

Dentons DCM Quick Guide to Negative Pledges

Practical summaries of interesting topics in the debt capital markets

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The negative pledge is a key tool for the protection of existing senior creditors from being effectively subordinated to later secured senior indebtedness. This article outlines how a negative pledge is used in the DCM context, the "typical" scope of an investment grade bond negative pledge and potential variations that may be seen. It also provides a step-by-step practical guide for an investment grade issuer with an existing "capital markets" negative pledge on how to interpret and analyse a proposal to grant additional security on a future deal.

This article is written in the context of senior unsecured DCM bond issues in the European market, offered to professional investors and under an exemption to the registration requirements of the US Securities Act of 1933 (as amended), on either a Regulation S or a Rule 144A/Regulation S basis. It is a high-level overview of a complex topic, intended to provide a general overview of the issues. Prior to taking any specific actions, the particular factual circumstances of an individual bond issue and issuer should be considered and specific legal advice sought.

Negative pledges in a DCM context

Whenever a bond issuer takes on further senior unsecured indebtedness, that new indebtedness will rank alongside any existing senior unsecured indebtedness on a winding-up of the issuer. However, if further senior indebtedness is taken on that is secured, that further indebtedness will have a priority claim to the assets subject to the security, ahead of existing senior indebtedness.

It is therefore common in loan agreements to include a restriction on the borrower granting security for other debts, without first granting equal security to the debt incurred under the loan agreement. This restriction is known as a "negative pledge" and, specifically, when it restricts the granting of security for all other debts, it is referred to as an "all monies" negative pledge. The purpose of an "all monies" negative pledge is to ensure

that the borrower does not grant security over assets which could otherwise be used to service or repay the existing senior debt of the borrower.

Although bonds issued by most corporates (but not banks and certain other financial institutions)¹ will contain a negative pledge clause, the drafting and scope of the negative pledge in investment grade bonds usually differs starkly from a standard loan agreement "all monies" negative pledge. In an investment grade bond issue, negative pledges tend to have a much more limited scope, and usually only restrict the issuer's ability to issue similar capital markets instruments (such as notes, bonds and other securities, capable of being listed or traded) on a secured basis, rather than restricting the ability to grant security in relation to other forms of indebtedness. The standard negative pledge found in investment grade bonds is therefore referred to as a "capital markets" negative pledge in order to distinguish it from an "all monies" negative pledge.

The purpose of the negative pledge in an investment grade bond context is not to completely restrict the issuer from giving security for the benefit of the holders of its other debt, but rather to provide some price protection (and potentially credit ratings protection) for the bonds containing the negative pledge. If the issuer issued similar capital markets instruments that were secured, investors may be more likely to purchase the secured bonds or the market may view the unsecured bonds as becoming a riskier investment proposition and thereby adversely affect the secondary market trading price of the unsecured bonds. That is, a "capital markets" negative pledge serves as a protection against the issuer issuing or guaranteeing "better bonds"² than the existing bond issue, and is thus sometimes referred to as a "no better bonds" negative pledge, as it only protects against security being granted in favour of other capital markets instruments.

Sovereign bond issuers will usually grant a "capital markets" negative pledge, often restricted only to ensuring that no security is granted over "external indebtedness" (i.e. debt denominated in a currency other than the sovereign's own currency, unless that currency is the euro). The negative pledge for certain eurozone sovereigns is drafted such that it does not apply to securities sold domestically and held through the local domestic clearing system (on the basis that such domestic securities are typically targeted at a different pool of investors and so unlikely to compete with or provide a secondary market price comparison against the issuer's international capital markets securities).

For high yield bonds³ it is usual to follow the loan market "all monies" negative pledge approach. Conversely, it would be quite unusual for an investment grade issuer to include an "all monies" negative pledge. In addition to financial institution issuers, some large, high credit quality corporate issuers may be able to issue senior unsecured bonds in a good market without including a negative pledge; however, such issuers would need to be conscious of any potential adverse primary or secondary market pricing impact or effect on demand that might result from the lack of the investor protection typically afforded by the negative pledge. Investor concern may increase if the issuer's credit standing deteriorates or in poorer market conditions.

Ultimately, the type of negative pledge included in a bond (or whether one is included at all), can be expected to have a pricing impact on a bond, as the inclusion of a negative pledge and the type of negative pledge, will inform the investors' credit analysis.

1 Many bank and certain financial institution issuers will not include a negative pledge in their bonds. This is because banks and certain other financial institutions raise secured indebtedness that could be within the scope of a standard "capital markets" negative pledge as part of their regular business activities, and so this is avoided by not including any negative pledge within their senior bonds. Alternatively, subject to also considering MREL eligibility and any other regulatory requirements, a bank or financial institution may include a negative pledge within their senior bonds, provided that certain appropriate carve-outs are provided to allow for secured financings customary for a bank or financial institution issuer.

2 That is, the security would make the secured bond a "better" (i.e. safer) bond for the investor to buy.

3 When referring to "high yield" bonds, we mean bonds assigned no rating or a sub-investment grade credit rating of BB+, Ba1 or BB+ or lower by Fitch, Moody's or Standard and Poor's, respectively. High yield bonds are likely to contain further highly negotiated variations to a negative pledge clause, including an extended list of categories of "permitted security" which can be granted in certain circumstances, consideration of which is beyond the scope of this article.

Example Negative Pledge wording for an Investment Grade, Senior, Unsecured Bond

The following is a simplified example of a negative pledge that may be found in the terms and conditions of an investment grade corporate issuer's senior unsecured bond:

Negative Pledge

So long as any of the Notes remain outstanding, the Issuer will not, and shall procure that none of its Subsidiaries will, create or have outstanding any Security Interest upon the whole or any part of its undertaking or assets (including any uncalled capital), present or future, to secure any Relevant Indebtedness of any person (or any guarantee or indemnity given in respect thereof), unless the Notes shall be secured by such Security Interest equally and rateably therewith in the same manner [to the satisfaction of the Trustee,] or by such other security for the Notes [as the Trustee shall, in its absolute discretion, deem not materially less beneficial to the Noteholders or]* as shall be approved by an Extraordinary Resolution of Noteholders.*

For the purposes of this Condition:

"Relevant Indebtedness" means any loan or other indebtedness in the form of, or represented by any bond, note, debenture, debenture stock, loan stock, certificate or other instrument which is, for the time being, or is of a type which is customarily, listed, quoted or traded on any stock exchange or in any securities market (including, without limitation, any over-the-counter market); and

"Security Interest" means any mortgage, charge, lien, pledge or other security interest, including, without limitation, anything analogous to any of the foregoing under the laws of any jurisdiction.

* Wording in square brackets is only included where the bond is issued with a Trustee structure.



Potential variations in the scope of a "capital markets" negative pledge

Although "capital market" negative pledges are relatively standard, they may be subject to some negotiation in the course of documenting the terms and conditions. Variations that may be observed include (but are not limited to) the following:

Scope of Relevant Indebtedness restricted:

- to capital market instruments *actually* (or *intended to be*) listed and traded (as opposed to *capable of being* traded or listed)
This is relatively uncommon, but the main effect of this is likely to be to exclude unlisted privately placed bonds from the scope.
- to non-domestic debt not denominated in the local currency; or
• to non-domestically sold and cleared debt
This is relatively uncommon for non-Sovereign issuers, but common for Sovereign issuers (apart from those in the Eurozone), who could meet domestic debt obligations in their local currency by printing money. Certain Eurozone sovereigns have restricted the definition of Relevant Indebtedness from applying to securities sold domestically and held through their local domestic clearing system.
- to debt with more than one year's maturity
Although uncommon, this variation reflects the fact that although commercial paper is capable of being listed or traded, it is customarily not listed and is traded in the short-term money markets as a separate product. It would be highly unusual for commercial paper to be secured, so this would represent a quite unusual variation for an issuer to require. Asset-backed commercial paper is normally issued by an SPV entity sitting outside of the corporate group and so would not be caught by a standard "capital markets" negative pledge in any event.

Carve-out for Permitted Security Interests introduced:

- specified listed carve-outs for certain security interests, and a potential general basket carve-out of any security interests up to a certain monetary amount (in aggregate)
While an extensive list is quite uncommon for "capital markets" negative pledges (while being standard for "all monies" negative pledges), it is not uncommon to see one or two specific carve-outs.
The most frequently seen carve-out often relates to security interests on the undertaking or assets of a company acquired by the issuer or the issuer's group after the issue date, provided that the security was not created in contemplation of such acquisition, and further provided that the principal amount secured has not been increased in contemplation of or since the acquisition.
Other carve-outs may cover a range of particular factual circumstances of concern to an individual issuer including, but not limited to, security interests arising by operation of law, certain types of non-recourse project finance or where the issuer has a specific secured financing transaction in mind and this is disclosed to the senior unsecured investors.

Additional carve-outs to the Negative Pledge for an investment grade bank/financial institution issuer:

- if a bank/financial institution issuer does agree to include a negative pledge in its bonds, it may require certain additional specific carve-outs of any secured financings which may take the form of capital markets instruments and which may be customary for a bank/financial institution issuer (for example, to allow for covered bonds).

Guarantee/guarantor/ group considerations

In addition to limiting the ability of the issuer to grant security, a "capital markets" negative pledge will also apply to any of the guarantors of the bond. The negative pledge will also apply to each of the issuer's and any guarantors' respective subsidiaries.

"Capital markets" negative pledges should in general not be negotiated to apply to "material subsidiaries" only, as opposed to all subsidiaries. This is because a "capital markets" negative pledge is already limited in scope to capital markets instruments, which are highly unlikely to be issued on a non-guaranteed basis from an immaterial subsidiary, so limiting the negative pledge only to "material subsidiaries" is not necessary. If prior to a bond issue an issuer is concerned that it plans to grant particular security at a subsidiary level in relation to a future capital markets instrument, it would be preferable to discuss with the arrangers of the bond issue whether a specific Permitted Security Interest carve-out may be acceptable to bond investors in the circumstances, rather than attempt to apply the negative pledge to material subsidiaries only, which would almost certainly not be acceptable to the arrangers and bond investors.

Trustee considerations

Where the bonds are issued with a trustee in place, as opposed to under a fiscal agency structure, the drafting of the negative pledge will provide that if a Relevant Indebtedness is to be secured, then either (i) the issuer must grant the security equally and rateably to the existing bonds, to the satisfaction of the Trustee, or (ii) the issuer must grant such other security as the Trustee considers, in its absolute discretion, to be not materially less beneficial to the interests of the bondholders than if they had been given equal and rateable security (unless the bondholders have approved the other security by an

Extraordinary Resolution). This wording is illustrated by the square bracketed wording in the example clause above.

Consequence of breach

The negative pledge is a provision of the terms and conditions of the bonds and is not equivalent to security. Consequently, the primary consequence of a breach of the negative pledge is that it will constitute an event of default⁴ if not remedied within the applicable grace period. The occurrence of an event of default would allow each bondholder (in the case of a bond issued with a fiscal agency structure), or a certain proportion of the bondholders by value (usually one-fifth or one-quarter), to instruct the Trustee (in the case of a bond issued with a trustee structure) to accelerate the maturity of the bonds (i.e. declare the bonds to be immediately due and payable at their principal amount together with any accrued interest). An event of default may also trigger cross-defaults in relation to the issuer's other borrowings.

⁴ Usually this would be on the basis of the "breach of other obligations" event of default.



Practical advice for investment grade bond issuers when interpreting "capital markets" negative pledges in the context of granting security

Any existing bond issuer considering granting security for other indebtedness, or permitting any security interest to subsist (i.e. by acquiring an entity with existing secured capital markets indebtedness), must first review the negative pledge requirements of the terms and conditions of their outstanding bonds.

For a quick summary of the key questions an investment grade bond issuer with a standard "capital markets" negative pledge in their existing bonds should ask themselves before deciding to grant security to other indebtedness, please refer to the table below. Specific legal advice, based on the particular factual circumstances, should be sought prior to taking any particular actions.

Question	Considerations
<p>1. Does the proposed security to be granted fall within the definition of "Security Interest" in the negative pledge?</p> <p>If yes, proceed to Question 2.</p> <p>If no, the security can be granted.</p>	<p>The definition of Security Interest is customarily very wide and usually includes analogous concepts under the laws of other jurisdictions, so if the issuer/guarantor or any of their subsidiaries is granting security, it will likely be caught.</p>
<p>2. Does the security fall within any "Permitted Security Interest" carve-outs (if any)?</p> <p>If no, proceed to Question 3.</p> <p>If yes, the security can be granted.</p>	<p>Any Permitted Security Interest carve-outs that are included in the particular terms and conditions will need to be considered.</p>
<p>3. Does the other indebtedness that is proposed to be secured fall within the definition of "Relevant Indebtedness" in the negative pledge?</p> <p>If yes, proceed to Question 4.</p> <p>If no, the security can be granted.</p>	<p>Unless the security is being granted in relation to a capital markets instrument (i.e. in relation to Relevant Indebtedness), it will not be caught by a "capital markets" negative pledge.</p> <p>The key consideration for the issuer to think about is whether the security they are proposing to grant would result in the creation of a better capital markets instrument (i.e. a "better bond").</p> <p>In particular, consider whether the other indebtedness is an instrument (such as, but not limited to, a bond), which is of a type which is customarily listed, quoted or traded on any stock exchange or securities market. If it is not of such a type then, based on the sample wording set out above, the answer to Question 3 will be no.</p>
<p>4. Can the security proposed be provided, equally and rateably, to the existing bond?</p> <p>If yes AND the existing bond has a trustee structure, proceed to Question 5.</p> <p>If yes AND the existing bond has a fiscal agency structure, proceed to grant the security to the new indebtedness and the existing bond.</p> <p>If no, proceed to Question 6.</p>	<p>At this point, it has been concluded that the negative pledge applies and the remainder of the questions relate to how the negative pledge requirement that the security be shared with the existing bond is complied with.</p> <p>Whether the security can be applied equally and rateably will depend upon the type of security and how it is proposed to be applied to the new indebtedness.</p>

Question	Considerations
<p>5. Is the provision of equal and rateable security acceptable to the Trustee?</p> <p>If yes, proceed to grant the security to the new indebtedness and the existing bond.</p> <p>If no, proceed to Question 6.</p>	<p>The issuer will need to engage with the Trustee to confirm this.</p>
<p>6. Can other security be granted?</p> <p>If yes AND the existing bond has a trustee structure, proceed to Question 7.</p> <p>If yes AND the existing bond has a fiscal agency structure, proceed to Question 8.</p> <p>If no, the security cannot be granted in compliance with the negative pledge. The issuer should not grant the security.</p>	<p>This will be dependent on the other assets that the issuer has available to provide as security.</p>
<p>7. Will the Trustee be able to consider, in its absolute discretion, that the other security is not materially less beneficial to the holders of the existing bonds than the security being proposed for the new indebtedness?</p> <p>If yes, engage with the Trustee to obtain confirmation of such discretion and, after obtaining this, proceed to grant the proposed security to the new indebtedness and the other security to the existing bond.</p> <p>If no, proceed to Question 8.</p>	<p>To answer yes here, the issuer will need to be confident that the Trustee will reach the conclusion that the other security is not materially less beneficial to all the bondholders than if they were instead receiving the security proposed to be offered to the new indebtedness.</p>
<p>8. Is it feasible for bondholder approval of the other security via an Extraordinary Resolution to be obtained?</p> <p>If yes, seek bondholder approval via Extraordinary Resolution and, after obtaining this, proceed to grant the proposed security to the new indebtedness and the other security to the existing bond.</p> <p>If no, the security cannot be granted in compliance with the negative pledge. The issuer should not grant the security.</p>	<p>The practicalities of this will depend on how well the issuer knows its bondholders and their likely commercial motivations.</p>

Every transaction is different...

Every negative pledge in a set of terms and conditions may be different, so each situation will need to be considered on a case-by-case basis. We hope that the general considerations and background provided in this article will be of help in analysing "capital markets" negative pledge clauses. If you would like to discuss the matters raised in this article further, please get in touch with the Dentons DCM team.

Key contacts



David Cohen
Partner, London
D +44 20 7246 7535
david.cohen@dentons.com



Nick Hayday
Partner, London
D +44 20 7246 7516
nick.hayday@dentons.com



Neil Dixon
Partner, London
D +44 20 7246 7522
neil.dixon@dentons.com



Cameron Half
Partner, Capital Markets
and US Securities Laws,
London
D +44 20 7246 7175
cameron.half@dentons.com



Alex Roussos
Partner, Dubai
D +971 4 402 0895
alex.roussos@dentons.com



Victoria Wyer
Partner, London
D +44 20 7320 6340
victoria.wyer@dentons.com



Brian O'Leary
Senior Associate, Dublin
D +44 20 7246 7499
brian.oleary@dentons.com



James Osun-Sanmi
Senior Associate, Dubai
D +971 4 402 0929
james.osun-sanmi@dentons.com



David Ferris
Managing Practice Development
Lawyer, London
D +44 20 7320 6353
david.ferris@dentons.com



Thomas Breheny
Associate, London
D +44 20 7320 6100
thomas.breheny@dentons.com



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