
CLIENT NOTE

THE “NEGATIVE PLEDGE” COVENANT: IS IT A DOUBLE-EDGED SWORD UNDER ARMENIAN LAW?



Overview

In June 2016, the Armenian Parliament passed a law (amendment to the Civil Code and *inter alia* in Article 236), with which it proclaimed that any limitations on the rights of the pledgor to repledge the object of the original pledge is null a void. What does this mean in a layman’s terms?

It ultimately means that any person who has taken out a loan against a piece of property such as a house can effectively use the same property (yes, the same house) as security to take out another loan. Since January 1st, 1999 (the day the Civil Code came into force) borrowers were at the mercy of

The “Negative Pledge” covenant is standard language in a host of financial transactions, such as subordinated loans and unsecured bond issuance (both of which the Armenian financial markets are experiencing extensively lately). Does this covenant work as a sensible legal protection in the Armenian reality?

their lenders (in Armenia's case usually the banks) when it came to repledging their property that was used as primary collateral. The lenders usually charged exorbitant fees (\$300 - \$3000) to provide a piece of paper to the borrowers notoriously known as *Consent to a Secondary Pledge*.



Obviously, this was a very important legislative amendment that somehow liberalized Armenia's secondary mortgage markets. It also increased access to financial resources for Armenian businesses and ordinary consumers of lending services. Additionally, it intensified competition among lenders who introduced financial incentives and marketing techniques to lure the best borrowers into their balance sheets. Concurrently, this amendment created another problem (that's usually the case, right?) and this time for unsecured debt holders. But, first things first. Let's explore two cases when this piece of legislation might create problems in financial markets.



1. The "Sub"s (don't confuse those with submarines or the famous sandwiches)

Back in June 2014, the Armenian Central Bank issued a regulation whereby it set the rules for extending subordinated debt to commercial banks in Armenia. This particular regulation sparked some significant activity in the subordinated debt market. Both shareholders and

independent third parties (the latest being the \$15 million transaction signed between BlueOrchard Microfinance Fund¹ and InecoBank (TK & Partners acted as BlueOrchard's legal counsel in this transaction)) started actively extending subordinated loans² to commercial banks.

¹ An independent Luxembourg Fund

² A subordinated loan is basically a loan that is not secured and below all other liabilities of the borrower in the list of priorities. In situations of default the subordinated creditors are paid right before any payment is made to the shareholders (of course if there are assets left).

2. FI markets blossoming

FI stands for Fixed Income instruments and Armenia has been seeing a lot of them lately. Yes, over the past few years, another trend is blooming in the Armenian financial markets and that is the issuance of bonds by banks and other financial institutions. In 2018, the following figures represent bond issuance figures on the Armenian Stock Exchange (AMX)³:

- AMD approximately 1.2 billion
- USD approximately 21 million
- EUR approximately 421 thousand

These figures we believe represent a serious leap⁴ from previous years and this is also due to encouragement from the financial regulator.



More often than not, bond holders do not get asset security to cover their issuer default risk, unlike other types of loan instruments. In lieu of physical collateral against issuer debt, bond holders have to live with specific “negative pledge” language that is weaved into prospectuses carefully drafted by law firms such as ours. This is where legislative trouble begins.

What’s a “negative pledge” anyway?

A “negative pledge” is a covenant intertwined into the loan agreement (subordinated loan for example) or the prospectus (bond issuance in this case), whereby the borrower agrees not to encumber its property with a lien for the benefit of third parties, usually without the consent of the beneficiary of the “negative pledge” covenant (i.e. the lender or the bond holder). In other words, the debtor promises the creditor not to pledge its property without asking the creditor’s permission first.

This covenant is a useful one in transactions involving debt, because it gives the creditor some kind of peace of mind that other creditors will not get seniority over its unsecured debt without prior knowledge and control, in case the debtor chooses to pledge its assets as security in other debt transactions. Actually, it’s a whole different story whether this covenant protects the creditor during the debtor’s insolvency or other default situations (well, another Client Note is boiling up!). We do believe that this is a “security” of good and peaceful times.

³ Source: AMX data <https://amx.am/en/9/trading/12/market-data?markets=2&dp=4&y=2018>

⁴ Have to admit though that these figures are very low compared to other transition economies.

Now, arguably Article 236 of the Armenian Civil Code prohibiting any contractual limitations on the rights of the debtor-pledgor to repledge its property also covers this covenant. We believe it does not. Why? Because the exact wording of the stated article talks about “property that is pledged”. As one might notice, in this case there is no prior pledged property. Therefore, if there is no pledge, there can be no limitations.

So how can we help?

Our team has extensive experience in putting together lending instruments and debt prospectuses that carefully protect the vulnerabilities of creditors under Armenian law, including this one. So please, do get in touch when you want to receive sophisticated advice.

NOTE: This material is for general information only and is not intended to provide legal advice

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