DESCRIPTION OF DEBT AS “SENIOR” AND THE “NEGATIVE PLEDGE” COVENANT

Background and Introduction

The International Capital Market Association (ICMA) has been an active participant in recent discussions between the sell-side and investors focusing on the timeliness and accuracy of disclosure and clarity of covenants, in particular in the Bondholders’ Dialogue, sponsored by the Association of British Insurers (ABI) and the BVI Bundesverband Investment und Asset Management (BVI). We recognise the need for such a debate and support the key conclusions of the Bondholders’ Dialogue Paper.¹ To this effect, we have already published formal recommendations concerning availability of offering documentation to investors.²

In the course of these discussions, some institutional investors raised concerns about difficulties they have understanding certain terms and covenants used in the documentation of bond issues, in particular the term “senior” and the “negative pledge” covenant.

We recognise that market practices regarding these two concepts are not always uniform. As the Bondholders’ Dialogue Paper noted, however, their mandated standardisation is not a feasible option. In line with the recommendations of the Bondholders’ Dialogue Paper, we therefore support any efforts to promote better understanding among the investors of the existing practices.

This explanatory note is a part of our commitment towards this goal. Its purpose is to provide a brief, “non-legal” explanation of the term “senior” and the “negative pledge” covenant, as currently usually used in practice.


² The IPMA Recommendations No. 1.26 (Including the date of base prospectus in screen announcements), No. 1.27 (Availability of draft offering documentation) and 1.28 (Availability of prospectus). See the IPMA Handbook, Section One.
**Description of Debt as “Senior”**

The word “senior” is used to describe ranking of a debt vis-à-vis other debts of the same issuer. Internationally, it has no fixed legal meaning. The issuers normally use the term to denote “ordinary” debt, not preferred or subordinated to other debts of the issuer.

Description of a debt as “senior” therefore **normally means** that the debt is legally “ordinary” debt which is neither, on one hand, secured or otherwise preferred in the insolvency of the issuer nor, on the other hand, subordinated to other debts of the issuer and which ranks equally (“pari passu”) with other such “ordinary” unsecured and unsubordinated debt.

The IPMA Handbook, administered by ICMA, discusses the information about ranking of the issue that should be provided by the lead manager to other members of the syndicate when the issue is launched. In this context it recommends that the ranking of the debt be spelt out in reasonable detail and that concise expressions which have a legal meaning such as “unsecured and unsubordinated” are used, rather than the more vague “senior.”

Use of the term “senior” is justified where it helps to distinguish differently ranked tranches of an issue, e.g., “senior notes” vs. “subordinated notes”, but also, although arguably less precisely, e.g., “senior secured notes” or “senior subordinated notes.”

Conversely, description of a debt as “senior” **does not by itself mean** that:

- The debt is in any way secured.
- The debt would get any other preferential treatment in the insolvency of the issuer under the applicable law similarly to, e.g., tax claims or employee claims.
- The economic ranking of the debt will not change in the future, e.g., as the issuer grants security over its other debts or incurs debts which get preferential treatment in its insolvency.
- The debt is not structurally subordinated, e.g., it is not a debt by a holding company which is by its nature “subordinated” to a debt by its subsidiary companies.
- The debt ranks equal to bank loan debt; that is because many standard negative pledges, discussed below, allow the issuer to grant security for bank loan debt.

**It is advisable:**

- Not to draw any conclusions as to the ranking of the debt solely on the basis of its description as “senior” and to make sure the ranking of the particular debt vis-à-vis other debts of the issuer is fully understood.
- To analyse carefully both the language of the clause on ranking or status of the debt in the terms and conditions of the issue and the applicable laws affecting satisfaction of debts in insolvency.

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3 The IPMA Explanatory Note on Ranking of the Bonds. See the IPMA Handbook, Section Six, Appendix B. The Explanatory Note also gives examples of the language used to describe senior and subordinated debt in terms and conditions of an issue.
“Negative Pledge” Covenant

“Negative pledge” is a term used to describe a covenant by the issuer in the terms and conditions of the issue which restricts the freedom of the issuer (and possibly other entities related to the issuer) to grant security for other debts **without** granting equal security for the debt in question.

In bond issues, the purpose of the negative pledge is to protect the price of the issue by preventing the issue by the issuer of similar issues on a secured basis. This can be contrasted with typical bank loans, where a negative pledge (usually more widely drafted) is coupled with non-disposal clauses and financial ratio covenants. Such a combination, which is not normally used in bond issues (high yield and long-term sterling issues being some of the exceptions), has a wider purpose, protecting the economic ranking of the debt by safeguarding the value of the issuer’s assets to the lenders.

The IPMA Handbook, administered by ICMA, discusses the information about negative pledge that should be provided by the lead manager to other members of the syndicate when the issue is launched. It recommends disclosure of the basic characteristics of the negative pledge as well as of any uncommon material exceptions.

The most common practice in international bond issues is that the negative pledge prohibits only granting of security for other listed bonds. Such an issuer then could not issue secured listed bonds without granting equal security for the existing bonds but could secure different kinds of its debt, for example by taking out secured bank loans. Nevertheless, the scope of the negative pledge may vary substantially from issue to issue.

Existence of a negative pledge therefore **only means** that the freedom of the issuer to grant security for its other debt is limited rather than unlimited.

Conversely, existence of negative pledge therefore **does not mean** that:

- The issuer is not permitted to give any security for its other debt at all. In particular, it could be expected that the issuer will be permitted to give security for its bank loan debts.
- The issuer is not permitted to dispose of its assets, e.g., for the purpose of securitisation.

**It is advisable:**

- Not to rely solely on the indication of the existence of a negative pledge.
- To analyse carefully the language of the negative pledge, focussing in particular on the entities covered by the prohibition, the definition of security and specification of debt covered by the negative pledge.

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4 The IPMA Explanatory Note on Negative Pledge. See the IPMA Handbook, Section Six, Appendix B. The Explanatory Note provides further guidance on the use of negative pledges and the usual meaning of certain expressions used in negative pledges.