under the loan agreement among others the covenants. This provision of syndicate democracy, subject to a few exemptions mainly in relation to alteration of interest rates, changes in the sums due to the banks and postponement of repayment date/alteration of repayment schedule, will in general bind the minority banks. It should however be appreciated that taking the i) sophistication of the lenders, ii) the sharing clause into consideration, one cannot imagine serious and lasting differences in opinion as to enforcement actions in case of breach of the negative pledge clause.

Alternatively or in the rare occasions that breach of the negative pledge clause is not an express event of default giving rise to an acceleration, the lender will be entitled to damages as a matter of ordinary contract law upon breach of a covenant. The size of such a claim is however uncertain, at least in those circumstance where the borrower does not become insolvent immediately after the completion of the transaction. It will thus be inherently difficult to ascertain the loss suffered as a consequence of the transaction should the borrower continue to honour its payment obligations and first default in a distant future. Damages recoverable due to a breach might thus just be nominal.

For the sake of completeness one might also consider whether the breach of the negative pledge clause could amount to an repudiation by the borrower thereby giving the lender the right to discharge the contract by accepting the repudiation.

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In relation to a eurobond negative pledge the situation seems rather different as breach of the negative pledge will in general not be an express event of default.

Such an consideration would be particular relevant in circumstances where breach of a covenant is not explicitly made an event of default in that this could have an impact on the borrower's ability to draw down further funds.[20] If the lender is to be discharged from his obligations under the contract ie to provide further funds, the breach will either have to be in way of renunciation, impossibility or failure to perform.

In the particular case breach of the negative pledge clause will probably amount to a failure to perform what has been promised. It should however be remembered that in general only a broken condition or breach of an intermediate term which deprives the plaintiff of substantially the whole benefit of the contract will entitle the lender to be discharged of further liabilities under the contract.[21] Breach of a term, which only amounts to a warranty, will thus only entitle the lender to damages. Whether the negative pledge covenant in absence of any express stipulation is a condition, a intermediate term or a warranty is a matter of construction. While the parties to the contract are free to stipulate that even a minor term should be regarded as a condition a court will have to look at the relative importance of the term broken when deciding which remedies are available in the absence of express stipulation.

If the term is essential to the contract as such – in the eyes of the court essentially 'making what is in effect a value judgement about the commercial significance of the term in question'[22] - or if the parties clearly intended that breach of the term should give the innocent party right to discharge himself, it will amount to a condition. If the term however is of such a nature that it can be broken either in a trivial manner, not undermining the contract as well as in a more

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20 The borrower's ability to draw down further funds is in general subject to a conditions precedent clause inter alia containing a provision that the borrower is not in default and that no default would arise immediately after the draw down. If breach of the negative pledge covenant is not classified as a default the borrower might be entitled to draw down further funds in spite of the breach.

21 Cf. *Hong Kong Fir Shipping Co. Ltd. v Kawasaki Kisen Kaisha Ltd.* [1962] 2 QB 26, 66.

22 Cf. *State Trading Cpn. Of India Ltd. v M. Golodetz Ltd* [1989] 2 Lloyd's Rep. 277, 283.

fundamental manner depriving the innocent party of the whole or a substantial part of the benefit it will be an intermediate term. If the breach is of the former type the remedy available will be a right for action of damages; in the later case the innocent party will have the additional right of discharging himself of further obligations.

In the current context it is submitted that the negative pledge is an intermediate term. Although one could argue that the negative pledge provision, at least in pure unsecured lending, is an essential obligation whereupon the loan agreement as such depends it is probably not per se a condition. It should thus be remembered that the negative pledge covenant could be breached in a number of ways, not all of them so fundamental as undermining the contract itself. In absence of express stipulation it is doubtful whether a court would allow the innocent party to discharge himself from a multimillion-pound loan agreement merely because the borrower carelessly has created a tiny security interests in relation to a trivial purchase. On the other hand a security interest created in favour of another lender securing old debt would almost certainly give the lender such a right.

(b) Specific Performance

Specific performance will normally not be relevant in relation to breach of the negative pledge clause due to the fact that it normally only contains a negative covenant. Only in relation to the affirmative negative pledge clauses will this remedy have some role to play. In eurobond issues where the borrower promises to furnish similar security should he subsequently issue secured bonds a claim for specific performance could be an additional option in stead of a claim for damages.

Although it has often been noted that specific performance is a discretionary remedy this does not imply that the choice of the courts will be exercised in a totally arbitrary manner.

On the contrary the grant of specific performance is to a substantial extent governed by rules and principles.[23] In general specific performance will only be granted in cases were this remedy will 'do more perfect and complete justice than an award of damages'.[24] The inadequacy of damages is therefore not per se a necessary condition for the grant of specific performance although it is an factor to be taking into consideration.

In relation to breach of a eurobond's negative pledge provision it is submitted that the award of damages will often be an adequate remedy, not least because the loss suffered due to the subsequent secured issue will often be easy to ascertain. In principle the decline in the price of the unsecured bonds immediately after the issue of the secured bonds would be the loss to the investors.

In those circumstances it is difficult to plead that the award of specific performance would do more perfect and complete justice. On the other hand it is clear that situations can arise where specific performance would indeed do more perfect and complete justice. In the aforementioned situation a claim for damages might jeopardise the issuers liquidity and thus subsequently his debt servicing capacity. Secondly, in some case the loss suffered may actually be difficult to ascertain as questions of causation could arise, eg was the decline in price due to the secured issue or to a market scepticism in relation to the issuers ability to service his debts.

In relation to the granting of specific performance it is submitted that the usual requirement as to mutuality will not be an issue in the context of bond issues. The investors will thus have performed all their obligations, ie the provision of funds, by the time a breach of the negative pledge might become relevant. Whether the provision of funds therefore is enforceable by way of specific performance becomes an irrelevant question.

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23 PH Pettit *Equity and the Law of Trusts* (9th edn Butterworths London 2001) p. 631 with reference to case law. The remedy is described as being discretionary due to the fact that the court in deciding whether to grant the remedy or not can take other circumstances into account which a irrelevant in the common law.

24 *Tito v Waddell (No. 2)* [1977] Ch. 106, 322; *Wilson v Northhampton and Banburry Junction Rly Co.* (1974) 9 Ch. App. 279, 284.

A factor, which however might prevent the grant of specific performance, is whether the obligation to grant 'similar security' is sufficiently defined for the courts to enforce it. It has thus be held that in cases where the obligations sought to be enforced are ill-defined a court will not grant specific performance on the grounds that the terms of the court's order compelling the performance would be equally ill-defined with the possible consequence of endless litigation over compliance. This argument however seems to apply more to cases where there is a continuing obligation and where continuing supervision by the courts might be required. In relation to the furnishing of similar security there seem to be no such problems. A similar security could be identified with reference to the security granted in breach of the covenant, ie with reference to the type of asset, the amount secured, the type of security interest etc. Where the borrower no longer has assets equivalent to the security securing the subsequent bonds, the court will by exercise of its discretion have to find the closets alternative.

While the remedy may work in some circumstances it is quite clear that it has its limitation; it is only useful against a borrower who still has unencumbered assets left. If the breach of the covenant is committed as a response to adverse financial conditions the remedy may be futile. Furthermore as an equitable remedy it is subject to the usual maxims of equity, among others that the investors come with clean hands.[25]

(c) Injunctions

While all the aforementioned remedies have an ex.post effect the use of a prohibitive injunction seeks to prevent the breach of the covenant in the first place.[26]

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[25] Another more practical problem is how to bring the enforcement actions. Bond investors will normally be dispersed around the world so even the gathering of the bondholders for a bondholder meeting, instructing a potential trustee to take the requisite action, might be a problem.

[26] The jurisdiction of the courts to grant injunctions is now to be found in the Supreme Court Act 1981 s.37(1) which also gives the High Court the jurisdiction to appoint receivers. The court can grant an injunction in all cases in which it would be 'just and convenient to do so'. Whether this jurisdiction actually enables the courts to grant injunctions in a wider extent than previous, ie pre- Judicature Act 1873, is not fully settled, cf. PH Pettit *Equity and the Law of Trusts*

While the injunction as such is an equitable remedy and thus prima facie subject to the discretion of the courts, the grant of an injunction to restrain a breach of a negative covenant will normally not be subject to much discretion. In the much-cited case of *Doherty v Allman*[27] it was thus noted by Lord Cairns that:

> If parties, for valuable consideration, with their eyes open, contract that a particular thing shall not be done, all that a Court of Equity has to do is to say, by way of injunction, that which the parties have already said by way of covenant that the thing shall not be done ...[28].

As it can be inferred from the obiter dictum, in circumstances where there is a clear breach of a negative term, the courts will de facto only have to sanction that breach by way of granting an injunction. No proof of damage seems to be required and thus also no proof as to the inadequacy of damages as remedy[29], thus making the way to the grant of an injunction to restrain a breach of pure negative covenant less onerous than usual.

In the event that a lender ex.ante should be aware of the fact that the borrower is furnishing security to a new lender, a prohibitory perpetual injunction should be readily available.[30]

(9th edn Butterworths London 2001) p. 541ff. for discussion with reference to case law. It is submitted that this discussion does not have a bearing in the present context since the jurisdiction of the courts to grant injunctions where a legal or equitable right is infringed follows from pre-1873 practice.

27 (1878) 3 App Cas 709 HL.

28 (1878) 3 App Cas 709, 720 HL

29 PH Pettit *Equity and the Law of Trusts* (9th edn Butterworths London 2001) p. 589, R Cranston *Principles of Banking Law* (2 edn Oxford University Press 2002) p. 317.

30 R Cranston in *Principles of Banking Law* (2 edn Oxford University Press) at p. 317 argues that there may be another problem with the grant of injunctions in this context, namely the notion that there is a clear line between positive and negative stipulations. If this were not so then the lender would have to show that damages would be an inadequate remedy, which could be difficult if the borrower is solvent. While R Cranston is right on this point it seems unlikely that a strict negative pledge would be drafted in a way which gave rise to speculations as to its negative nature.

The problem that arises is that the lender might not have the requisite knowledge as to the breach of the clause until it is to late. In fact where a borrower in financial difficulties knowingly breaches the covenant in order to overcome the adverse conditions he will normally see to it that the original lender is kept in the dark until the transaction is completed and the additional finance is secured, preferably even longer. Since an injunction will not be granted retrospectively the remedy seems futile in most practical circumstances.

Should the borrower threaten to breach the covenant or undertake some kind of behaviour which clearly shows his intention to breach the covenant in the future a quia timet injunction might be available although no infringement or alleged infringement of the lenders rights has taken place. It is unclear what behaviour absent from a clear statement as to the intention to break the covenant that would be sufficient in order to obtain such an injunction. The taking up of negotiations with credit institutions, which can only provide secured credit[31], could be one example, but even in this case the claimant must show that breach is an inevitable result, ie the breach will occur with great probability.[32]

In the previous paragraph it was presupposed that the transaction actually amounted to a breach of the covenant, thereby infringing the lenders rights. In some cases this will however not be that apparent. Especially when it comes to transactions which technically do not constitute security interests, but which might have the effect of being security interests, doubts as to the alleged infringement may arise. Examples of such transactions are various sale and repurchase transactions. Should the borrower be in financial difficulties the undertaking of such transactions may be a way of raising additional finance on quasi security terms. In those circumstances the courts may not grant a perpetual injunction on the grounds that it is unclear whether the transaction would be a violation of the legal rights of the lender.

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31 Examples of such institutions are Danish mortgage credit institutions, which are prohibited from making loans unless these are secured by real estate mortgages.

32 cf. *Pattison v Gilford* (1874) LR 18 Eq 259.

A trial might thus be necessary in order to establish whether the contemplated transaction infringes the right of the lender. If however the borrower is allowed to proceed with the undertaking the damage to the lender might be irreparable if the borrower is insolvent or near insolvent at the time the lender's potential rights might be established. In situations like this the application for an interim or interlocutory injunction might be of some help. The interim injunction will thus, if granted, restrain the borrower's contemplated action, until the trial of the action or until further order. In this connection it should be noted, that the grant of interim injunctions have been made somewhat easier by the HL decision in the *American Cyanamid Co v Ethicon Ltd.*[33]

Contrary to the previous rule where an interim injunction would only be granted given that the claimant could present a prima facie case, Lord Diplock made it clear that this was not longer the rule. The rule laid down in the *American Cyanamid* case is that unless the case is clearly vexatious it will be allowed as long as there is a 'serious question' to be tried. Whether the injunction as such will be granted will then depend on the balance of convenience test. It however seems that this only applies in circumstances where the inadequacy of damages to either party is equal. Should one party suffer irreparable damages compared to the other in the intervening period prior to the trial, an injunction would be granted in favour of this party.

In the case of the negative pledge it is submitted that in general the lender will suffer such irreparable damages, if the borrower is allowed to proceed with the transaction in the interim period. If a court thus later finds in favour of the plaintiff, the asset may well be out of reach for the lender and the claim for damages will often be a pity comfort if the borrower is unable to pay. The borrower will however in most cases be adequately protected by the usual undertaking to damages, save the case where the borrower exhausts his liquidity before the case is heard and thus is bound to be winded up in an insolvent liquidation. Although a claim for damages will be possible it will be difficult for the estate to estimate the loss suffered.

33 [1975] AC 396.

(d) Receivership

Finally it should be mentioned that the appointment of a receiver might be an additional option in some – although somewhat unusual - circumstances. In a situation where the borrower breaches the negative pledge in a large scale thereby decimating the assets available to the lender, an appointment of a receiver by the court may be available in order to preserve the property.

The jurisdiction for such an in court appointment of a receiver is now found in the Supreme Court Act 1981 s. 37(1) which gives the High Court jurisdiction to appoint a receiver in 'all cases in which it appears to the court to be just and convenient to do so'.

Side-stepping the discussion on the width of this jurisdiction compared with the pre-1873 jurisdiction[34] it is clear that the jurisdiction to appoint a receiver is quite wide.[35] Since the nature of the receiver however is to take possession of property and to collect and receive any rents or profits emanating from this, it is clear that the appointment of receivers in essence is confined to two situations. Firstly an appointment is made in situations where the claimant seeks to enforce his rights over property, other legal remedies being inadequate. Secondly an appointment is made in order to preserve property from danger, given that it would be unreasonable for the time being to appoint one party to administer and receive the income from the property.

In relation to the negative pledge lender the appointment of a receiver might be relevant in situations where the borrower breaches the covenant and thus decimates the assets available to the lender in a foreclosure situation. While it is clear that the clause only gives the lender a contractual right and thus not any legal or equitable rights the court has the jurisdiction to appoint a receiver to preserve the assets. The question that remains is under which circumstances the court will exercise its jurisdiction to appoint a receiver.

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[34] cf. note 26.

[35] For a discussion on the width of the jurisdiction of the Supreme Court Act 1981 s. 37(1) compared to the pre-1873 jurisdiction as to the appointment of receivers see R Walton and M Hunter *Kerr on the Law and Practice as to Receivers and Administrators* (17th edn Sweet and Maxwell 1989) p. 3 ff.

In the case of *Bond Brewing Holdings Ltd v. National Australian Bank Ltd.*[36] the focal point was whether a unsecured creditor could obtain the appointment of a receiver in a situation where the borrower inter alia had breached a negative pledge provision.[37] In relation to the question of jurisdiction The Full Court of the Supreme Court of Victoria was of the opinion that the court had jurisdiction to appoint a receiver even in cases where the applicant has no proprietary interest in the property. A negative pledge lender can thus prima facie apply for the appointment of a receiver.

Whether the court will actually exercise this jurisdiction will of course depend upon whether a proper case can be made and whether the case justifies the intervention of equity. In the current context this will require the lender to establish that the legal remedies at hand are inadequate.

It is submitted that this will seldom be the case. If the borrower is solvent the remedies in form of an action for damages will generally be considered to adequate.[38] Only where the borrower is insolvent or close to being insolvent will an action for damages be inadequate. In these situations it is however doubtful whether a receiver will be appointed since – as Mr. Stone points out – different principles namely statutory principles regarding insolvency should apply in this situation.[39]

The Full Court of the Supreme Court of Victoria took the same view when it declined to appoint a receiver, stating that a receiver will not be appointed to manage the affairs of a financial embarrassed company, at least not in circumstances where the company opposes this.

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36 (1990) 8 ACLC 330.

37 It should be noted that parts of the credit facilities made available to the borrower were secured loans which inter alia contained provisions regarding the out of court appointment of receivers. It was however not these provisions which gave rise to the dispute.

38 JB Stone 'Will a Court Appoint a Receiver at the Request of a Negative Pledge Lender' JIBL 1991, 6(10), 405, 408.

39 Ibid.

Based on the decision of the Full Court it seems that a negative pledge lender's request for the appointment of a receiver only in rare occasions will be meet. While this may be the case in some circumstances and certainly was the case in the *Bond Brewing Holding* case this is not always evident. First of all it must be noted that the banks in the particular case in their pleadings before the court to some extent brought the rejection upon themselves. By insisting on the appointment of a receiver to ensure the orderly governance of the debtor's business the attention was shifted from the preservation of asset situation to some kind of quasi liquidation thereby making an application for an appointment of a receiver somewhat mislead. Had the banks made it clearer that the receiver was needed in order to prevent the decimation of assets the outcome might have been different.

The argument could have been even more convincing if it - in conjunction with the preservation of asset argument - was pleaded that the very essence of the negative pledge clause is to ensure the availability of the debtor's assets. If the courts are not willing to prevent the erosion of a debtor's asset base the very foundation of the negative pledge clause vanishes. It is however admitted that even in this situation the banks would still have to establish that a claim for injunctive relief would be inadequate, since the courts will not appoint a receiver merely because this remedy might be more convenient than an injunction. Although the appointment of a receiver might be viable in some circumstances it is clear from the aforementioned that the remedy only has a limited application in the current context.

As an alternative to the court appointed receiver the parties can agree upon – as a matter of contract – that the lender is entitled to appoint a receiver out of court should the borrower breach certain covenants. Although the original basis for the receivership was the possession of mortgaged lands there can today be no requirement that the creditor as such must be secured or otherwise have a legal or equitable interest in the property of the debtor, hence a negative pledge lender should be able to appoint a receiver out of court.[40]

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Ibid. p. 405.

A receiver appointed out of court will however in some ways differ from a court appointed receiver. Thus a receiver appointed out of court will prima facie be the agent of the creditor who appointed him, in contrast to the receiver appointed by the court, who will be an officer of the court. Liability for the receiver's actions or omissions will thus fall upon the creditor being the principal.[41] Furthermore since the receiver is not an officer of the court any interference with the property the receiver is to administer is not contempt of court.

In practice the use of out of court appointed receivers seems to be very limited apart from domestic secured finance. In unsecured finance where the lender is exclusively relying on the negative pledge clause for protection one only on very rare occasions sees provisions for the appointment of a receiver out of court.[42]

2. Enforcement Against a New Lender

It follows from the section above that the remedies against the borrower might not always bring with them the desired result. While most of the remedies are fully adequate against a solvent borrower they are only of limited use in an insolvency situation. It is this feature which causes the main problem, since the negative pledge clause is probably only breached in such situations.

The lenders have realised this and have therefore sought after additional ways to protect their positions in such situations. The efforts have thus far resulted in two different approaches. The first approach seeks to enhance the strength of the clause itself by adding undertakings as to the provision of equal security or by the inclusion of automatic security clauses,

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This is however only a theoretical problem since the provisions in eg debentures often provide for that the receiver is agent of the company thus relieving the creditor from a potential liability cf. PH Petit *Equity and the Law of Trusts* (9th edn Butterworths London 2001) p. 666.

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This observation is based on the examination of a substantial number of bonds/medium term notes and loan agreements. Furthermore it is noted that the sample loan agreement recommended by the Loan Market Association does not contain such provisions.

cf. section II subsection 3. In accordance with the introduction this approach will not examined further. The other approach focuses on the application of the economic torts.

(a) Economic Torts

This approach realises the evident, namely that the borrower cannot by itself breach the negative pledge clause. In each breach of the clause there will be a counter party, which either demands or at least accepts the contested security over the debtor's assets. This counter party can in principle be any creditor at all, but will often in all cases that matter be either an existing lender seeking to improve his position or a new lender providing funds to the debtor for the first time.[43]

In either case the original lender might consider whether he can recover any losses suffered by the breach from the third party (ie the existing or new lender) who facilitated the breach of the clause.

Such a claim can be based on the economic, torts ie actions in tort available to a party which economic interests have been intentionally violated by a third party – in the present context by another bank. In this connection it must be noted that the relevant torts are the so-called "general" economic torts[44], ie conspiracy, inducing breach of contract/interference with contractual relations[45], intimidation and the more general unlawful interference with trade.[46] The economic torts of deceit, passing off and injurious falsehood are thus not included.

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It can be argued that in this case there is no need for the original lender to be concerned, since the loss of an unencumbered asset is off set by the provision of additional funds which *ceteris paribus* improve the debtor's credit standing. It should however be remembered that the negative pledge clause not only seeks to preserve the debtor's pool of assets, but also to discourage excessive borrowings by the debtor. Furthermore the additional funds might be used to pay off other creditors, thus leaving the original creditor worse off.

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See H Carty 'Intentional Violation of Economic Interest' (1988) 104 LQR. 250, 251 n. 5 for this terminology.

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There seems to be no firm opinion in the literature as to which term is to be preferred, so the two terms are used interchangeably.

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In *Merkur Island Shipping Corpn. v. Lauhgton* [1983] 2 AC 570, Lord Diplock described this tort as the 'genus' of all economic torts. This was the first 'official' acknowledgement of the tort although previous cases had come close by in applying the tort, see namely *Rookes v. Barnard* [1964] AC 1129, which however in the end applied the tort of intimidation instead.

A brief examination of the various torts will reveal that in the end only the tort of inducing breach of contract stands any reasonable chance of success in the current context. In accordance with this section IV will exclusively focus on this tort.

IV. TORT OF INTERFERENCE WITH CONTACTUAL RELATIONS

In order for any liability to arise under this tort the original lender will have to establish the presence of the various elements of the tort. To be more specific, the lender must prove that the new lender knowingly and with intention interfered with the contractual relations between the borrower and the lender thereby inducing the borrower to breach the negative pledge clause. This interference must have caused a loss to the original lender and the defendant must have no justification for his interference. The various elements of the interference doctrine are hereafter examined.

1. Type of Interference

The tort of interference encompasses various forms of interference. In order to structure the following analysis it is useful to set out the various forms of interference.[47]

In situations where an existing or new lender directly approaches the borrower in order to obtain security or accepts security offered by the borrower the interference with the contract is direct and hence the situation can be described as *direct inducement* to breach the contract. In this situation, which is – it is submitted – the relevant in our context, no unlawful means as such have to be employed in order for the tort to occur. The direct inducement to breach the contract is sufficient.

Direct intervention is said to occur in situations where a third party by the use of unlawful means prevents or hinders the performance of the contract, eg by breaking the contractor's tools.

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The following distinctions between the different kind of interference were set out by Jenkins LJ in *D.C.Thomson & Co. LD v Deakin and Others* [1952] Ch. 646, 694 ff.

Contrary to the previous tort the heart of this tort is not as much the infringement of the plaintiff's contractual rights but more a desire to inflict harm upon him through the use of unlawful means. This form of interference will, it is submitted, not arise in the present context. A lender seeking security will do so in order to protect his credit position towards the borrower and does not per se seek to inflict harm on the other creditors.

Finally *indirect intervention* will arise where a defendant uses unlawful means to persuade an intermediary to impose pressure on the contract breaker to breach his contract with the plaintiff. This kind of intervention will often arise in case of secondary industrial action.[48] This kind of intervention will not be relevant in the current context.

In accordance with the aforementioned only the direct inducement situation will be subject to further examination in the following sections.

2. Knowledge of the contract and its terms

If the tort of interference is not to hamper the everyday trading activities in a market based economy, its application must be limited in some ways. The first limitation in this context is the requirement that the third party interfering with the contract must have knowledge of its existence. This requirement is quite straightforward since the very essence of the tort is the intentional violation of the plaintiff's economic interest. One cannot violate interests intentionally if one does not have the required knowledge.

A problem however arises as to which state of knowledge is required and to what extent knowledge of the precise terms of the contract is necessary. It is clear that actual knowledge on behalf of the secured lender as to the existence of the original loan agreement and the negative pledge provision herein fulfils the criteria of knowledge.

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48 See *Middlebrook Mushrooms Ltd. v Transport & General Workers Union* [1993] ICR 612 for an example of indirect intervention.

A bank with such knowledge would thus risk being sued in tort should it demand or accept security, given that the other elements of the tort are established.

A more interesting and relevant question is however whether the requirement of knowledge can only be fulfilled if actual knowledge is present or whether constructive knowledge will suffice. This question has been fiercely contested.

Authority for the actual knowledge doctrine is to be found in *Swiss Bank Corporation v Lloyds Bank Ltd. and Others*[49], where Swiss Bank had furnished funds to the debtor company in order to enable it to buy securities. The loan agreement inter alia contained a negative covenant that these securities and their yield were only to be used to service and repay the loan. It should be noted that this provision was inserted in order to comply with the Bank of England's exchange control requirements and not as such intended to protect the plaintiff's credit. Lloyds Bank subsequently took a charge over the securities without – at that time - having actual knowledge of the restriction and subsequently enforced the charge. In this connection Swiss Bank sought an injunction restraining Lloyds Bank from applying the proceeds from the sale of the securities, on the grounds that this would be an interference with the restriction in the loan agreement. The underlying argument was that Lloyds Bank could not rely on any lawful proprietary interest under the charge, since this charge was created when Lloyds Bank had constructive knowledge of the restriction.

This argument was clearly rejected by Browne-Wilkinson J. stating that in his judgement constructive knowledge was not sufficient since actual knowledge of the contract was a requisite element of the tort.

While the judgement seems very definitive it should be noted – as pointed out by Mr. McKnight[50] – that the judgement is inconsistent with both the Court of Appeal decision in *Emerald*

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[49] [1979] Ch. 548.

[50] A McKnight 'Restrictions on Dealing with Assets in Financing Documents: Their Role, Meaning and Effect' JIBL 2002, 17(7) 193, 200.

Construction Co. Ltd v. Lowthian[51] and the decision in *Merkur Island Shipping Corporation v Laughton*[53].

In the *Emerald* case Denning M.R. held that actual knowledge of the precise terms of the contract was not necessary in order to establish the tort, if only the party inducing the breach of contract had the means of knowledge.[54] Similar in the *Merkur* case Donaldson M.R. stated the following:

> Whatever the precise degree of knowledge of the defendants at any particular time, faced with a laden ship which, as they well knew, was about to leave port, the defendants must in my judgement be deemed to have known of the almost certain existence of contracts of carriage to which the shipowners where parties.[55]

On appeal to HL Lord Diplock agreed with the statement and further noted more generally as to whether the defendants I.F.T. (a trade union) could be deemed to have knowledge:

> Quite apart from this, however, there can hardly be anyone better informed than I.F.T. as to the terms of the sort of contracts under which ships are employed, particularly those flying flags of convenience.[56]

Further support although a bit vague can be found in *D.C. Thomson & Co. Ltd v Deakin*[57] where Eversheds M.R. indicates that common knowledge as to the way business is conducted might be sufficient to fulfil the knowledge criteria.[58]

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51 [1966] 1 WLR 691.
52 [1983] 2 AC 570.
53 [1983] 2 AC 570.
54 [1966] 1 WLR 691, 700.
55 [1983] 2 AC 570, 591.
56 Ibid. p. 608.

Since it can be inferred from the aforementioned cases that less than actual knowledge may be sufficient the question remains how the inconsistency with the *Swiss Bank* case is to be solved. It is submitted that the approaches taken in the *Emerald* and the *Merkur* cases should prevail. Several arguments can be presented in favour of this proposition.

Firstly it is important to realise that if one insists on the application of a strict knowledge criteria the tort would in most circumstances and certainly in relation to negative pledges be useless. Only on very rare occasions would a plaintiff be able to prove that not only did the tortfeasor have actual knowledge of the existence of the contract as such but also specific knowledge of the provisions causing the interference. It is evident that this will rarely be the case not least because banks seldom publish or otherwise make their financing documents available to a greater audience. A strict knowledge doctrine would thus leave the original lender without any efficient remedies against interfering third parties.

Secondly, it is submitted that the application of a strict knowledge requirement could lead to absurd results. One could think of a situation where a new lender wishes to forward funds to the debtor on secured terms only. Being a diligent lender the secured lender would examine the financial situation of the debtor and inter alia the debtors other financing documents. This lender would on the discovery of negative pledge provisions either be forced to abstain from lending at all or on secured terms, or run the risk of being sued in tort.

An existing lender with a large unsecured credit at stake could on the other hand, by recklessly shutting his eyes to the obvious, demand security as a prerequisite for not accelerating the loan should the borrower experience financial difficulties[59] and not be liable in tort.

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57 [1952] Ch. 646.

58 Ibid. p. 687.

59 The basis for such an acceleration could either be an outright breach of the covenants due to the financial difficulties or even without an actual breach it could – in principle – be based on the Material Adverse Change clause.

Even if this lender had actual knowledge of other loan agreements he would still escape liability if he did not have actual knowledge of the negative pledge provisions as such. This can hardly be a desirable result.

Counter arguments in favour of a strict knowledge requirement are however also at hand. The most powerful argument is of course the floodgate argument. By applying a more relaxed knowledge regime the amount of litigation could potentially surge as the risk of interfering with other parties' contractual relations would rise. This could in the end lead to a hampering of normal business activities and make the entering into contracts far more onerous due to an extended regime of inquiry. It is thus evident that the constructive knowledge doctrine has to be kept within certain very strict limits.

It is however submitted that based on the aforementioned case law the courts have diligently struck the right balance between providing remedies for the injured party while at the same time ensuring that normal business activity is not hampered. It is thus to be noticed that knowledge has only been imputed on the defendant in circumstances where the existence of other contracts was almost certain or when the specific provisions breached were so common that every reasonable business man would expect them to be present in any contract.

Before addressing which implications this doctrine is considered to have in relation to negative pledges it is useful briefly to go through one further objection against the constructive knowledge doctrine. The objection is based on the incorporation of the equitable notion of constructive knowledge into the common law.[60] The argument is undoubtedly implicit based on the notion that law and equity are 'two streams of jurisdiction, though they run in the same channel, run side by side and do not mingle their waters'.[61]

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[60] JB Stone 'Negative Pledges and the Tort of Interference with Contractual Relations' JIBL 1991, 6(8) 310, 314.

[61] Ashburner's *Principles of Equity* (2nd edn) p. 18.

This notion has however recently been questioned not least by Lord Diplock in *United Scientific Holdings Ltd. v Burnley Borough Council*[62] where the following was stated:

> [T]o perpetuate a dichotomy between rules of equity and rules of common law which it was a major purpose of the Supreme Court of Judicature Act 1873 to do away with, is, in my view, conducive to erroneous conclusions as to the ways in which the law of England has developed in the last 100 years.[63]

If this view is accepted as being correct, any objections against the incorporation of constructive knowledge into common law should vanish.[64] On a more practical level it should be noticed – as pointed out by Mr. Stone – that the doctrine of constructive notice has already to some extend been incorporated in common law, eg in agency law.[65]

Based on the aforementioned considerations it is suggested that in relation to the negative pledge situation the following should apply:

Any lender contemplating to lend substantial funds to any large corporate entity should be deemed to have knowledge of any negative pledge provisions in the borrower's other finance agreements as to their basic content, ie the prohibition against the granting of security interests in favour of third parties.

It is submitted that authority for this proposition is to be found in the aforementioned case law. In all cases the courts have thus either applied or considered to apply a principle where knowledge is imputed on defendants in circumstances where the provisions interfered with were

62 [1997] 2 All ER 62.

63 Ibid. p. 68.

64 For the sake of completeness it should be mentioned that the view taken by Lord Diplock is being contested. For a discussion see PH Pettit *Equity and the Law of Trusts* (9th edn Butterworths London) p. 10 ff. with reference to additional case law.

65 JB Stone 'Negative Pledges and the Tort of Interference with Contractual Relations' JIBL 1991, 6(8) 310, 314.

either common in the conduct of business or where the provisions would almost certainly have been applied in the relevant context.

In relation to debt finance of large corporate entities it is submitted that the vast majority of all lending takes place as unsecured lending, not least in the international context. By the same token it is submitted that unsecured loan agreements will invariably contain negative pledges since it is a fundamental covenant in any loan agreement. The negative pledge provisions are thus common in the lending business and any lender, or at least any professional lender, should be deemed to have knowledge of those.[66]

Since the negative pledge provisions are however subject to extensive negotiations and since not all negative pledges have the same exclusions only the very core provision of the clause should be included in the doctrine of constructive knowledge.

3. Intention

Knowledge of the contract interfered with is not sufficient in order to establish the tort. It must also be established that the defendant actually intended the breach of the contract and that the breach as such was not merely caused by negligence.

The requirement of intention will certainly be fulfilled in circumstances where the new lender actively seeks to procure a breach of the negative pledge clauses in the borrower's other finance documents in order to injure one or more specific banks. This situation would however be highly unusual for which reason it seems more expedient to consider the boundaries of the intention requirement. Namely two questions must be considered; firstly whether it has to be shown that the defendant intended to interfere with a particular lender's contract in order to establish intention and secondly if intention to breach a contract can be established in cases where the contract can also be terminated lawfully.

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66 Some small creditors, eg trade creditors should thus not be deemed to have knowledge of such provisions.

In the current context it is quite clear that any lender seeking security in order to protect its credit against the insolvency of the borrower, will embark on this course for his own purposes and not for the purpose of harassing the other lenders. The interfering lender will thus not have any particular lender in mind when he takes the security and thereby interferes with the contractual relations of the other lenders. In fact he may not even know the identity of the other lenders cf. the aforementioned in relation to the constructive knowledge doctrine. The question therefore arises whether such interference, which is not aimed at any particular contract party, can be caused intentionally.

This question was touched upon in *Lonhro plc v Fayed and Others.*[67] Woolf LJ in giving his judgement first of all emphasised that unlike the tort of conspiracy the tort of interference did not require a predominant intention to injure. More generally on the requirement of intention he stated the following:

> This tort is not based upon any agreement, but interference, and frequently it will be fully appreciated by a defendant that a course of conduct he is embarking upon will have a particular consequence to a plaintiff, and the defendant will have decided to pursue that course of conduct knowing what the consequence will be. Albeit that he may have no desire to bring about that consequence in order to achieve what he regards as his ultimate ends, from the point of view of the plaintiff, whatever the motive of the defendant, the damage which he suffers will be the same. If a defendant has deliberately embarked upon a course of conduct, the probable consequences of which to the plaintiff he appreciated, I do not see why the plaintiff should not be compensated.[68]

67 [1990] 2 QB 479.

68 Ibid. p. 494.

Albeit the case in question concerned a particular plaintiff it is indicated by the statement of Woolf LJ that the defendant's actions do not necessarily have to be aimed at a particular plaintiff in order to fulfil the requirement of intention. It suffices that the defendant knew that probable consequences of his action could be an interference with any plaintiffs' rights.

An even clearer case is however to be found in *Falconer v ASLEF and NUR*.[69] The case concerned industrial actions taken by a trade union against British Rail. As a consequence of a strike by the trade unions members British Rail was unable to perform their contracts for transportation of people. A businessman who as a result of the strike was unable to travel on the requested date incurred additional travel expenses and subsequently sued the trade union for unlawful interference. The question of intention was central to the judgement as the defendants argued that in order for the tort to succeed there had to be an identifiable plaintiff at the time of the tort and the plaintiff had to be the object of the defendants actions. In giving his judgement Henham J stated the following:

> In my view the plaintiff was one of a definite and identifiable group of people in contractual relations with the BR Board. The fact that his actual name and description was unknown to the defendants at the time does not preclude him from beginning the action and succeeding in his claim provided he satisfies the Court in regard to other matters which must be proved.[70]

While it is admitted that the judgement being a County Court decision does not provide the strongest authority it does favour a position towards a relaxed intention criteria.

If this criteria is applied to the previously described situation then a lender taking security in breach of negative pledge provisions would be deemed to have acted intentionally, even

69 [1986] IRLR 331

70 Ibid. p. 333.

though he did not aim his actions at any particular lender and even if he had no knowledge of their identity. It is thus suggested that the situation here is quite similar to the situation in the *Falconer* case. A debtor's other lenders are in fact a definite and identifiable group of persons, as stated in *Falconer* case.

The second question in relation to intention is whether it has to be established that the third party actually intended a breach of the contract. The question namely arises in situations where the contract breaker has the additional option of terminating the contract lawfully before entering into the new contract with the inducing party. A possible defence for the inducing party could thus be that although he exerted pressure to end the contract his intention was not that the contract should be ended by a breach but instead through lawful termination.

Whether this defence will be successful or not will depend upon the exact content of the inducement. In the *Emerald* case Lord Diplock stated the following as to the requirement of intention:

> The element of intent needed to constitute the tort of unlawful procurement of a breach of contract is, in my view, sufficiently established if it be proved that the defendants intended the party procured to bring the contract to an end by breach of it if there were no way of bringing it to an end lawfully. A defendant who acts with such intent runs the risk that if the contract is broken as a result of the party acting in the manner in which he is procured to act by the defendant, the defendant will be liable in damages to the other party to the contract.[71]

It can be inferred from this statement that in cases where the defendant insists on the termination of the contract he will be liable in the event of a breach even if it could have been terminated lawfully.

71 [1966] 1 WLR 691, 704.

Thus in situations were the defendant must realise that it is most likely that the induced party will respond to the inducement by breaching the contract the defendant will be liable if that breach actually occurs. On the other side the defendant cannot be said to have intended the breach in situations where the outcome might as well have been a lawful termination of the contract.

In relation to the negative pledge situation it is submitted that an existing lender who insists on the furnishing of security to secure an *existing* loan will have intended a breach of the borrower's negative pledge provisions. In should namely be noted that it is highly unlikely that a borrower can furnish security for existing loans without breaching any negative pledge clauses. This would viz. mean that the borrower had obtained waivers from the other lenders – a highly unlikely event in such a situation.

The situation may be slightly different in relation to a new lender who seeks security as a condition for the furnishing of any funds. As previously noted the assets of the borrower are not per se diluted by such a transaction since one asset is exchanged for another. Even if most negative pledge clauses also tend to prevent such transactions – in order to prevent excessive borrowing – there may be exclusions available and waivers will more easily be given. Thus the consequence of such a request is not necessarily a breach of the negative pledge clause. The borrower might eg use the funds obtained to discharge other debts and thus discharge the appurtenant negative pledge clause. In such situation an intention to breach the clause cannot per se be inferred.

4. Causation

It is a requirement of every tort that in order for liability to arise there must be causation between the tortious act and the damages caused. This requirement will normally not give rise to any specific problems – often the problem arises in relation to the proximity of the losses caused.

The tort of interference is however somewhat special, since the damages to the plaintiff are not solely due to the tortfeasor's acts but also to a certain degree attributable to the contract breaker's willingness to breach his contract with the plaintiff. Thus a problem of causation arises as to whether the damage to the plaintiff was caused by the defendants interference with the contract or by the contract breaker's willingness to give in to this inducement. In the negative pledge situation it can thus be argued that the damages to the original lender where not caused by the other lender's taking of security, but by the borrower's willingness to grant security in order to secure new funds or prevent the acceleration of a loan in default.

In deciding upon this issue of causation it is clear that the interesting point for further examination is to decide the lower threshold for facilitation by the defendant in order to establish causation, since the contract breaker will already be liable due to the breach of contract.

In the case of *Batts Combe Quarry Limited v Ford and Others*[72] the lower limits of the causation requirement was tried. In the case three defendants accepted their fathers provision of capital and advise in relation to the set up of a quarry business. This assistance was provided by their father in contravention of a negative covenant on his behalf, owed to the purchases of his former business not to assist in the set up of any other quarry businesses.

The Court of Appeal held that this mere acceptance of a bounty did not amount to a procurement of breach of their father's covenant.[73]

In the case of *British Motor Trade Association v Salvadori*[74] causation was again an issue. In the case a trade association of British car manufacturers and their authorised dealers operated a so-called covenant system, where each purchaser of a car had to undertake a covenant not to resell the car within twelve months unless permitted so by the association. The system was set in place inter alia to avoid inflation of car prises due to a shortage of cars in the aftermath of the Second World War.

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72 [1943] Ch. 51.

73 Ibid. p.51. The gist of the case was hereafter whether the father himself by providing this assistance was in breach of the covenant.

74 [1949] Ch.556.

The defendants so it was alleged undermined the system by inducing persons acquiring a car to breach their covenant to the defendants who then on sold it to other purchasers at considerable higher prices.

The plaintiff inter alia claimed that the defendants thereby interfered with the contracts between the authorised dealers and the purchasers of the car. On behalf of the defendants it was pleaded that the plaintiff had not established that any persuasion was 'exerted to break the covenant'[75] in essence pleading a lack of causation between the contact of the parties and the breach of the covenant. In giving his judgement Roxburgh J considered what kind of interference was necessary for the tort to succeed. The following was stated:

> But, in my judgement, any active step taken by a defendant having knowledge of the covenant by which he facilitates a breach of the covenant is enough. If this be so, a defendant by agreeing to buy, paying for and taking delivery of a motor-car known by him to be on offer in breach of covenant, takes active steps by which he facilitates a breach of covenant …[76].

In relation to the willingness of the purchaser to breach the covenant and its implications for the acts undertaken by the defendants Roxburgh J stated:

> The covenantor who offers a car for sale is not unconditionally ready to break his covenant but only if the price offered is high enough and, accordingly, a defendant who offers such a price induces the seller to take the final step towards breaking his covenant by making his willingness to sell unconditional.[77]

75 Ibid. p. 560.

76 Ibid. p. 565.

77 Ibid. p. 566.

Based on this case law it seems like the threshold for establishing causation is very low. Even the slightest form of participation by the third party – like stating a price - leading to breach of the contract will be sufficient.

Only in circumstances where the action taken by the third party is limited to mere acceptance of an offer will causation not be established. Even in this situation caution is however called for. It should thus be noticed that the *Batts Combe Quarry* case concerned the making of a gift and the provision of some advice. Had the situation been that of the sons asking or somehow indicating a desire for advice and finance, the decision might easily have been the opposite[78].

Transferring this approach to the negative pledge situation one would find that under practical all circumstances would causation be established where a lender accepts security in knowingly breach of the provision. A lender who contemplates to accelerate a loan in default would thus be facilitating a breach of contract if he where to accept any security offered by the borrower in consideration for not accelerating the loan. This would be true even in situations where the borrower subsequently would offer security to another lender on the refusal of the first to accept the offer.

Only in situations where the borrower unilaterally without any prior contact or negotiations offers security could one conceive a lack of causation. This situation can however only be of academic interest since it does not correspond with the commercial realities.

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The finding of causation or lack of causation does thus not only depend upon the degree of involvement by the third party but also on who initiated the original contact. If the contract breaker initiated the contact and the third party was only the ”tool ”of the contract breaker causation might not be established. This view can however not be taken to far since first of all it might be difficult to establish who took the initiative and secondly because the parties themselves might have an interest in displaying the situations as one where the contract breaker took the initiative. Finally it should be noted that the decision has been criticised cf. JB Stone ‘Negative Pledges and the Tort of Interference with Contractual Relations’ JIBL 1991, 6(8) 310, 317.

5. Damages

In order to have a claim against the defendant the plaintiff must have suffered a loss due to the interference with the negative pledge. In cases where the borrower does not immediately afterwards goes into corporate insolvency this loss could be difficult to estimate and subsequently prove.

As it has however been seen from the previous sections an action for the tort of interference will often only be commenced in situations where the borrower is insolvent or near insolvent. Under these circumstances the loss suffered will be the value of the asset which is not longer available to the unsecured creditors. In cases where the original lender is only one among a number of unsecured creditors the loss to him will only be a fraction of the total value of the asset.

6. Defences

Even in situations where all the previous conditions are fulfilled and the defendant prima facie will be liable, he will still be able to invoke the defence of justification and thus – if successful - escape liability. While the existence of the defence of justification has been confirmed a number of times[79] it is still unsettled what constitutes sufficient justification and in which circumstances the defence can be applied.

Whether an action is justified will depend on the particular circumstances in each case. In *Glamorgan Coal Co. Ltd v South Wales Miners' Federation*[80] Romer LJ considered which circumstances it might be relevant to consider:

> I think that regard might be had to the nature of the contract broken; the position of the parties to the contract; the grounds for the breach; the means employed to procure the breach; the relation of the person procuring the breach to the person

[79] *Glamorgan Coal Co. Ltd v South Wales Miners' Federation* [1903] 2 KB 545; *Quinn v Leathem* [1901] AC 495; *Mogul Steamship Co v McGregor, Gow & Co.* 23 QBD 598.

[80] [1903] 2 KB 545.

who breaks the contract; and I think also to the object of the person in procuring the breach.[81]

Although the above statement seems to indicate that justification can be available in a number of situations and the defence of justification is correspondingly broad this is not the case. On the contrary the defences is quite narrow in the present context of inducing breach of contract compared eg with the one available in the tort of conspiracy.

Correspondingly the case law on justification is rather thin and thus does not give much guidance. It is however clear that furtherance of ones own interest or those of third parties will generally not provide justification, even if conducted without any malice.[82] A slight modification of this principle is however found in *Brimelow v Casson*[83] where interference can be justified on grounds of a moral duty to intervene.[84]

On the other hand however interference can be justified if the contract interfered with is in itself inconsistent with the inducing party's contract given that this contract has been entered into before the inconsistent contract.[85] Furthermore interference can be justified if the defendant has equal or superior rights in comparison with the plaintiffs rights[86], as applied in the case of *Edwin Hill and Partners v First National Finance Corporation Plc.*[87]

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81 Ibid. p. 574.

82 In the *Glamorgan Coal* case the defendants inter alia pleaded that the actions taken were in the interest of the miners and thus taken in order to further their interest. This argument was however dismissed. See also *Read v Friendly Society of Operative Stonemasons of England, Ireland and Wales* [1902] 2 KB 88.

83 [1924] 1 Ch 302.

84 A committee of trade unions induced theatre proprietors to deny the plaintiff access to their theatres in order to persuade the plaintiff – a theatrical manager – to pay his chorus girls the minimum wage so that they were not forced into prostitution. The court held that this interference was justified.

85 cf. *Smithies v National Association of Operative Plasterers* [1909] 1 KB 310, 337.

86 cf. *Read v Friendly Society of Operative Stonemasons of Englamd, Ireland and Wales* [1902] 2 KB 88, 96.

87 [1989] 1 WLR 225.

In this connection it should be mentioned that although the *Hill and Partners* case concerned a legal right in form of a legal charge a pure contractual right will suffice.[88]

In relation to the negative pledge situation the defence of justification will have the following consequences.

A lender who demands security as consideration for not accelerating an otherwise unsecured loan in default, would in general not be justified in his action, even if he acted without malice or only with the aim of furthering his own interests, which he undoubtedly will do.

An exception applies in cases where the lender has lent funds to the borrower on the basis of an equal security clause. In such cases the lender would be entitled to demand security upon breach of the clause. It should thus be noticed that in this situation the lender only insists upon that the borrower fulfil his contractual obligation. In this situation the lender is thus relying on the justification based on an equal or superior right vis-à-vis the rights of the plaintiff.[89]

This position must however be qualified in situations where the lender from the outset on knows that such a provision would by itself be inconsistent with a previous loan agreement entered into by the borrower. A lender who thus includes a equal security clause in his loan agreement with the borrower even though he has knowledge of the negative pledge provisions in other loan agreements would arguably not be able to invoke the defence of justification when he later on insists on the furnishing of security.

V. CONCLUSION

As a purely contractual provision the negative pledge clause has its advantages and drawbacks. The advantages are its flexibility and the ease with which it can be incorporated into any finance agreement.

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88 Ibid. p. 233.

89 If the loan is made on the basis on an automatic security clause the lender will correspondingly be justified in any interference caused by accepting the security that is intended to arise automatically upon breach of the clause.

Unlike a security interest there is no need to comply with local laws as to form, content or registration which is a particular attractive feature in international and hence multi-jurisdiction finance. The drawbacks of the clause flow from the fact that it is not a security. If the clause is not honoured the lender has no proprietary claim against the assets of the borrower, but must rely on various remedies against the borrower. Those remedies, which consist of an acceleration of the loan, a claim for damages and sometimes specific performance or the use of injunctions and receivership, are however in general only viable against a borrower in a sound financial state. In situations where the negative pledge clause is breached due to severe financial difficulties only the use of injunctions or receivership will be useful. The application of these remedies is however restrained by the fact that they either require knowledge of the prohibited transaction before it take effect or by the willingness of the court to appoint receivers. In essence the inadequacy of the negative pledge clause and the associated remedies will be most pronounced in circumstances where a security interest would be most appropriate, namely in situation of insolvency of near insolvency.

The tort of interference does not as such rectify the flaws of the negative pledge clause. It will not provide the lender with a proprietary claim on the borrower's insolvency. It does however act as a deterrent to a breach of the negative pledge clause in the first place, by imposing a potential liability on any interfering lender. This is a particular important feature, because one cannot expect the borrower to be deterred from breaching the clause in a difficult financial situation where the stakes are sufficiently high.

It is submitted that although the tort of interference mainly has found applications in other areas of the law it has a role to play in the current context. Although the various elements of the tort makes a claim of interference quite onerous it should in general succeed at least against existing lenders who seek to enhance their position vis-à-vis other creditors prior to a financial break down.

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