

Commercial Lending Review

VOLUME 4, NUMBER 1

WINTER 1988-89

- Good Faith and Fair Dealing:
The K.M.C. Case, Discretionary Loans, and Demand Notes 3
Ronald W. Hanson
- Learning to Let Go:
Professionalizing the Entrepreneurial Business 12
Herbert M. Dicker
- Lending to Nursing Homes 18
Joseph G. Duncan
- The Impact of Federal Criminal
and Bankruptcy Laws on Letters of Credit 28
Gerald T. McLaughlin
- Interest-Rate Movements and the Credit Risk
of Interest-Rate Swaps 39
Donald J. Smith
- Assessing Environmental Risks Before Booking a Loan 53
Daniel A. Rowley, Tara Leah Witmer
- Intercreditor Agreements in Workouts 65
Gerald M. Mayer, John D. Rosenberg, Paul A. Mohtares

DEPARTMENTS:

- | | |
|---|--|
| MARKETING 73 | LEASING 87 |
| Art Equity Loans
A Market Opportunity for
Commercial Bankers
<i>Mitchell Zuckerman</i> | Targeting Your
Marketing Efforts
<i>Terry J. Winders</i> |
| LENDING STRATEGIES 77 | SOFTWARE 91 |
| Lending and the Golden Rule
<i>Paul S. Nadler</i> | Database of Loans
to U.S. Companies
<i>Kenneth C. Abbott</i> |
| ACCOUNTING 81 | BOOKS 94 |
| Commercial Real Estate
Loans and Economic Cycles
<i>James M. Zinn</i> | The New World of
Commercial Banking
<i>Lawrence B. Bloom</i> |

Unilateral action against a troubled debtor will not necessarily maximize the proceeds of a loan. This article shows how to use intercreditor agreements to avoid foreclosure, bankruptcy, and liquidation.

Intercreditor Agreements in Workouts

GERALD M. MAYER
JOHN D. ROSENBERG
PAUL A. MOHTARES

AN INTERCREDITOR AGREEMENT is a contract. Historically, intercreditor agreements have been used to establish and document relative lien priorities among creditors, but an intercreditor agreement may address matters other than lien priorities.

Often, intercreditor agreements enhance a creditor's ability to recover or secure loans from distressed borrowers. However, potential problems must be evaluated carefully before a bank makes agreements with other creditors. This article will discuss the creative use of intercreditor agreements and similar consensual arrangements as an alternative to foreclosure, bankruptcy, and liquidation.

There are few hard and fast rules or requirements for intercreditor agreements other than general principles of contract law, which vary from state to state. Generally, an intercreditor agreement, like any other contract, is interpreted according to the intent of the parties as set forth in the agreement. Intercreditor agreements offer the parties tremendous flexibility and a legitimate alternative to measures like bankruptcy or liquidation.

One of the most common intercreditor agreements is a waiver or

Mr. Mayer is president and CEO of DiversiCorp., Inc., Dallas. Mr. Rosenberg and Mr. Mohtares are members of the law firm of Goins, Underkofler, Crawford & Langdon, Dallas.

subordination of a landlord's lien. In such an arrangement, the landlord of the debtor will subordinate its contractual or statutory liens to the lien of a secured lender or waive them. Other intercreditor agreements are more complex. They may involve the debtor's promise to establish and to maintain detailed financial and operational controls for the benefit of all lenders and creditors. Often, the debtor is an essential party to such agreements.

Unilateral Action, Reduced Returns

An event-oriented approach to workout generally results not in a restoration to profitability but in liquidation or restructuring. An event is a significant unilateral action by either a creditor or a debtor that harms the other party. Examples of an "event" are foreclosure or liquidation by a creditor and the filing for relief by a debtor under federal bankruptcy laws.

The secured creditor may take action because it realizes that a troubled borrower has exhausted all external credit resources and that the foundation of the secured lending arrangement—the collateral—is endangered. Other lenders, most notably trade suppliers, react to their perceptions of debtor duress by ceasing credit sales or taking formal legal action to position themselves ahead of other creditors.

Even creditors with clear priority positions benefit from a more cooperative approach to other creditors. A secured creditor that does not cooperate with other creditors can lose a chance to maximize the value of its collateral. Often, the greatest value of an asset may be realized by other creditors. Unsecured creditors may unlock value in a workout or liquidation because of their special knowledge of the trade and potential users of collateral.

Unilateral action such as foreclosure or liquidation could lead to legal action by other creditors. Claims for equitable subordination or claims based upon alleged fraudulent conveyance or control of the borrower may be instituted not only by debtors but also by other creditors claiming injury as a result of the actions of an aggressive secured lender. The creditors should make a collective effort to understand fully the debtor's position and viability.

Give-and-Take Leads to Resolution

Successful workouts generally result from cooperative management, systematic problem identification and solving, and careful plans. Trade creditors, lessors, security holders, government agencies, and employees should be involved. Independent analysis by outsiders is essential.

Early recognition of the problem is crucial. Ideally, the troubled debtor will disclose problems voluntarily. Secured and unsecured creditors should communicate openly and regularly with the debtor. The lender's analysis should include collateral control, document review, independent verification of the causes and effects of the debtor's prob-

lems, and a realistic evaluation of the debtor's short- and long-term viability.

All parties must recognize that the phrase "give to get" applies in workouts. In a cooperative environment, trade creditors can replace credit risks the bank is unwilling or unable to assume. In manufacturing and distribution, inventory is often the lifeblood of a troubled company. If a lender is unwilling to share liens, it may nevertheless assist the debtor and its suppliers by implementing controlled release and remittance programs. Many traditional workouts fail when secured and unsecured creditors fail to recognize mutual needs and the cash-to-cash cycle of the debtor.

Intercreditor agreements may be used effectively in many other situations. For example, leveraged buyouts generally require extensive and detailed intercreditor agreements because of the varied and numerous lenders and creditors as well as the relatively high levels of debt incurred.

Competing creditors, common goals

Intercreditor agreements may be used by suppliers as a prerequisite to continued sales to a troubled customer. For example, if the debtor has a secured financing arrangement with a commercial bank, the bank will have a blanket lien on the debtor's property, including property to be acquired in the future. A significant inventory supplier often demands, at a minimum, a security interest in the inventory it sells. The supplier who creates and perfects a purchase money security interest in the inventory will hold a security interest superior to the bank's security interest, notwithstanding the bank's prior filing and perfection. To create an enforceable purchase money security interest in inventory, the supplier does not need the bank's consent.

In many cases, the superior purchase money security interest of the supplier will impair the bank's collateral position. So the bank may cease to advance additional funds or declare the loan due in full at the earliest opportunity. Default or acceleration generally means disaster for all parties.

As an alternative to such measures, the two creditors may enter into an agreement to establish and protect their respective rights. The intercreditor agreement may cover additional matters, such as inventory controls and related safeguards and financial reporting requirements, and other covenants of the debtor. Many of these covenants benefit both the bank and the supplier.

Identifying parallel, although potentially competing, interests of the trade creditor and the secured lender is the key to effective intercreditor agreements. The bank may take comfort in knowing that the debtor will purchase goods or services from a relatively small number of suppliers known to the bank. In many cases, the bank may have little, if any, incentive to cooperate with the supplier and other creditors because of its superior blanket first lien position. If, however,

the bank wants the supplier to continue to finance the debtor's inventory without risk to the bank, an intercreditor agreement is extremely useful.

Each party must be willing to give something up to gain additional overall protection while maximizing the chances for a debtor's survival. Although the bank may relinquish or subordinate its security interest in inventory, for example, the supplier is often better able to maximize the proceeds from such collateral upon foreclosure. Creditors that understand each other's concerns and objectives learn that they share many common goals.

Example: Cooperation increases final payout

For example, a lender may negotiate to provide direct remittances from loan proceeds to suppliers through a third party, subject to the collateral controller's administrative oversight, in exchange for those suppliers providing credit for purchases by the debtor on an open account or unsecured basis.

In the recent workout of a distribution company, the trade creditors used a collateral manager to bring product to the debtor's warehouse and control inventory movement. Working through a mediator, the suppliers agreed to replace inventory that was liquidated to repay the bank with new title-retained inventory. The bank's desire to maintain receivables financing and the related first lien were achieved. By using the resources of the suppliers, the debtor was afforded new product on a title-retained basis. The intercreditor agreement preserved the responsibilities and duties of the parties without altering the lien priorities or the underlying loan agreement. In return for being relieved of the inventory financing burden, the bank provided the suppliers with an automatic direct remittance program under which the collateral manager invoiced the debtor with a copy to the bank. The bank, with debtor consent, remitted vendor invoices through draws against eligible receivables and remitted on the due date without compromising its superior lien position. The suppliers were paid directly and continued to provide inventory financing.

Keeping the accounts receivable proceeds out of the hands of the debtor provides security for the supplier to continue to provide credit. The bank gives its trustee services and gets raw materials or products that increase receivables to the debtor, thereby improving its collateral position without increasing exposure. The remittances to the supplier(s) can include negotiated payments in excess of the current invoice amounts to reduce or pay off any delinquent balances.

In this case, the debtor and its creditors ultimately decided to liquidate. The bank liquidated with assistance from the debtor and other creditors in a mutually cooperative environment. The liquidation proceeds exceeded the parties' expectations. Only a small portion of the accrued interest, including expenses, was written off by the bank. The principal was paid in full. The suppliers reclaimed their product and

the memo invoices outstanding were paid. The unsecured creditors were no worse off from working with the debtor and the bank. Since the bank had waived enforcement of the guaranties because the debtor cooperated, the principals were able to establish a new entity and the trade creditors enjoyed a new, healthier customer.

This example shows the benefits of cooperation. The debtor gains working capital and credit, the supplier gains sales and antecedent debt payments, and the bank expands or strengthens its collateral base without lending additional funds. The proceeds were maximized because a cooperative management and its employees were more knowledgeable than the bank or any of its appointed liquidators in disposing of the assets. The trade creditors assisted in disposing of the residual inventory and procuring buyers for most of the repurchased assets through their contacts and knowledge of the market.

In certain situations, lenders may be wise to consider minor concessions to guarantors and other creditors to create an incentive to allow the entire business to be sold as a going concern or to otherwise maximize the ultimate recovery. This approach may be useful if a lender concludes that a piecemeal sale of assets and pursuit of guarantors may result in a smaller recovery of outstanding indebtedness.

Constraints on Intercreditor Agreements

Intercreditor agreements often are implemented in conjunction with a workout. While creditors and debtors often benefit from them, such agreements may eventually be critically examined by a bankruptcy court and trustee, by creditors of the debtor, or by an antagonistic debtor. Issues include rights of third parties, lender liability claims, preference payments, and fraudulent conveyances questions.

Rights of third parties

An intercreditor agreement that is otherwise enforceable between the parties must comply with the Uniform Commercial Code (UCC) to ensure that the agreement is enforceable against third parties. Section 9.316 of the UCC expressly acknowledges that nothing in Article 9 prevents subordination by agreement by any person entitled to priority. While this principle is true for arrangements between creditors who are parties to an intercreditor agreement, a creditor still must perfect security interests to ensure that the priorities established under the intercreditor agreement are enforceable against third-party creditors (that is, creditors who are not parties to the intercreditor agreement). The possible existence of other liens, such as purchase money security interests, tax liens, or mechanics' liens, should be investigated to ensure that the claims of third parties do not frustrate the intent of the agreement.

For example, it is imperative that the debtor remain current on its federal, state, and local tax obligations, especially federal employment taxes. In many instances, the Internal Revenue Service will shut down

operations for failure to pay employment taxes. Typically, the IRS will not waive or subordinate its rights to subsequent lenders.

Lender liability

The strategic advantage lenders have over a troubled debtor has stimulated numerous lawsuits. Intercreditor agreements that regulate the operation of a debtor may lend credence to a claim that the lenders conspired to control the debtor, enhance their own positions relative to that of other creditors, or in other ways inequitably treat the debtor or its other creditors.

Claims that a lender is liable for damages or other relief often involve the lender's "control" over the debtor. Many courts distinguish between control over the management of the debtor and control over the finances of the debtor to protect a security interest.

The case law is not clear about whether the controlling person must actually exercise the ability to control or whether the ability itself may be sufficient to establish liability. Many courts are not hesitant to accept broad theories about control over a debtor. In some cases, a dominant corporation has been found to be liable for the claims against the subservient corporation if the latter corporation is used as the agent or instrumentality of the former corporation for its own purposes. Consequently, intercreditor agreements should not be structured to allow lenders to make decisions or to dictate to a debtor about the management of the debtor or day-to-day business decisions.

Preference problems

A lender's exercise of control over a debtor may have other ramifications in bankruptcy. The Bankruptcy Code empowers the trustee to recover preference payments made by the debtor to most creditors within 90 days of bankruptcy. However, the trustee may recover preference payments to insiders made within one year of bankruptcy. A preference payment is one that is made (1) to or for the benefit of a creditor, (2) for or on account of an antecedent debt owed by the debtor, (3) when the debtor is insolvent, (4) within the applicable 90-day or one-year period, and (5) when the creditor received more than it would without the payment in a Chapter 7 liquidation proceeding.

If it received a preferential payment or transfer, a creditor is protected to the extent that it gave new value to or for the benefit of the debtor. If the debtor is a corporation or partnership, an insider under the Bankruptcy Code includes, "a person in control of the debtor." Consequently, a lender found to be in control of the debtor may be subject to the extended one-year period for the recovery of preference payments. For example, if as part of an intercreditor agreement the debtor agrees that the lenders can veto the debtor's personnel decisions and if the debtor files for bankruptcy, a bankruptcy court may find that the one-year period should be used in considering whether lenders received preferential payments. Lenders should structure intercreditor

agreements to avoid having control over the debtor that may define them as insiders subject to the extended period for consideration of preference payments.

Fraudulent transfers

Intercreditor agreements may require the debtor to pledge substantial assets to secure the lenders or require the debtor to abandon assets or allow lenders to foreclose their security interests. Certain voluntary and involuntary transfers of interests or obligations incurred by the debtor on or within one year of bankruptcy are condemned as fraudulent under the Bankruptcy Code and may be avoided by the bankruptcy trustee. A fraudulent transfer includes any transfer of an interest or any obligation incurred with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted on or after the date of the transfer or the date the obligation was incurred. A fraudulent transfer also includes transactions in which the debtor received less than reasonably equivalent value in exchange for the transfer or obligation and (1) was insolvent on the date the transfer was made or the obligation was incurred or became insolvent as a result of the transaction; (2) was engaged in business or was about to engage in a business or transaction for which any property remaining was an unreasonably small amount of capital; or (3) intended to incur, or believed it would incur, debts beyond the debtor's ability to pay as they mature.

It is important for lenders to evaluate and document the value of the debtor's property before structuring intercreditor agreements or foreclosing on property pursuant to or outside of an intercreditor agreement. To minimize any preference or fraudulent transfer problems, a lender should document clearly that the value of any property transferred or pledged by the debtor is "reasonably equivalent" to the value received by the debtor. With the debtor's consent, a bank may foreclose its security interest and sell the collateral to a third party that leases the collateral to the debtor. The amount that the lender bids for the collateral at the foreclosure sale or the amount for which it sells the collateral is critical. If the lender bid or agreed to sell the collateral for less than its reasonably equivalent value, the transaction may be considered a fraudulent transfer of the debtor's property.

Treatment of Intercreditor Agreements in Bankruptcy

Some intercreditor agreements may be considered to be executory contracts if the debtor files for or is involuntarily put in bankruptcy. The Bankruptcy Code does not define executory contracts, and the case law differs in its definition. A definition accepted by many is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other" (Countryman, Executory Contracts in

Bankruptcy, 57 Minn L.Rev. 439, 460 [1973]). Under certain conditions, executory contracts may be assumed or rejected by the debtor in bankruptcy.

For example, an agreement may require the debtor to establish and maintain financial and operational controls for the benefit of lenders by employing a third party to monitor and report the results of the debtor's operations. Thus, the lenders receive unbiased financial information with independent controls and minimize the risk of allegations of lender control. In the event of bankruptcy, the agreement between the debtor and the third party establishing inventory control may be considered an executory contract and rejected by the debtor. On the other hand, such an agreement may provide the basis for a reorganization or provide adequate protection to the lenders so that the debtor can continue to use the collateral. Consequently, a debtor often will assume such a contract in bankruptcy. Lenders should not overreach in such agreements so the debtor has some incentive to continue the agreement. For example, a lender may want to avoid a catchall provision that if it deems itself insecure, this would be an event of default allowing the lender to pursue its remedies or to terminate the agreement. Intercreditor agreements also may be part of an overall plan of reorganization agreed to by the debtor and the lenders to try to pay the debts outside of bankruptcy. Often, the debtor ends up in bankruptcy after some, but not all, of the creditors agree to the plan. Under certain conditions, the Bankruptcy Code and Rules allow acceptances or rejections of a plan of reorganization to be obtained before the commencement of a bankruptcy case.

Conclusion

Creditors who use a long-term cooperative approach to workouts are more likely to be successful than those that take unilateral action. Creditors and debtor may benefit from intercreditor agreements, but the problems with such arrangements must be considered carefully. The effective use of intercreditor agreements is limited only by the parties' imaginations and willingness to agree.