Intercreditor Agreements

With These Documents, Understand All the Caps, Wraps, and Traps

By JAMES SHEILS

It is not unusual for two or more lenders to have loan relationships with a borrower. The lenders might both be banks, or the second (junior) lender might be a government agency that is advancing funds for a particular project (examples of the latter would include housing developments, specialized equipment financing, and the like).

Frequently, both loans are secured by the same property (collateral) of the borrower. When that occurs, an intercreditor agreement is often required by the first (senior) lender. That document typically establishes the rights and priorities of the lenders if the borrower's financial conditions deteriorates and the lenders want to exercise their respective rights regarding the collateral. Absent such an agreement, each lender could theoretically exercise its rights at the same time, perhaps inconsistently, and the process could be confusing, inefficient, or worse.

This article addresses some of the principal issues that arise when an intercreditor agreement is negotiated.

Areas of Negotiation

The senior lender will want to have maximum control over any foreclosure process, and both lenders will want the process to be as efficient as possible. Common areas of negotiation include the following:

• How much of the senior lender's debt is to be afforded first priority? This issue has at least two components — what type of debt, and any cap on the amount of debt. Principal and interest, of course, are customarily protected, but other components could include late fees, pre-payment, or 'make-whole' charges; amounts due under cash-management or hedging/'swap' arrangements; indemnity provisions; and similar related costs, fees and expenses. Also, the agreement may cover all debt owed to the senior lender, whenever incurred, or it may be limited to a specific transaction.

Once the components are determined, the junior lender may insist on a cap on the amount entitled to first lien priority — for example, are future advances included? Since the junior lender is relying on any excess collateral value to be available for the repayment of the junior debt, the junior lender will want a cap, and will want it to be progressively reduced by the amount of any permanent reductions in the debt owed to the senior lender.

• Is all of the collateral 'shared' by the lenders? A common alternative is a 'wrap,' where one lender has a first lien on asset A, and the second lender has a first lien on asset B, with each lender obtaining a junior lien behind the other lender's first lien.

The application of proceeds received from the sale of the shared collateral is sometimes subject to what's known as a 'waterfall' provision. The senior lender gets proceeds up to a certain amount, then payments go to the junior lender up to a certain amount, then remaining proceeds (if any) go to the senior lender.

The senior lender will want to have maximum control over any foreclosure process, and both lenders will want the process to be as efficient as possible.

• Is the junior lender entitled to any priority if the senior lender has failed to do everything required to make its lien on the shared collateral a first-priority lien absent the intercreditor agreement? Many intercreditor agreements contain such provisions, even though the practical result can be a serious reduction in the amount recovered by the junior lender in a foreclosure proceeding. The junior lender may obtain recovery from the collateral, but be required to turn it over to the senior lender. If there is insufficient collateral, the junior lender may wind up with little or nothing, while the possibly negligent senior lender obtains a full recovery.

• What happens if the borrower wants to sell an asset that is collateral for both loans? The senior lender will want the junior lender to consent in advance to any sale which it approves; it doesn't want the junior lender to leverage its consent to obtain payments or changes in terms. In return, the junior lender will insist that any such sale be 'commercially reasonable,' and may also attempt to require that the sale proceeds be used to permanently reduce the amount of debt secured by the senior lender's lien.

• How does the senior lender exercise its control? Typically, the junior lender agrees to a 'standstill,' meaning a time period during which it agrees it will allow the senior lender sole discretion on if, how, and when to proceed against the collateral. The duration of the standstill is often heavily negotiated; six months is not unusual. Intercreditor agreements typically provide for an automatic extension of the standstill so long as the senior lender has commenced action against the collateral and is diligently pursuing its rights.

The 'trigger' which starts the standstill is also a point of discussion. It will be based on a default under the junior lender's documents, so the nature and materiality of the default is important, as well as whether the standstill clock is reset if the default is 'cured' within the standstill period. For example, the senior lender may insist on having the right (but not the obligation) to cure a default under the juunior lender's documents, with a corresponding re-set of the standstill.

Other Issues

While a detailed discussion of the impact of a insolvency is beyond the scope of this brief review, many issues may arise in a bankruptcy, including voting rights on a plan of reorganization, restrictions on the junior lender exercising rights (which may result in the junior lender having fewer rights than an unsecured creditor), and the value (if any) of any subrogation claims available to the junior lender.

Obviously, each lender and borrower anticipate and expect a profitable, uneventful relationship, in which case the intercreditor agreement is likely to sit on a shelf and never be looked at again after the loan closing. If things go south, as they can and do, an intercreditor agreement can be a critical component to the orderly liquidation of collateral as the repayment source to both lenders. ■

James B. Sheils, a partner of Shatz, Schwartz and Fentin, P.C., concentrates his practice in the areas of commercial finance law, creditors' rights, banking law; and telecommunications siting matters; (413) 737-1131; jbsheils@ssfpc.com