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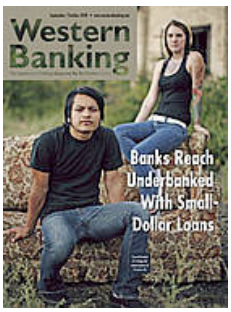

Western Banking Magazine

Negative Pledge Agreements: Are They Enforceable?

Many lenders are willing to provide a commercial line of credit without obtaining a deed of trust, but require the borrower to execute a negative pledge agreement. These negative pledges or negative covenants, which are usually recorded, generally provide that the borrower will not encumber or transfer specified real property during the life of the subject loan. The lender holds "a contractual guarantee that property in which the debtor has an equity will remain unencumbered and unconveyed, and thus available for levy and execution should the creditor reduce his debt to judgment," according to Tahoe National Bank v. Phillips in 1971.

Although few courts have addressed the issue, it is fairly well settled that such an agreement does not create a security interest in the property against which the agreement was recorded. The question presented is whether a negative pledge agreement is unenforceable and, if so, whether a lender who places a demand into escrow as a condition of releasing the recorded instrument has any exposure to the borrower for slander of title.

Many states (such as California and Colorado) render unenforceable any agreement that unreasonably restricts the right to transfer property. Determining in advance whether a restraint on alienation will be deemed enforceable can be difficult, particularly because some states have enacted consumer protection statutes aimed at protecting home equity, such as Arkansas and California. The issue generally turns on whether or not a court will find the restraint to be reasonable, "While generally the common law rule is that limitations on the free alienation of real property are invalid as against public policy, reasonable restraints that are justified by legitimate interests of the parties are not necessarily void," which was decided in Terry v. Born in 1979.

While many types of restraints have been found to be reasonable, some freely agreed to by the parties have also been held to be unenforceable. For example, at least two states — Florida and Texas — have held that options to purchase property at a fixed price for an indefinite period of time were unenforceable as an unreasonable restraint on alienation. The California Supreme Court held that a due on sale clause, which accelerated a loan on sale of the property, was unreasonable unless the lender could demonstrate that its security was impaired, and that enforcement of the instrument was necessary to protect its security interest. This happened in Wellenkamp v. Bank of America in 1978.

If a lender is required to show that enforcement of an instrument is necessary to protect its security interest in order to validate the instrument, is a negative pledge agreement enforceable given that it creates no security interest? Some courts have held that the question of whether a restraint on alienation is reasonable is one of fact, meaning neither party could expect a court to decide the issue prior to trial, raising the specter of a lengthy and expensive litigation, which cannot be decided by motion.

If a borrower attempts to sell property that is subject to a recorded negative pledge agreement, the title insurer will likely demand that the

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lender release it as a condition to closing escrow. Often a borrower may be unwilling to repay the loan out of escrow proceeds because such funds are needed to purchase a new home or satisfy other obligations. Such a demand may occur close to the scheduled close of escrow, and a lender may quickly have to decide whether to release the recorded instrument and lose whatever protection it has against default, or refuse to release the instrument and face claims for damages arising from the failed sale of the property.

Some states have held that an unreasonable refusal to release a recorded instrument can create exposure for slander of title. While no published decision appears to have addressed the issue directly, it is conceivable that a lender who refuses to release a negative pledge agreement, unless the borrower repays the loan out of escrow, could face exposure to the borrower for slander of title if a court later determines that the negative pledge agreement was unenforceable.

Lenders may wish to abandon marketing unsecured lines of credit whenever a secured position is advisable and consider securing the loan with a typical deed of trust instead of a negative pledge agreement.

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