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THE NEGATIVE PLEDGE AS A "SECURITY" DEVICE

The negative pledge clause has been in use for many years and is to be found in virtually all loan documents. The negative pledge clause usually seeks to protect the unsecured creditor by providing contractually that the debtor shall not, so long as any part of the indebtedness remains outstanding, create any security in favour of another creditor. It is also used to protect floating chargees by restricting the freedom which the chargor has to deal with the assets comprised in the floating charge. The efficacy of the negative pledge clause depends on a number of factors. In some instances, the negative pledge clause will improve the position of the unsecured creditor and the floating chargee. This "security" aspect of the negative pledge clause is discussed in this article.

I. INTRODUCTION[1]

NEGATIVE pledge clauses[2] have been in use for many years in financing transactions. The impetus for their development can be traced to the development of the floating charge. The floating charge has the great advantage of allowing security over a shifting pool of assets to be taken without affecting the chargor company's right to continue to trade in the ordinary course of business.[3] The consequence of this, however, is to reduce the protection afforded to the floating chargee. The floating chargee may find his security postponed to a subsequent fixed chargee even if the fixed chargee had notice of the earlier floating security.[4] To prevent this from happening, debentureholders under a floating charge began to insist that clauses be inserted into the debenture prohibiting certain specified transactions capable of affecting the priority of the floating charge while generally allowing the

1 There is much literature on negative pledges. See Wood, *International Loans, Bonds and Securities Regulation,* paras 3-10 to 3-26, Goode, *Legal Problems of Credit and Security* (2nd ed), pp 17-23, Gough, *Company Charges* (2nd ed), Ch 10, Gabriel, *Legal Aspects of Syndicated Loans*, pp 82-97, Stone, "The 'Affirmative' Negative Pledge" [1991] 9 JIBL 364 for helpful analyses.

2 Apparently, the term "negative pledge" is an Americanism. In some parts of the Commonwealth they are referred to as restrictive clauses, see Farrar, "Negative pledges, debt defeasance and subordination of debt" in *Contemporary Issues in Company Law*, pp 137-158.

3 *Re Yorkshire Woolcombers' Association Ltd* [1903] 2 Ch 284, at 295; *Illingworth* v *Houldsworth* [1904] AC 355.

4 *Wheatley* v *Silkstone and Haigh Moor Coal Co* (1885) 29 Ch D 715; *Robson* v *Smith* [1895] 2 Ch 118, at 124.

company to continue to trade.[5] The most important of the prohibited transactions was to restrict the ability of the company to create security which might rank *pari passu* or in priority to the floating charge. Such a restrictive clause prohibiting a company from creating security of such a nature appears to have been introduced as a result of a suggestion in the 1st edition of Palmer's Company Precedents.[6] A typical negative pledge clause would read as follows:

> Not without the previous consent in writing of the Bank (and then only to the extent that such consent permits and in accordance with any conditions attached to such consent) to create or attempt to create any mortgage, pledge, charge (whether fixed or floating) or other incumbrance on or over the whole or any part of the Charged Property or permit any lien to arise on or to affect any part and not (save as mentioned above) to increase or extend any liability of the Company secured on any of the above forms of security.[7]

It is clear that a negative pledge clause does not give rise to a security interest.[8] In *Bristol Airport Plc* v *Powdrill*[9] Browne-Wilkinson V-C, whilst not holding that it was a comprehensive definition of security, accepted the following as a description of a security interest:

> Security is created where a person ('the creditor') to whom an obligation is owed by another ('the debtor') by statute or contract, in addition to the personal promise of the debtor to discharge the

5 See Gough, *op cit*, at 221-223; *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd (in liquidation)* (1992) 7 ACSR 365, at 376-378.

6 See *Palmer's Company Precedents* (16th ed), Vol III, at 55. Also see the first instance decision of Charles J in *English and Scottish Mercantile Investment Trust* v *Brunton* [1892] 2 QB 1, at 9.

7 *The Encyclopedia of Forms and Precedents* (5th ed), Vol 4, at 148, cl 4.9. Although this clause was drafted in the context of a debenture secured by a floating charge, negative pledge clauses are used in unsecured loans as well. Furthermore, "[i]n practice not merely is the creation of subsequent specific charges ranking in priority or *pari passu* prohibited but also, by other negative pledges, so are other arrangements such as sale and lease-back transactions and factoring arrangements", *per* Sheller JA in *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd (in liquidation), supra,* at 377-378.

8 *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd (in liquidation), ibid.* On the legal nature of security interests generally, see Gower's *Principles of Modern Company Law* (5th ed), pp 408-411, Goode, *Commercial Law* (2nd ed), Ch 22, Oditah, *Legal Aspects of Receivables Financing*, Ch 1 for helpful analyses.

9 [1990] Ch 744.

> obligation, obtains rights exercisable against some property in which the debtor has an interest in order to enforce the discharge of the debtor's obligation to the creditor.[10]

Security interests can be divided into consensual and non-consensual securities. Consensual security arises by agreement between the parties and there are at least four types of consensual security, namely the pledge, the mortgage, the charge and the lien.[11] Non-consensual security interests arise by operation of law and include common law liens.[12] A negative pledge clause does not give rise to a security interest because it does not give the creditor any proprietary interest in the property of the debtor.[13] Nevertheless, a negative pledge is capable of achieving a limited security function in that its existence is capable of improving the priority or legal position of the creditor (whether secured or unsecured) over other creditors in the event of the borrower going into liquidation. In this sense it can be regarded as a security device or a *quasi*-security interest because it behaves like a security interest.[14] It is this theme which will be explored in this article.

In addition, a clause requiring the borrower to provide security to the lender upon the breach of a negative pledge clause, or providing for security to automatically arise in favour of the lender upon the breach of such a clause, is sometimes attached to the negative pledge clause. Such a clause may read as follows:

> If the Borrower creates or permits to subsist any Encumbrance contrary to [the obligations contained in the negative pledge], all the obligations of the Borrower hereunder shall be immediately secured upon the same assets equally and rateably with the other obligations secured thereon.[15]

Such a clause is not, properly speaking, a restrictive covenant.[16] However, insofar as such clauses purport to strengthen the protection offered by a negative pledge, the effect of clauses of this nature will also be examined in this article.

[10] *Ibid*, at 760.

[11] Goode, *op cit*, at 10-15; Bell, *Modern Law of Personal Property in England and Ireland*, Ch 6; Goode, *Commercial Law*, Ch 22.

[12] Bell, *op cit*, at 138-141.

[13] Also see *Pullen* v *Abalcheck Pty Ltd* (1990) 20 NSWLR 732.

[14] See Oditah, *op cit*, at 11.

[15] Gabriel, *Legal Aspects of Syndicated Loans*, at 82.

[16] They have been referred to as "affirmative" negative pledges, see Stone, "The 'Affirmative' Negative Pledge" [1991] 9 JIBL 364.

II. Negative Pledges and Floating Charges

As mentioned earlier, the security offered by a floating charge is a vulnerable one. Because it is implicit in the nature of a floating charge that the company is allowed to trade in the ordinary course of business, the holder of a floating charge may find himself postponed to a security created after the creation of the floating charge.[17] This will be so even if the subsequent security holder had actual knowledge of the existence of the floating charge for it is a consequence of the floating security that the chargor company has the authority to grant further security.

To strengthen the security of the floating charge against subsequent security interests created by the company, the debenture constituting the floating charge may contain a negative pledge clause. The effect of such a clause is to restrict the authority of the company to create further security having priority to the floating charge. However, in the absence of actual notice of such a clause by a subsequent chargee, the chargor will continue to have apparent authority to deal with its assets in the ordinary course of business. As such, in the event of the chargor's liquidation, a prior floating chargee may find his security postponed to a subsequent fixed charge, provided the subsequent fixed chargee took his security without notice of the negative pledge clause. This point is illustrated by the case of *The English and Scottish Mercantile Investment Company, Ltd* v *Brunton*.[18] A company issued debentures secured by a floating charge over all its present and future property. The debentures contained a term stating that the company should not be at liberty to create any mortgage or charge in priority to the debentures. Subseqently, the company assigned its interest in moneys due from an insurance company to the plaintiffs as security for a loan. The plaintiffs' solicitor knew of the existence of the earlier debentures but did not know of their terms. The Court of Appeal held that the plaintiffs had a charge upon the insurance moneys in priority to the holder of the floating charge. Merely being aware of the existence of the debentures did not fix the plaintiffs with knowledge of its terms and the doctrine of constructive notice ought not to be extended to such cases. No duty is to be imposed on a subsequent lender to seek out the precise terms of the debenture. To the same effect is the following statement by Henchy J in *Welch* v *Bowmaker*:

[17] But not a subsequent floating charge, see *Re Benjamin Cope & Co* [1914] 1 Ch 800. However, where the first floating charge contemplates the creation of a subsequent floating charge over a particular class of the property of the chargor, the second floating charge over that class of assets will have priority over the first, *Re Automatic Bottle Makers Ltd* [1926] Ch 412.

[18] [1892] 2 QB 700. Also see *Welch* v *Bowmaker (Ireland) Ltd* [1980] IR 251.

> Whatever attractions there may be in the proposition that priority should be deemed lost because a duty to inquire was called for but ignored, and that such inquiry would have shown that the company was debarred from entering into a mortgage which would have priority over the debenture, the fact remains that it would be unfair to single out the bank for condemnatory treatment because of their failure to ascertain the full terms of the debenture when what they did was in accord with judicially approved practice and when such a precipitate change in the law would undermine the intended validity of many other such transactions. If the proposed extension of the doctrine of constructive notice is to be made, the necessary change in the law would need to be made prospectively and, therefore, more properly by statute.[19]

On the other hand, where the subsequent chargee has notice of the negative pledge at the time he takes his security, his charge will be postponed to the prior floating charge. This is because he knows of the restriction on the chargor's authority to create further security and no estoppel can arise in his favour.[20] Accordingly, even if the floating charge remained uncrystallised at the time the fixed charge was created, the floating charge is entitled to priority over the subsequent fixed charge. Knowledge of the negative pledge, in the words of Lord Esher MR, "would have prevented [the subsequent chargee] in equity from saying that their mortgage could be enforced in priority to the debentures [secured by a floating charge]. If they had known what was in the debentures they would, in equity, have taken the mortgage with notice of prior charges on the subject matter of it."[21]

The question which remains to be considered is the extent to which the element of notice is affected by the requirement for registration of charges under the Singapore Companies Act (the "Act")[22] and other equivalent Commonwealth legislation. Section 131(1) of the Act provides that in

[19] *Ibid*, at 256.

[20] Gough, *op cit*, at 228, offers an alternative explanation for the principle. He says that "it would be unconscionable on the part of a subsequent adverse third party, with knowledge of the breach of the restrictive clause, to hold his interest so as knowingly to defeat the prior restrictive contractual right or equity of the floating chargee."

[21] *English and Scottish Mercantile Investment Co* v *Ltd* v *Brunton*, *supra*, at 707 (CA). Also see *Cox* v *Dublin City Distillery Co* [1906] IR 446. Tjio Hans has discussed five possible explanations for the efficacy of the negative pledge in this context, see Tjio, "Of Prohibitions on Assignments, Restrictive Covenants and Negative Pledges in Commercial Law: Clogs on Commerce" (1994) 6 SAcLJ 159, at 174-178. He concludes that while none of the explanations may hold up, it is too late to argue against this rule of priority.

[22] Cap 50 (1994 Rev Ed).

respect of certain charges created by a company, a statement of the particulars of such charges must be lodged with the Registrar for registration. If the section is not complied with, the charge so created shall be void against the liquidator and any creditor of the company. Section 134(1) of the Act states the prescribed particulars which must be lodged with the Registrar. No mention, however, is made of the need to lodge particulars of any restrictive clause with the Registrar. Form 34 of The Companies Regulations, however, contains a section whereby particulars of the restrictions or prohibitions on the company in connection with the charge can be recorded and filed with the Registry of Companies. This is commonly done. One effect of a system of registration is to give notice to third parties taking a registrable security of any matter requiring registration and disclosed.[23] In the case of an optional "extra" like a negative pledge, it is submitted that even if particulars of such a clause are lodged with the Registrar, this would not constitute sufficient notice to persons taking a registrable security. For such persons to be affected, they must have actual notice of the restrictions imposed upon the chargor company which they will have if they examine the Forms lodged with the Registrar.

The position of a floating chargee who has lodged particulars of any restrictive clause contained in the debenture is considerably improved by the decision of Justice Chan Sek Keong in *Kay Hian & Co (Pte)* v *Jon Phua Ooi Yong*[24] where the learned judge held that a subsequent chargee who asserts that he had no actual notice of the negative pledge clause has the burden of proving the absence of such notice. It is apprehended that this burden of proof will be extremely difficult to discharge where the subsequent chargee has engaged solicitors to prepare the loan documents and conduct the usual due diligence searches.

III. The Contractual Effect of a Negative Pledge Clause

Although a negative pledge does not give rise to a charge, there is no doubt that it constitutes a personal covenant.[25] As such, infringement of a negative pledge will give rise to a cause of action for breach of contract. However, in the event of the borrower's liquidation, the existence of such a cause of action may be little consolation to the holder of a floating charge who finds his security postponed to a subsequent fixed charge, or the unsecured covenantee who finds himself postponed to a secured creditor. To strengthen

[23] Gower, *op cit*, at 432-433.

[24] [1989] 1 MLJ 284; also see *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd (in liquidation), supra,* at 374.

[25] *Pullen* v *Abalcheck*, *supra*, at 734; *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd (in liquidation), supra*, at 378.

the protection afforded by a negative pledge, breach of it is usually made an event of default in loan transactions and, where there is a floating charge, an event which may entitle the floating chargee to intervene to crystallise the floating charge. This will entitle the lender, upon a breach of the restrictive covenant, to call for repayment of the loan on demand, and/or to enforce the floating charge which will have crystallised upon the intervention of the lender. Again, the limitations of such a remedy should be noted. The remedy is of little assistance unless the breach is discovered sufficiently early for the lender to exercise his rights meaningfully. The right to have a debt paid on demand, or to crystallise a charge by intervening, is unlikely to be of much use to a creditor if the borrower is already insolvent, or has already effectively charged its assets to a third party without notice of the prior floating charge. In fact, even where the breach is discovered early enough, a default in respect of one loan transaction may trigger off cross-default clauses in other loan transactions. Where this happens, the various creditors of the borrower will all be entitled to demand repayment of moneys lent. In such a scenario, the position of the negative pledgee, especially if he is unsecured, may be far from ideal.

Apart from these remedies, the existence of a restrictive covenant should entitle the negative pledgee to an injunction to restrain a breach of the negative pledge. The general principle is that where there is a negative covenant in a contract, breach of it may be restrained by injunction.[26] In such cases, an injunction is normally granted as a matter of course, although theoretically, being an equitable remedy, the grant is subject to the discretion of the court. In *Doherty* v *Allman*[27] Lord Cairns LC made the following statement:

> if there had been a negative covenant, I apprehend ... a Court of Equity would have had no discretion to exercise. 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; and in such case the injunction does nothing more than give the sanction of the process of the Court to that which already is the contract between the parties. It is not then a question of the balance of convenience or inconvenience, or of the amount of damage or of injury – it is the specific performance, by the Court, of that negative bargain which the parties have made, with their eyes open, between themselves.[28]

[26] See Treitel, *The Law of Contract* (9th ed), at 936-941.
[27] (1878) 3 App Cas 709.
[28] *Ibid*, at 719-720.

Thus in *Marco Productions, Ltd* v *Pagola*[29] the defendants undertook to perform for the plaintiffs and the contract contained an express provision restricting the defendants from performing for any other person during the period of engagement. The plaintiffs sought a declaration that the defendants were bound to perform for them and an injunction to restrain them from breach of the restriction. Although they could not prove that damage would result from a breach of the restriction, Hallett J granted an injunction restraining the breach of the negative undertaking.

While it may be possible to restrain a breach of a negative covenant if the negative pledgee discovers an attempted breach in time, a prohibitory injunction to this effect will not lie if the breach has already taken place. In such a case the plaintiff must seek a mandatory injunction, ordering the breach to be undone.[30] A mandatory injunction is a much more drastic remedy than a prohibitory injunction. Not only does a mandatory injunction look to the past, it also requires the taking of positive steps to undo the matter complained about.[31] Accordingly, mandatory injunctions are not granted as of right.[32] Instead, the court will be concerned to ascertain whether the grant of such an injunction would have the effect of causing possible damage to the Defendant out of all proportion to any possible advantage which the Plaintiff ought to obtain.[33] Relevant considerations will include the nature of the breach and whether damages will provide an adequate remedy.[34]

Where there has been a breach of a negative pledge clause, it seems doubtful if a mandatory injunction ordering the borrower to undo the breach will be granted. The breach of a negative pledge will inevitably constitute an event of default and the more appropriate remedy would seem to lie in restricting the lender to the exercise of his right to call for the repayment of the outstanding moneys, as well as his remedy in damages against the borrower. In an appropriate case, the negative pledgee may also be able to sue the taker of security in tort for interfering with the negative pledgee's contractual rights. A mandatory injunction would be inappropriate since the unsecured negative pledgee is only an unsecured lender and has no proprietary interest in the borrower's assets. To grant an injunction would unwind the security obtained by the third party and this would cause the third party damage out of all proportion to any advantage which the unsecured

[29] [1945] 1 KB 111.

[30] On mandatory injuctions, see Treitel, *op cit*, *supra*; Spry, *Equitable Remedies* (3rd ed), at 503 *et seq*.

[31] *Shepherd Homes Ltd* v *Sandham* [1971] Ch 340, at 348.

[32] *Ibid*, at 351.

[33] *Sharp* v *Harrison* [1922] 1 Ch 502, at 515.

[34] *Doherty* v *Allman, supra*, at 720-721.

negative pledgee ought to obtain since the unsecured negative pledgee's "interest" in the assests comprised in the security would be restricted to a share of the said assets rateably with other unsecured creditors, if any.

In the case of a floating charge where the debenture contains a negative pledge clause, a mandatory injunction will not be granted against the subsequent chargee since, if the subsequent chargee had no notice of the existence of the negative pledge clause, the subsequent chargee would obtain a good security in priority to the floating charge. If the subsequent chargee had notice of the existence of the negative pledge clause, a mandatory injunction would be unnecessary since the subsequent chargee would find his security postponed to the prior floating charge.

IV. Tort of Interference with Contractual Relations[35]

One consequence of the negative pledge constituting a personal covenant is that any subsequent lender who takes security with notice of the clause may be sued in tort by the prior lender for interfering with the latter's contractual relations. Historically, the tort of interference with contractual relations had its roots in the relationship between master and servant. In *Lumley* v *Gye*[36] this principle was extended generally to include all forms of contractual obligations. In that case, it was specifically held that an action lay even though there was a contract for services rather than a contract of service. The classic statement of the elements of the tort is to be found in the judgment of Jenkins LJ in *DC Thomson & Co Ltd* v *Deakin*.[37] Essentially, the tort is committed where a breach of contract has been brought about by a third party who, without justification,[38] directly and intentionally[39] persuades, procures or induces one of the

[35] On the tort of interference with contractual relations generally, see *Salmond and Heuston on Torts* (20th ed), at 357-366; *Clerk & Lindsell on Torts* (17th ed), at paras 23-09 to 23-37; Fleming, *The Law of Torts* (8th ed), at 688-698. Also see Stone, "Negative Pledges and the Tort of Interference with Contractual Relations" [1991] 8 JIBL 310.

[36] (1853) 2 E & B 216. Also see *Bowen* v *Hall* (1881) 6 QBD 333; *Allen* v *Flood* [1898] AC 1.

[37] [1952] Ch 646, at 690-699.

[38] "The tort is committed if a person without justification knowingly and intentionally interferes with a contract between two other persons", *ibid*, at 702, *per* Morris LJ.

[39] Or "deliberately", see *Torquay Hotel Co Ltd* v *Cousins* [1969] 2 Ch 106, at 138, *per* Lord Denning MR.

[40] *DC Thomson & Co Ltd* v *Deakin, supra*, at 694. Also see *Quinn* v *Leathem* [1901] AC 495, at 510, *per* Lord Macnaughten: "a violation of legal right committed knowingly is a cause of action, and that it is a violation of legal right to interfere with contractual relations recognised by law if there be no sufficient justification for the interference"; *Lonrho* v *Fayed* [1989] 2 All ER 65, at 71, *per* Ralph Gibson LJ.

parties to the contract to break it.[40] It should be noted, however, that although many of the older cases use the language of breach, the more recent cases have held that an actual breach of contract is not, strictly speaking, necessary. The modern view is that the tort extends to direct or indirect interferences with contractual rights even where there is no breach of contract, provided, it seems, if the interference (which does not amount to a breach of contract) has been brought about by unlawful means.[41]

An actionable interference also arises where the contract breaker is a willing party to the breach without any persuasion by the third party, provided the third party knew that his dealings with the contract breaker were inconsistent with the earlier contract. If the third party did not know of the contract at the outset, no tort will be committed by him but it has been said that if he continues dealing with the contract breaker after he has notice of the earlier contract, the tort is thereby committed.[42]

It is submitted that where a lender takes security with knowledge[43] of the existence of a negative pledge, the lender *prima facie* commits the tort of interference with contractual rights. The taking of security would constitute a direct interference with the contractual rights of the prior lender and it does not matter that the borrower may have been willing to give security without any persuasion on the part of the later lender. In most cases, however, the later lender will expressly bargain for security as a condition for making the loan and this will undoubtedly give rise to an action in tort if the other elements of the tort are present. The prior lender need not show that the later lender knew with exactitude all the terms of the negative pledge; it is enough if the lender had sufficient knowledge of the contract to know that what he was proposing to do would amount to an interference of it.[44] It has also been said that constructive knowledge of the terms of the contract breached may suffice, in that knowledge of the way business is commonly

41 See *Clerk & Lindsell on Torts, supra,* at para 23-19.

42 *DC Thomson & Co Ltd* v *Deakin, supra*, at 694; *British Motor Trade Association* v *Salvadori* [1949] Ch 556. On the scope of this principle, see below.

43 Knowledge would include wilfully turning a blind eye to the obvious and might include recklessness. In *Emerald Construction* v *Lowthian* [1966] 1 WLR 691, at 700, Lord Denning MR stated that "even if they did not know of the actual terms of the contract, but had means of knowledge – which they deliberately disregarded – that would be enough."

44 *JT Stratford & Son Ltd* v *Lindley* [1965] AC 269, at 332, *per* Lord Pearce: "...had sufficient knowledge of the terms to know that they were inducing a breach of contract." Also see *Torquay Hotel Co Ltd* v *Cousins, supra*, at 140.

45 *JT Stratford & Son Ltd* v *Lindley, ibid*; *James McMahon Ltd* v *Dunne* (1965) 99 ILTR 45. Also see Cohen-Grabelsky, "Interference with Contractual Relations and Equitable Doctrines" (1982) 45 MLR 241, at 251-252, where the author states that there is a trace of the idea of an "enlarged" knowledge in the following situations:

(a) where [the tortfeasor] deliberately ignored sources of information;

conducted may be imputed to the defendant.[45] Thus in *Merkur Island Shipping Corporation* v *Laughton*[46] Donaldson MR stated that officials of a union were "deemed to have known of the almost certain existence of contracts of carriage to which the shipowners were parties."[47] It is suggested on a parity of reasoning that if a lender knows of the existence of a negative pledge clause but does not know its exact terms, knowledge of the terms can in an appropriate case be imputed to the lender[48] for the terms of a negative pledge clause and the exceptions to such a restrictive covenant are reasonably well known.[49] The lender who knows of the existence of a negative pledge clause and who wishes to take security should therefore be under an obligation to ensure that the taking of security does not infringe the negative pledge.

Apart from having knowledge of the negative pledge, the lender must also take security with the intention of interfering with the contractual relations between the prior lender and the borrower.[50] This will usually not be difficult to establish. As Diplock LJ put it:

> The element of intent is sufficiently established if it is proved that the defendants intended the party procured to bring the contract to an end by breach of it or if there was no way of bringing it to an end lawfully.[51]

Where security is taken with knowledge of a negative pledge, there can be little doubt that the taker of security intended to bring about a breach of the contract. It is difficult to see how the negative pledge can be brought to an end lawfully, short of the borrower repaying the earlier loan, perhaps

(b) where the existence of the contract can be reasonably assumed on the basis of the common knowledge about the way business is conducted;
(c) if the circumstances create doubts as to whether the contractual rights of another might be impaired then [the tortfeasor] is bound to inquire and to acquire actual notice.

46 [1983] 2 AC 570.

47 *Ibid*, at 591; adopted by Lord Diplock at 608.

48 Also see Stone, "Negative Pledges and the Tort of Interference with Contractual Relations" [1991] 8 JIBL 310, at 314.

49 See Boardman and Crosthwait,"Whither the Negative Pledge" [1986] 3 JIBL 162.

50 The requirement of knowledge of the contract and intention to interfere with its performance was described by Lord Diplock as a "two-fold" requirement, *Merkur Island Shipping Corpn* v *Laughton, supra*, at 608.

51 *Emerald Construction Co Ltd* v *Lowthian, supra*, at 704.

52 Even this is doubtful as it would be ususual for a loan agreement to give the borrower the right to remedy a breach by repaying the balance of the loan. The right to demand immediate repayment of the loan would usually be available to the lender only and be one of several remedies available to the lender. Still, the borrower is often given the option to prepay the

with the moneys newly borrowed.[52] In most cases, this would not be the intention of the borrower, and since the lender would usually know the purpose for which the loan moneys are to be used, this will preclude the defence that he expected the borrower to use the loan moneys to discharge the prior loan. It is therefore difficult to resist the inference that a taker of security in these circumstances does intend to procure a breach of the negative pledge clause.

A potential problem arises where the lender does not have knowledge of the negative pledge clause at the time he takes security but subsequently discovers its existence. This is because an interference begun in good faith but continued after notice is said to be actionable. As Jenkins LJ put it:

> The inconsistent dealing between the third party and the contract breaker may, indeed, be commenced without knowledge by the third party of the contract thus broken; but, if it is continued after the third party has notice of the contract, an actionable interference has been committed by him.[53]

What exactly is the scope of this rule? Fleming regards it as applicable only in exceptional cases and seems to restrict it to interferences with contracts of service.[54] In an earlier edition of *Clerk and Lindsell on Torts*, it was observed that most cases of this kind have involved the "harbouring" of another's servant. It was further "suggested that in saying 'if it is continued', Jenkins LJ was envisaging a continuance of some active dealing under the second contract, not just the acceptance of its benefits."[55] Cohen-Grabelsky suggests that "where no proprietary rights are involved, the sound rule would seem to be that the tort is not committed if the knowledge is

loan upon sufficient notice being given and damages are likely to be nominal if the borrower is in a position to repay in full the balance of the loan.

53 *DC Thomson & Co Ltd* v *Deakin* [1952] Ch 646, at 694, citing *De Francesco* v *Barnum* (1890) 63 LT 514 (a case concerning a contract of employment).

54 *The Law of Torts, supra*, at 692. It should be noted that even in the area of labour relations, the position of the employer is now very much weakened by the requirement that the employee must be willing to return to him but for the interference of the second employer. Where the employee is unwilling to do so, no damage is caused to the employer, *Jones Brothers (Hunstanton) Ltd* v *Stevens* [1955] 1 QB 275.

55 *Clerk and Lindsell on Torts* (14th ed), at para 797, note 98. Also see the 17th ed, *supra*, at para 23-29; *Denaby and Cadeby Main Collieries* v *Yorkshire Miner's Association* [1906] AC 384, especially p 406, *per* Lord James; *cf Smithies* v *National Association of Operative Plasterers* [1909] 1 KB 310, at 335.

56 "Interference with Contractual Relations and Equitable Doctrines" (1982) 45 MLR 241, at 255.

acquired after entering into the conflicting transaction."[56]

It is suggested that these approaches which seek to restrict the scope of the rule relating to continuing interferences are preferable and that the rule is in fact narrower than at first sight. Where there is no intention on the part of A to interfere with B's contract with C at the time of the inconsistent dealing (because A has no knowledge of the existing contract), it is clear that the tort is not committed. If knowledge of the contract between B and C is subsequently acquired by A, it is difficult to see why B should be able to sue A in tort in addition to B's rights against C for breach of contract. Such a general proposition would come close to implying that contractual obligations are capable of binding innocent third parties. If A is to be bound at all, it should be on the basis that B can establish some proprietary interest in the subject matter of A's contract with C such that A's continued acts constitute an interference with B's prior rights. This analysis does not mean that the law still regards masters as having proprietary rights to their servants. It is submitted that contracts of employment should be regarded as an exceptional class of cases which does not have the effect of displacing the general rule. The anomalous position of contracts of employment is understandable when seen in the context of the historical development of the tort.[57]

In the context of a negative pledge, it is submitted that the rule relating to continuing interferences is inapplicable. There are two possible reasons for this. First, on the assumption that the rule only applies where the earlier contracting party has a proprietary right which is affected by the subsequent contract, the rule is inapplicable because a negative pledge clause does not give the unsecured negative pledgee any proprietary rights in the subject matter of the security granted to the third party. In fact, the converse is true in that security granted to such third party passes a proprietary interest in the property to him. Since the proprietary interest became vested in him at a time when he did not have notice of the negative pledge, he should not be liable merely by continuing to be a secured creditor after notice of the restrictive covenant has been brought home to him.[58] The secured creditor is in a position analogous to that of the *bona fide* purchaser for

[57] *Ibid.*

[58] Also see Stone, "Negative Pledges and the Tort of Interference with Contractual Relations" [1991] 8 JIBL 310, at 316. In *Mac-Jordan Construction Ltd* v *Brookmount Erostin Ltd* [1992] 56 BLR 6 it was held that a floating charge granted by the employer to the bank did not interfere with a contractual clause which required the employer to set aside retention moneys for the benefit of a contractor. As such, the bank could enforce its security. Scott LJ said that when the bank took the floating charge, it was not interfering with any contractual right of the contractor since the contractor could enforce its contractual right prior to crystallisation.

value without notice and his interest should be effective against others. He should not be vulnerable to a suit in tort for interfering with the negative pledgee's contractual relations.

Second, it is suggested that the rule is also inapplicable where the transaction which is said to have interfered with the plaintiffs' contractual relations has been completed and no further act is required on the part of the alleged interferer. Accordingly, the rule does not apply to cases where a negative pledge has been breached because the breach of the restrictive covenant by the borrower which enabled the later lender to become a secured creditor is a past rather than a continuing breach. No further act on the part of the borrower or the secured lender is required. This should be contrasted with contracts of service which give rise to continuing obligations until the contracts are terminated. Thus if an employer continues to employ a servant even after notice of an earlier inconsistent contract of employment between that servant and another, it is possible that the continued employment might be seen as an act which interferes with the contractual rights of the prior contractor. This analysis, however, is inapplicable where no further act is envisaged under the second contract at the time when notice of the first contract is brought home to the alleged interferer. It is suggested that it cannot be right that merely because a third party continues to enjoy the benefits of a breach of contract by one of the parties thereto, the third party must, on notice of the prior contract, restore or disgorge those benefits or be liable in an action for interference with contractual relations. If the third party has provided valid consideration for his security and has done nothing that can be regarded as an interference with contractual relations after notice of the prior contract has been brought to him (apart from continuing to be a secured creditor), no suit ought to lie against him.[59]

Two further scenarios must be contemplated. In the first the debtor has a contract with the defendant to give the defendant a charge over certain property upon the occurence of a stipulated event. Alternatively, the agreement may provide for a charge to arise automatically in the future upon the occurence of a contingency. Subsequently, the debtor enters into a loan agreement with the plaintiff. The loan agreement contains a negative pledge clause. If, at the time the defendant is entitled to call for security, or the contingency occurs, the defendant has notice of the negative pledge, would the defendant be interfering with the contractual relations between the borrower and the plaintiff? In the second scenario the contract to give security or for security to arise automatically is entered into when there

[59] Also see *Swiss Bank Corporation* v *Lloyds Bank Ltd* [1979] 1 Ch 548, at 572.

is already a negative pledge in existence. Subsequently, the defendant discovers the existence of the negative pledge. Can the defendant still take security without committing the tort?[60]

It will be assumed here (and will be discussed in greater detail later in this article) that a specifically enforceable right to call for security gives rise in equity to a charge, for equity treats as done that which ought to be done. It will further be assumed here that upon the happening of the specified contingency a valid security will arise automatically over the assets in question without any act on the part of the defendant. The facts in both these scenarios are once removed from the previous situation contemplated. In the previous situation the defendant is already a secured creditor prior to the discovery of the negative pledge, while in both the scenarios presently contemplated the defendant is unsecured until the right to call for security can be exercised or the contingency occurs. Although the matter is not entirely free from doubt, it is submitted that the defendant can take security in both scenarios without committing an actionable interference. There are two possible justifications for this view.

First, if the assumptions made here are correct, the charge will arise without any further act on the part of the defendant. This is because the occurence of the stipulated event will give rise in equity to a charge, or cause a charge to arise automatically (depending on how the agreement is drafted). There is therefore no basis for saying that the defendant has interfered with the plaintiffs' contractual relations for there must at least be some act on the part of the defendant for the tort to arise.[61] An analogy can be drawn with situations where security arises by operation of law. A good example is the lien a lawyer obtains on documents he draws up or on an opinion he drafts.[62] Suppose such a lien arose by operation of law in favour of a lawyer in respect of a document drawn up by him for a company which has given a negative pledge to a third party, should the negative pledgee be able to sue the lawyer for interfering with his contractual rights where the lawyer had notice of the restrictive covenant

[60] Although both scenarios are different in terms of temporal priority, insofar as in the second scenario there was no notice of the negative pledge at the time the creditor entered into the agreement for security, it is submitted that both scenarios can be considered on the same footing. Admittedly though, the position of the defendant in the first scenario appears more meritorious.

[61] In *British Motor Trade Association* v *Selvadori*, *supra*, at 565, Roxburgh J said that "any active step taken by a defendant having knowledge of the covenant by which he facilitates a breach of that covenant is enough."

[62] *Hollis* v *Claridge* (1813) 4 Taunt 807; *Steadman* v *Hockley* (1846) 15 M & W 533.

[63] It should be noted that most negative pledge clauses exclude security arising by operation of law provided they are discharged within a reasonable period of time.

at the time he drew up the document over which he now claims a lien?[63] It is submitted that the answer should be in the negative. This is because apart from the acts relating to the drawing up of the document, the lawyer has done nothing which has brought about the breach of contract on the part of the company. As far as the said acts themselves are concerned, they are irrelevant for they are not acts which are directed towards procuring a breach of the restrictive covenant. Rather, the infringement of the negative pledge clause has resulted incidentally from the work done by the lawyer and without any active step on his part. In addition, it is not inevitable that the lawyer's lien will arise for there is nothing to prevent payment in advance for legal services rendered.

Second, even if there is a sufficient act on the part of the secured creditor, the tort is not committed if he has acted justifiably. The scope of this defence is notoriously uncertain. In *Glamorgan Coal Company* v *South Wales Miners' Federation*[64] Romer LJ made the following observations:

> I think it would be extremely difficult, even if it were possible, to give a complete and satisfactory definition of what is 'sufficient justification,' and most attempts to do so would probably be mischievous ... 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 who breaks the contract; and I think also to the object of the person in procuring the breach.

Will the defendant in both scenarios have acted justifiably in taking security despite their knowledge of the negative pledge? *Salmond and Heuston* states that "it would be a good justification if, in inducing a breach of contract made by A with the plaintiff, the defendant was doing nothing more than insisting on the performance of another and inconsistent contract previously made between himself and A."[65] The case of *Pratt* v *British Medical Association*[66] was cited as authority. In that case, however, the contract with the defendant was prior in time to the plaintiff's. As such, the case affords no authority for the proposition that a defendant without notice of the plaintiff's prior contract is justified in interfering with the plaintiff's contractual rights even though his contract is subsequent in time to the plaintiff's. Thus while the defendant in the first scenario should be entitled to plead justification, it is not entirely clear if the defendant in the second

64 [1903] 2 KB 545.
65 *Salmond and Heuston on Torts*, *op cit,* at 364.
66 [1919] 1 KB 244, at 265.

scenario can.

If the unsecured negative pledgee can successfully establish an action in tort for interference with his contractual relations, he can sue for damages. Damage to the negative pledgee would arise if the borrower company, in breach of the restrictive covenant, has encumbered its assets such that it now has insufficient assets to pay its unsecured creditors fully. The broad principle for damages in tort is to restore the plaintiff to the position he would have been in if the tortious act had not been committed. Thus even if the defendant has knowingly induced a breach of the negative pledge clause, the plaintiff is not entitled to the value of the defendant's security as damages. The plaintiff is only entitled to the difference between the amount he would have received if the negative pledge had not been breached, and the amount he actually received on the distribution of the borrower's assets.[67] Accordingly, if the plaintiff is an unsecured creditor, the quantum of damages would only be a fraction of the value of the defendant's security for if the assets subject to the security were unemcumbered they would have been available for distribution amongst all the unsecured creditors and not the negative pledgee alone. On the other hand, from the defendant's perspective, knowledge of the negative pledge does not affect his proprietary interest in the borrower's assets which have been encumbered. Accordingly, it will still be commercially advantageous for him to take security in breach of the restrictive covenant since the maximum amount payable as damages for inducing the breach of contract will not, in the absence of exceptional facts, exceed the value of the security.

V. The Principle in *De Mattos* v *Gibson*[68]

Broadly speaking, the case of *De Mattos* v *Gibson* stands for the proposition that where a person purchases property with notice of a prior contract between the vendor and a third party concerning the use of that property, the person purchasing the property can be restrained from using the property inconsistently with the contract. In *De Mattos* v *Gibson* Knight Bruce LJ said:

> Reason and justice seem to prescribe that, at least as a general rule,

[67] This is also Stone's view, see Stone, "Negative Pledges and the Tort of Interference with Contractual Relations" [1991] 8 JIBL 310, at 319.

[68] (1859) 4 De G & J 276. For useful analyses, see Gardner, "The Proprietary Effect of Contractual Obligations Under *Tulk* v *Moxhay* and *De Mattos* v *Gibson*" (1982) 98 LQR 279; Cohen-Grabelsky, "Interference with Contractual Relations and Equitable Doctrines" (1982) 45 MLR 241; Tettenborn, "Covenants, Privity of Contract, and the Purchaser of Personal Property" [1982] CLJ 58; Tjio, *op cit*, at 165-170.

> where a man by gift or purchase, acquires property from another, with knowledge of a previous contract, lawfully and for valuable consideration made by him with a third person, to use and employ the property for a particular purpose in a specified manner, the acquirer shall not, to the material damage of the third person, in opposition to the contract and inconsistently with it, use and employ the property in a manner not allowable to the giver or seller. This rule, applicable alike in general as I conceive to moveable and immoveable property, and recognized and adopted, as I apprehend by the English law, may, like other general rules, be liable to exceptions arising from special circumstances; but I see at present no room for any exception in the instance before us.[69]

In that case the plaintiff entered into a charterparty with the owner of the ship. The owner later mortgaged the ship to the defendant Gibson who had knowledge of the charterparty and in fact advanced the mortgage money in order to enable the owner to perform it. Subsequently, on the charterparty voyage to Suez, the ship met with some damage and had to be diverted to Penzance. Gibson threatened to sell the vessel under his power of sale and the plaintiff asked for an injunction to restrain Gibson from interfering with the ship's voyage. The Court of Appeal granted an interlocutory injunction, Knight-Bruce LJ on the basis of his statement of principle but Turner LJ on a different ground, that the balance of convenience favoured the grant of an injunction.

The matter then went on to a full hearing and on the appeal from that hearing Lord Chelmsford LC said that in order to entitle the plaintiff to an injunction against the defendant, "he must show that [the defendant] has done, or threatened to do, some act which has interfered with the performance of the contract of which he had had notice."[70] The injunction was refused on the basis that it could not be shown that the mortgagee had done, or threatened to do, some act which would have interfered with the performance of the contract. This was because the charterer was in no position to effect the necessary repairs to enable the vessel to proceed to sea. Accordingly, it could not be said that the defendant had threatened to do anything to interfere with the performance of the charterparty which

[69] *Ibid*, at 282.

[70] *Ibid*, at 300. According to Diplock J, an analysis of Lord Chelmsford's judgment indicates that "he treated the right to an injunction as depending on the same principle as the right to damages in *Lumley* v *Gye* ... namely, that it is a tort knowingly to procure a breach of contract by another person", see *Port Line Ltd* v *Ben Line Steamers Ltd* [1958] 2 QB 146, at 165; for a contrary view, see Gardner, *supra*, at 281 *et seq*.

was wholly incapable of being performed.

Knight-Bruce LJ's statement of law in *De Mattos* v *Gibson* has been criticised but the Privy Council followed it in *Lord Strathcona SS Co* v *Dominion Coal Co*.[71] The Lord Strathcona was chartered by the Lord Curzon SS Co to the Dominion Coal Co for 10 successive seasons, with an option to extend for another 8 seasons. The ship went into service in 1916 but was requisitioned at the end of that season and remained so till July 1919. The vessel was sold in 1917 and the eventual owner of the ship, Lord Strathcona SS Co, who knew of the charterparty and had agreed to respect it, sought to use it without reference to the existing charterparty. The Privy Council held that the case was indistinguishable from *De Mattos* v *Gibson*. Lord Shaw, delivering the judgment of the court, expressed the view that the case remains of "outstanding authority".[72] He went on to say that it would be incorrect to hold, on the basis of *De Mattos* v *Gibson*, that there was a species of implied privity; rather the rule only allows the remedy of injunctive relief where a person takes property with notice of an existing negative covenant governing the use of the property.[73] In one respect, however, the case is unsatisfactory. In the course of his judgment Lord Shaw said that the person seeking to enforce such a restriction must have "an interest in the subject matter of the contract."[74] This point was picked up by Diplock J in *Port Line Ltd* v *Ben Line Steamers Ltd*[75] who refused to follow the *Lord Strathcona* case. As the judge rightly pointed out, it is difficult to see in what sense a charterer under a charter has an interest in the subject matter except in the broad sense that it is to his commercial advantage that the charterparty be performed. Clearly, the charterer of a ship under a time charter obtains no proprietary or possessory rights in the ship. Diplock J then went on to say that even if the case was not wrongly decided, it did not purport to decide:

(1) that anything short of actual knowledge by the subsequent purchaser at the time of the purchase of the charterer's rights,

71 [1926] AC 108.

72 *Ibid*, at 118.

73 *Ibid*, at 119, 121.

74 *Ibid*, at 121. Additionally, it was said at 125 that the purchaser was in the position of a constructive trustee with obligations which a court of equity will not allow him to violate. This would be an unusual form of constructive trust and in *Port Line Ltd* v *Ben Line Steamers Ltd* [1958] 2 QB 146, at 167, Diplock J makes the point that the observations of the Privy Council strongly suggest that the only remedy against the subsequent purchaser was the purely negative remedy to restrain a user of the vessel inconsistent with the terms of the charterparty with the former owner. As a "constructive trustee", therefore, the subsequent purchaser seems to be *sui generis*.

75 [1958] 2 QB 146. Also see *Greenhalgh* v *Mallard* [1943] 2 All ER 234.

the violation of which it is sought to restrain, is sufficient to give rise to the equity;

(2) that the charterer has any remedy against the subsequent purchaser with notice except a right to restrain the use of the vessel by such purchaser in a manner inconsistent with the terms of the charter;

(3) that the charterer has any positive right against the subsequent purchaser to have the vessel used in accordance with the terms of his charter.[76]

In *Swiss Bank Corporation* v *Lloyds Bank Ltd*[77] Browne-Wilkinson J, after discussing *De Mattos* v *Gibson*, said:[78]

> In my judgment that case is an authority binding on me that a person taking a charge on property which he knows to be subject to a contractual obligation can be restrained from exercising his rights under the charge in such a way as to interfere with the performance of that contractual obligation: in my judgment the *De Mattos* v *Gibson* principle is the equitable counterpart of the tort [of interference with contractual relations].

It is outside the scope of this article to embark on a discussion of the merits of Browne-Wilkinson J's approach in equating the rule in *De Mattos* v *Gibson* with the tort.[79] Likewise it is not proposed here to examine the rationale underlying the rule in *De Mattos* v *Gibson*.[80] Although its validity has often been doubted, the rule was accepted by the English Court of Appeal in *Mac-Jordan Construction Ltd* v *Brookmount Erostin Ltd*.[81] In that case Scott LJ said that "[t]here are, undoubtedly, circumstances in which notice of contractual rights will be held to bind persons who acquire interests in

76 *Ibid*, at 168.
77 [1979] 1 Ch 548.
78 *Ibid*, at 573.
79 This approach has been criticised, see Gardner, *supra*, at 289-293; Tettenborn, *supra*, at 81-83.
80 On this, see the articles cited in note 68. In *Law Debenture Trust Corpn* v *Ural Caspian Oil Corpn Ltd* [1993] 1 WLR 138, Hoffmann J said (at 144) that neither the *Strathcona* case nor the *Swiss Bank* case make it entirely clear when the principle applies and when it does not."
81 [1992] BCLC 350.
82 *Ibid*, at 356.

property affected by those contractual rights".[82] It appears, therefore, that notwithstanding much criticism, Knight-Bruce LJ's statement is still good law. Its scope should not be exaggerated, however. As Hoffmann J put it: "the *De Mattos* principle permits no more than the grant of a negative injunction, to restrain the third party from doing acts which would be inconsistent with performance of the contract by the original contracting party."[83] In the context of the negative pledge, the principle may suggest that a person who takes security with notice of a negative pledge clause can be injuncted from realising the security inconsistently with the said restrictive covenant. Even if this is correct, an injunction will only be granted if the negative pledge clause relates to specific assets.[84]

VI. The 'Affirmative' Negative Pledge

As has been mentioned, to strengthen the effectiveness of an unsecured negative pledge, it is sometimes provided that security shall automatically arise in favour of the negative pledgee upon a breach of the restrictive covenant, or that upon such breach, the borrower agrees to grant similar security to the negative pledgee. There does not appear to be any judicial decision on the effect of such a clause and academic opinion is divided. Goode takes the view[85] that an agreement for automatic attachment of a security interest to an asset upon the debtor subsequently charging the asset to a third party creates nothing more than a contractual right in favour of the first creditor. Furthermore, even if the debtor gives security to a third party, this right is incapable of giving rise to a security interest in favour of the first creditor because it lacks the essential requirement of value. This is because a contingent agreement for security does not lead to the creation of a security interest until the occurence of the contingency. Money advanced by the creditor prior to the contingency does not count as value; on the

[83] *Law Debenture Trust Corpn* v *Ural Caspian Oil Corpn Ltd*, *supra*, at 144. Also see *Swiss Bank Corpn* v *Lloyd's Bank Ltd, supra*, at 573 where Browne-Wilkinson J said that "an injunction can be granted to restrain a subsequent purchaser of a chattel from using it so as to cause a breach of contract of which he has express notice."

[84] *Mac-Jordan Construction* v *Brookmount Erostin, supra,* at 13. It is questionable if such an injunction ought to be granted because, like other types of injunctions, it should be granted only if it is practicable to do so. It is difficult to see what advantage the injunction would give to the negative pledgee that he would not already obtain by suing for damages under the tort of interference with contractual relations. The injunction does not transform the negative pledgee into a secured creditor nor does it enable him to appropriate the securityholder's security as his own. There being no real benefit to the negative pledgee, an injunction should not be granted.

[85] Goode, *Legal Problems of Credit and Security* (2nd ed), at 17 *et seq*.

contrary, it represents no more than an advance by an unsecured creditor who may, at some unspecified time, be able to call on the debtor for security in the future. Even where there is fresh consideration to support the granting of a security interest at the later date, the security will only secure the amount newly advanced and not the earlier amount as well.

It is submitted that the preferable view is that an affirmative negative pledge clause, if breached, creates a security interest without the necessity for further value.[86] An agreement for security to arise automatically upon the breach of a negative pledge clause, or an agreement to grant security in such circumstances, gives the creditor a contingent right to security. While Goode is correct that the agreement does not constitute an inchoate security,[87] it is difficult to see why no valid security should arise upon the occurence of the contingency stipulated for in the affirmative negative pledge clause, namely, breach of the restrictive covenant.[88] In *National Provincial Bank of England* v *Charnley*,[89] Scrutton LJ stated:

> I think that the substance of an equitable charge is this: if an agreement be made to grant some interest in existing or future property for the purpose of securing the payment of a debt, that agreement to give the security confers an equitable security or charge, though all the formalities necessary to create the actual security have not yet been complied with. Equity treats that as done which ought to be done.

Accordingly, since equity treats as done that which ought to be done, where the negative pledge clause gives the first creditor a right to call for security upon a breach of the restrictive covenant and such breach occurs, this gives rise to an equitable charge in favour of the first creditor even though the formalities necessary to the creation of such security have not been complied with.[90] The position of the first creditor should be even stronger if the

[86] See Gabriel, *Legal Aspects of Syndicated Loans*, at 82 *et seq*; Stone, "The 'Affirmative' Negative Pledge" [1991] 9 JIBL 364.

[87] A present right to a charge over future assets, see *Holroyd* v *Marshall* (1862) 10 HLC 161; *Tailby* v *Official Receiver* (1888) 13 App Cas 523.

[88] Also see Gough, *op cit,* at 707 where he says that "[a] creditor may stipulate for a future charge to be given on a contingency, *eg*, if the creditor as guarantor is called upon to honour his guarantee of the company's indebtedness. That agreement contains no present equitable charge, but merely a right to the creditor to have a charge of a certain kind on the occurence of a future event. Such a charge is created and becomes registrable not at the date of the initial agreement but at the date of the happening of the future contingency."

[89] [1924] 1 KB 431, at 445.

[90] See *Holroyd* v *Marshall, supra*; *Tailby* v *Official Receiver, supra*, particularly the judgment of Lord Macnaghten.

agreement provides that the occurence of the contingency automatically results in security in favour of the the first creditor without the necessity for any other act.

It is suggested that no new value needs to be advanced to support the charge. When a creditor advances money and an affirmative negative pledge clause is one of the terms of the loan agreement, the advance of money is consideration for the clause and indeed, for all the other covenants from the borrower in favour of the lender. The affirmative negative pledge clause, like all the other usual covenants from borrower to lender, is part of the bargain for the advance of the loan moneys. Surely there is nothing to prevent the parties to a loan agreement from saying: "if I advance a sum of money to you, you will agree to grant a charge over your book debts to me should you fail to meet any of the instalment payments". No charge arises at that stage but failure to meet an instalment payment will cause the contingent right to become a present one, thus giving rise to a charge over the book debts because equity treats as done that which ought to be done. No new value is necessary for the advance of money provides adequate consideration.

If this is the correct analysis, an unsecured creditor with the benefit of an affirmative negative pledge clause is in a more advantageous position compared to another unsecured creditor without the benefit of such a clause. At least four problems remain, however, and these have the effect of diminishing the advantage offered the affirmative negative pledgee. These problems will be examined in turn.

First, a security interest over the debtor's assets must be sufficiently identifiable. As Lord Herschell put it in *Tailby* v *Official Receiver*,[91] "[t]here is no doubt that an assignment may be so indefinite and uncertain in its terms that the Courts will not give effect to it because of the impossibility of ascertaining to what it is applicable." Accordingly, merely providing that security will arise automatically, or be given, upon the breach of a negative pledge clause, is too vague and indefinite as to subject matter and the agreement will not be enforced. This problem can be avoided by providing that security will arise or be given over the same assets which have been granted as security to a subsequent creditor in breach of the negative pledge clause,[92] or by the first creditor specifying in a schedule to the loan agreement a list of fixed assets on which the charge is to attach.[93]

More problematic is the question of priority. Even if an affirmative

[91] *Ibid*, at 529.
[92] Goode, *Legal Problems of Credit and Security*, at 20.
[93] Stone, "The 'Affirmative' Negative Pledge" [1991] 9 JIBL 364, at 368.

negative pledge can lead to the creation of valid security, such security will only arise after the occurence of the stipulated contingency, *ie,* the grant of security to a subsequent creditor. The subsequent creditor will therefore have priority since his security would have been created prior to the negative pledgee's. To avoid this problem, it has been suggested that the affirmative negative pledge clause be drafted to include terms similar to those found in certain automatic crystallisation clauses in floating charge debentures. Such automatic crystallisation clauses seek to protect the floating chargee against a subsequent fixed chargee by making it possible for crystallisation to take place *in scintilla temporis* before the creation of the fixed charge. In the context of the 'affirmative' negative pledge, such provisions will instead seek to protect the first creditor by giving him security *in scintilla temporis* before the breach of the negative pledge clause by the borrower.[94] An example of an automatic crystallisation clause and its effect can be seen in the case of *In Re Manurewa Transport Ltd*.[95] In that case the debenture provided for a floating security. It also provided that the principal should become immediately payable and the charge should immediately attach and become fixed if, *inter alia*, the company "mortgages charges or encumbers or attempts to mortgage charge or encumber any of its property or assets contrary to the provisions hereof without the prior written consent of the lender." The company subsequently executed a chattel mortgage and Speight J held that the floating charge took priority because the floating charge crystallised the moment the company "put pen to paper" and executed the security.[95]

It is not entirely clear if such a device will work in the context of the affirmative negative pledge. In the case of floating charges, there is already a present security[97] and the question is at which point in time the security fastens on the assets in question. In the case of a negative pledge clause there is no present security, only a right to have security upon the occurence of a contingency. While the arrangements with respect to floating charges have been upheld, there is no certainty that the courts will extend the reasoning to affirmative negative pledges where there is not already a present security in existence. It is suggested that the extension should be made. It has been recognised that the circumstances giving rise to

94 *Ibid*, at 369.

95 [1971] NZLR 909. Also see *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd* (1992) 7 ACSR 365.

96 *Ibid*, at 917.

97 *Re Margart Pty Ltd* [1985] BCLC 314.

98 *Re Brightlife Ltd* [1986] BCLC 416; *Re Manurewa Transport Ltd, supra*, *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd*, *supra*.

crystallisation of a floating charge are matters for agreement between the parties.[98] Similarly a charge, being a consensual security, is created by contract. Accordingly, provided the conditions for the charge to arise are sufficiently clearly defined, there should be no objection to the security arising *in scintilla temporis* to the breach of the negative pledge clause.[99]

The third problem relates to section 131 of the Act which requires that particulars of certain types of charges[100] have to be lodged with the Registrar within 30 days after the creation of the charge. As no charge is created at the time the agreement containing the affirmative negative pledge clause is entered into, lodgment of the particulars of the agreement at that time will not fulfil the requirements of section 131. The particulars relating to the charge can only be filed with the Registrar after the creation of the charge. That being so, it is difficult to see how the affirmative negative pledgee can realistically comply with the requirement for registration. If the borrower is prepared to breach the negative pledge clause, it is unlikely that he will inform the negative pledgee of the breach of the restrictive covenant. In the absence of such information, the negative pledgee will not know that security has arisen in his favour as a result of the fulfilment of the contingency. As such, the security is likely to remain unregistered and be void against the liquidator and secured creditors[101] of the company.[102] Only a cumbersome process such as monthly searches of the Register of Charges may ameliorate the problem.

It has been suggested[103] that this problem can be avoided in jurisdictions where the Companies Act defines a charge as including "any agreement to give or execute a charge or mortgage whether upon demand or otherwise".[104] This suggestion can only be right if an agreement to give a charge upon the occurence of a contingency is no less an agreement to give a charge within the language of the statute. It is submitted, however,

[99] Care should be taken in the drafting, however, to ensure that there is no inversion of the order of cause and effect, see *Fire Nymph Products Ltd* v *The Heating Centre Pty Ltd, supra*. For example, a clause which provides that security shall be deemed to arise immediately prior to the breach of a negative pledge clause may not be able to create such a security interest retrospectively so as to be entitled to priority over a subsequent creditor who has already taken security. The operation of such a clause in this manner would involve a certain degree of temporal incongruity.

[100] Only charges which fall within those enumerated in s 131(3) need to be registered. Particulars of other types of charges need not be registered.

[101] *Re Ehrmann Brothers Ltd* [1906] 2 Ch 697.

[102] See *Dresdner Bank Aktiengesellschaft and Ors* v *Don Ho Mun-Tuke and Anor* [1993] 1 SLR 114.

[103] Stone, "The 'Affirmative' Negative Pledge" [1991] 9 JIBL 364, at 369.

[104] The Act, s 4(1); Australian Companies Code, s 5(1).

that there is a better, albeit narrower, interpretation of the definition. An agreement to give a charge is only a charge if it gives a present right to a charge. An agreement to give a charge on a contingency gives no such present right. It is only upon the fulfilment of the contingency that there will be a present right to have the security made available. Accordingly, it is only at that point in time that the agreement to give a charge creates a charge in equity, equity treating as done that which ought to be done. If this is correct, the only solution available to the 'affirmative' negative pledgee who has not effected registration of his charge is to apply to the High Court for an order that the time for registration be extended.[105]

The final problem which has to be considered arises under the law dealing with undue preferences. If a company goes into insolvency within 3 months of the creation of a charge, the charge may be void as an undue preference.[106] Security which arises under an affirmative negative pledge is more vulnerable to this rule as the charge would have arisen only upon the breach of the restrictive covenant and not at the time the loan agreement was entered into. The first lender's position is also not helped by the fact that the third party creditor's charge may itself be valid as having been given in good faith and for valuable consideration and not with a view to prefer the third party creditor.[107] While the original advance of money by the first creditor may be sufficient consideration to support the charge which arises upon the breach of the negative pledge clause, fresh consideration is necessary if the rule against undue preferences is to be negated. This is because the policy underlying the rule against undue preferences is to prevent unsecured creditors from taking security when the company's financial difficulties become apparent. Any security at such point must therefore be supported by fresh consideration which is unobjectionable insofar as it results in a fresh infusion of money or property to the company which otherwise might never have gone to the company and which might have the effect of helping the company overcome its present difficulties.

VII. Conclusion

As can be seen, a creditor who has the benefit of a negative pledge has certain advantages over other unsecured creditors. The negative pledgee

[105] The Act, s 137.

[106] The Act, s 329. Also see *In re Eric Holmes (Property) Ltd (in liquidation)* [1965] 1 Ch 1052.

[107] Also see Stone, "The 'Affirmative' Negative Pledge" [1991] 9 JIBL 364, at 370.

can sue to restrain a breach of the negative pledge and for damages if there has been a deliberate interference with his contractual rights. A security interest can also arise in favour of the unsecured negative pledgee if the restrictive covenant is coupled with an 'affirmative' negative pledge clause. A negative pledge can also improve the position of the floating chargee against subsequent fixed chargees who had notice of the restrictive covenant. Despite these advantages, however, the foregoing discussion clearly illustrates that there are limitations to the "security" functions of a negative pledge.

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