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SECURED LENDING ALERT

LIEN SUBORDINATION AGREEMENTS

This article explores issues relating to lien subordination agreements customarily employed in commercial loan transactions involving collateral governed by Article 9 of the Uniform Commercial Code (such as accounts, inventory, equipment, chattel paper, etc.).

Lien subordination agreements (also commonly referred to as "intercreditor agreements") are often confused with debt subordination agreements. A lien subordination agreement is an agreement between two (or more) secured creditors whose respective security interests attach to the same collateral. Generally, the subordinating party agrees that its lien is inferior to the lien of the other creditor, notwithstanding the priority that would otherwise prevail under Article 9 of the Uniform Commercial Code (hereafter, the "Code"). By virtue of the lien subordination agreement, the subordinating party's recourse to the collateral in question is typically limited until the senior secured party's claim has been satisfied, subject to negotiated exceptions or qualifications the parties may agree to.

The typical lien subordination agreement usually does not contain a subordination of debt and only affects the priorities in the collateral securing debt. In contrast, a debt subordination agreement generally is an agreement whereby the holder of the junior debt voluntarily postpones its right to payment of the junior debt, until the senior debt has been paid in full, subject to various negotiated exceptions or qualifications.

In certain circumstances, it is appropriate or desirable to also include debt subordination provisions in a lien subordination agreement. This generally occurs when the subordinating party is not another bank or financial institution, but instead an investor, affiliate or some other non-institutional third party who would be willing to subordinate its debt.

A. Establishing The Facts.

The first step in determining whether a lien subordination agreement is necessary is to obtain UCC searches on the borrower in the appropriate offices.

Once a lender determines that another creditor has a potential conflicting security interest in the lender's prospective collateral, the lender can determine whether the other creditor's existing UCC filing is still effective (and as a result, the security interest needs to be subordinated), or whether it is an old UCC filing covering a debt previously paid off and needs to be terminated prior to the closing.

Some potential traps to watch out for in reviewing UCC searches include the following:

1. Don't rely on a summary search by a search company or filing office. Get the full UCC search including all filings, attachments, amendments, etc. so you can fully review and evaluate the search record. It is not prudent to rely on some filing clerk's summarization or interpretation of the contents of a UCC filing or attachment.

2. Be wary of equipment leases attached to a UCC filing. A number of leasing companies attach a copy of a small print lease as an exhibit to the UCC filing, which lease includes a grant of a blanket security interest in all of the debtor's (lessee's) assets buried in the body of the lease. In at least one recent case, the leasing company was held to have a valid blanket lien ahead of a subsequent filed lending institution. This practice is downright sneaky because the face page of the filing does not clearly disclose the blanket lien and many searchers would not expect to find a blanket lien buried in a small print equipment lease.

3. Remember the important basic rule that "accounts" are proceeds of inventory, so that if a creditor has filed ahead of the lender on all "inventory of the borrower, whether now owned or hereafter acquired", that filing also automatically includes "accounts" as proceeds, and will have priority over a subsequent UCC filing covering "accounts" directly.

4. Order an R9 name variation search on the borrower from the search company to find out whether there are any UCC filings against similar names. A UCC search on a debtor may not pick up filings with slight name variations (such as commas, periods, spaces in the name, ampersands, abbreviations, etc.). A review of the name variation search listing may turn up additional filings that need to be pulled for review.

Please also bear in mind when ordering UCC searches that the Secretary of State's office in any particular state does make mistakes from time to time in listing an entity's legal name

either on its web page or on a good standing certificate. The cautious lender will take the extra step of reviewing the filed articles of the debtor (in the case of a corporation, limited partnership or limited liability company) to make sure that the correct legal name of the borrower has been confirmed.

5. Read each filing and attachment carefully to make sure there is no blanket lien or broad or conflicting language anywhere.

6. Remember when reviewing searches that UCC terminations need to be authorized by the secured party of record to be effective. This means either that the secured party of record actually filed the termination itself or authorized another party in writing to terminate its UCC filing. The net effect is if a debtor or other third party wrongfully terminates a secured party's UCC filing, such UCC filing remains effective even though the wrongful termination was filed. This places the burden on the new lender to verify that all prior terminations on the same collateral were in fact authorized by the secured party named in each termination.

Once a lender determines that there is a conflicting UCC filing which requires a lien subordination agreement, the lender should also obtain and review copies of the loan documents or security documents between the borrower and the other secured party so that the lender can understand the terms of the transaction between such parties.

In reviewing this article, please remember that equipment in the hands of a lessor that is either leased by the lessor to a third party or is held for lease is classified as "inventory" under the Uniform Commercial Code, and references to "inventory" in this article include equipment leased by a lessor or held by the lessor for lease (such as motor vehicles, computer equipment and other equipment).

B. Examples of Situations Requiring Lien Subordination Agreements.

Factored Accounts.

On occasion, a borrower will ask a blanket lien lender to allow certain of its accounts to be factored by a third party. If such factoring is permitted by the lender, the lender will need a carefully tailored intercreditor agreement with the factor, as well as appropriate modification of the lender's loan documents with the borrower.

Multiple Lenders on Leases and Leased Inventory.

Another situation occurring frequently which warrants an intercreditor agreement is when multiple lenders are financing for a borrower different leases and leased inventory described in such leases (such as motor vehicles, computer equipment and other equipment) being acquired by such borrower. The highest form of protection which can be built into the intercreditor agreement is a system where each lender signs off on schedules presented from time to time by the other lender, disclaiming an interest in the specific leases and leased inventory described therein. This method will reduce the risk of double financing by the borrower. Of course, this is not always practical, and many

lenders have indicated that they are willing to assume the risk of double financing. In such case, the intercreditor agreement provides that each lender shall have a priority in the specific leases and leased inventory financed by it.

Other Intercreditor Situations.

There are many other factual situations requiring the use of a lien subordination agreement. One in particular worth mentioning is when a revolving lender requires a first priority security interest in all present and future accounts receivable of a borrower, and another lender will maintain a first priority security interest in all other collateral of the lender. The revolving lender should also consider obtaining a first priority security interest in all accounts-related collateral, including payment intangibles (defined in Code Section 9-102 as "a general intangible under which the account debtor's principal obligation is a monetary obligation") and where possible, inventory (or at least, returned inventory). The reason why the lender wants to include payment intangibles is that not all payment streams payable to the borrower would be classified as "accounts" under the Code. The borrower may be entitled to receive payments from contracts or other agreements that are classified as a payable intangible (which is a subcategory of general intangibles).

C. The Statutory Foundation for Lien Subordinations.

1. The Code expressly sanctions the use of lien subordination agreements. Section 9-339 of the Code provides: "This article does not preclude subordination by agreement by a person entitled to priority." The Official Comment adds: "This section makes it entirely clear that a person entitled to priority may effectively agree to subordinate its claim."

2. The Code does not require that a subordination agreement be in writing. All that is required under Section 9-339 of the Code is that an "agreement" to subordinate exist. The Code defines "agreement" as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance...".

Although courts have enforced some subordination agreements based on “oral” agreements or "course of dealing" or “usage of trade”, it is highly desirable for lenders to obtain a comprehensive written lien subordination agreement, in order to provide the protections and benefits that can be derived from a complete written agreement.

Instead of obtaining a comprehensive written agreement, some creditors have included a mere subordination sentence in a UCC Statement or UCC Amendment or a letter. This form of subordination is clearly not adequate to fully protect the senior creditor or junior creditor.

3. The Code does not require the parties to a lien subordination agreement to file a UCC Statement (or amend any existing UCC Statement) to reflect such subordination. That being said, it is still desirable, if the junior creditor has filed first, for the senior creditor to require the junior creditor to amend its UCC Statement to reflect the subordination of its security interest. Sample language would read as follows:

> The Initial Financing Statement is amended to add the following sentence: "The secured party has subordinated its security interest in all collateral described in the Initial Financing Statement [or if not all collateral, specify the collateral in question] to the security interest of (insert name and address of senior creditor) in said collateral pursuant to Lien Subordination Agreement [use title of actual document] dated _____."

The above described filing serves to publicize the alteration of the rights of the parties involved. Possible benefits of such filing may include (a) prevention of a third party's turnover of collateral proceeds to the first to file (being the junior creditor after giving effect to the subordination agreement), and (b) putting potential purchasers of the junior creditor's interest on notice of the subordination. While a purchaser of the junior creditor's position would likely be bound by the provisions of the subordination agreement even in the absence of the UCC amendment disclosing the subordination, such public filing can reduce the possibility of misinformation and potential costly litigation.

While these risks may appear to be remote, if an amendment can be obtained, there is no reason not to obtain one. A well-drafted lien subordination agreement will include a provision requiring the junior creditor to amend its UCC statement(s) to reflect the subordination (or in some cases authorize the senior creditor to amend the junior creditor's UCC to reflect the subordination; although, the junior creditor should be wary of allowing another party from tinkering with its UCC and some pre-approval process for the proposed amendment should be employed).

D. Drafting Considerations.

1. **Description of Collateral**. The definition(s) of the collateral should be clear and precise, and the lien subordination agreement itself should set forth the collateral definitions (and any other defined terms), rather than incorporating definitions contained in the parties' respective security agreements. Moreover, each creditor's collateral description in the subordination agreement should be consistent with the collateral description contained in its security agreement.

If both parties will claim a security interest in the same class or classes of collateral (such as the specific inventory, accounts, or chattel paper each creditor will finance), particular care must be used to identify their respective interests.

2. **Order of Perfection and Effect of Non-Perfection.** The lien subordination agreement should clearly state the parties' intention to have the relative priorities of their security interests controlled solely by the agreement and be unaffected by rules of priority that would otherwise control. Sample language follows:

"The subordinations and priorities specified herein are applicable irrespective of the time, manner, or order of attachment or perfection of any security interests, liens or claims, or the time or order of filing of any financing statements, or the giving or failure to give notice of

the acquisition or expected acquisition of any purchase money security interests or other security interests."

It is crucial, especially for the junior creditor, that the agreement further condition the effectiveness of the subordination(s) contained in the agreement upon the existence of perfected, unavoidable security interests. Sample language follows:

"The subordinations and relative priority arrangements set forth in this Agreement are expressly conditioned on the nonavoidability and perfection of the security interest and/or lien to which another security interest and/or lien is subordinated and if the security interest and/or lien to which another security interest and/or lien is subordinated is not perfected or is avoided for any reason, then such subordinations and other provisions shall not be effective to the extent of any such avoidability or nonperfection."

This provision is important for the junior creditor because if it later turns out that the senior creditor's security interest in unperfected or is avoided in a bankruptcy, the junior creditor's lien will be elevated ahead of the senior creditor, to the extent of such unperfection or avoidability. This provision may also thwart an aggressive bankruptcy trustee's argument that absent such a provision, the trustee's ability to set aside the senior creditor's security interest also means the trustee steps ahead of the junior creditor's security interest due to the subordination agreement.

It is also common to add that each party agrees not to contest the perfection, priority, validity or enforceability of the other party's security interest.

3. **Standstill by Junior Creditor.** The lien subordination agreement should contain a clear and precise standstill provision whereby the junior creditor agrees not to enforce its subordinated lien or rights or otherwise interfere with the senior creditor's security interest. In the absence of a standstill provision, the junior creditor can cause a host of problems for the senior creditor, such as (i) commencing enforcement proceedings of its junior lien, and even though the proceeds will go to the senior creditor, the timing and control of the collateral liquidation may be adverse to the senior creditor, or (ii) challenging the commercial reasonableness of the senior creditor's liquidation, or (iii) seeking to require the senior creditor to marshal assets (discussed in the next section below). The standstill provision is often a heavily negotiated provision.

Of course, the senior creditor will want to have the strongest standstill provision as possible. The strongest provision is one that flatly prohibits a junior creditor from enforcing its security interest in the collateral without the prior written consent of the senior creditor or until the senior debt has been paid in full. This type of provision is typically obtained in transactions where the senior creditor has the greatest leverage (e.g., where the junior creditor is related to the borrower in some fashion, principal, shareholder, family member, affiliate, etc.). A more moderate provision is one that requires the junior creditor to give the senior creditor prior notice of the junior creditor's intended disposition of the collateral (this prior notice requirement typically can range from 15 to 180 days). The longer the notice period the better so the senior creditor can have as much time as possible to weigh its options carefully and either conduct its own disposition or seek other solutions. It is

important that the senior creditor's security agreement contain a default trigger - providing that the senior creditor's receipt of notice from the junior creditor of any notice of intent to foreclose the junior security interest shall be a default under the senior creditor's security agreement). This gives the senior creditor the option to accelerate the senior debt and initiate foreclosure of its security interest, thus, preventing the junior from conducting its own foreclosure.

The lien subordination agreement should also include the junior creditor's agreement that if the junior creditor does enforce its junior security interest, it will first apply the entire net proceeds thereof towards payment of the senior debt, before applying any such proceeds towards payment of the junior debt.

In order to enable a senior creditor to quickly and efficiently liquidate the collateral (and avoid frustrating or losing potential purchasers of the collateral), some senior creditors further require the junior creditor to agree to release its security interest in any collateral disposed of by the senior creditor. This prevents the junior creditor from hindering or blocking the senior creditor's liquidation activities. This type of provision may be resisted by some junior creditors but it is a reasonable provision under certain factual situations.

4. **Waiver of Marshaling and Other Rights.** The lien subordination agreement should also contain a provision whereby the junior creditor waives its rights to marshal the collateral or any portion thereof. Official Comment 5 to Code Section 9-610 recognizes the equitable doctrine of marshaling whereby a junior creditor can request that a court require the senior creditor to first satisfy the senior debt from other collateral in which the junior creditor does not have a security interest or lien in, before resorting to the collateral in which both the senior creditor and junior creditor have a security interest. Unless the junior creditor waives such rights, it can seek to invoke such equitable doctrine of marshaling and attempt to circumvent the priority scheme established by the lien subordination agreement.

The following sample language includes a waiver of a junior creditor's rights to marshal in subsection (a):

"Junior Creditor hereby waives any and all rights to (a) require Senior Creditor to marshal any property or assets of Borrower or to resort to any of the property or assets of Borrower in any particular order or manner, (b) require Senior Creditor to enforce any guaranty or any security interest or lien given by any person or entity other than Borrower to secure the payment of any or all of the Senior Creditor Indebtedness as a condition precedent or concurrent to taking any action against or with respect to the Senior Creditor Collateral, and/or (c) commence any proceedings (whether through the filing of an involuntary petition against Borrower or otherwise) under any bankruptcy, insolvency, reorganization, receivership or similar laws for arrangement of debts of Borrower."

5. **Bankruptcy Provision.** Section 510(a) of the Bankruptcy Code provides that subordination agreements among creditors are enforceable in bankruptcy to the same extent that they are valid in nonbankruptcy situations. The following sample language reinforces this Bankruptcy Code provision:

"This Agreement shall continue in full force and effect after the filing of any petition for relief by or against the Borrower under the United States Bankruptcy Code (the "Code") and all converted or succeeding cases in respect thereof, and shall apply with full force and effect with respect to all Collateral acquired by the Borrower (including the Borrower as a debtor-in-possession, and a trustee for the Borrower), subsequent to such filing."

In addition, language can be included in a lien subordination agreement dealing with a senior creditor's potential desire to permit the use of cash collateral by the borrower or to provide post-petition financing:

"The Junior Creditor agrees that if, following the filing of a petition for relief by or against the Borrower under the Bankruptcy Code, the Senior Creditor shall desire to permit the use of cash collateral by the Borrower or to provide post-petition financing (a) adequate notice to the Junior Creditor shall be deemed to have been provided for such use of cash collateral or such post-petition financing if the Junior Creditor receives notices thereof at least three (3) business days prior to the earlier of (i) any hearing on a request to approve such use of cash collateral or such post-petition financing or (ii) the date of entry of an order approving the same; and (b) no objection will be raised by the Junior Creditor to any such use of cash collateral or such post-petition financing on the grounds of a failure to provide adequate protection for the Junior Creditor's lien. No objection will be raised by the Junior Creditor to the Senior Creditor's motion for relief from automatic stay in any such proceeding to foreclose on, sell or otherwise realize upon the Senior Creditor Collateral."

6. **No Third Party Beneficiaries/Reservation of Security Interests.** A lien subordination agreement is intended to benefit only the senior creditor and junior creditor. Accordingly, the agreement should provide that it is for the benefit of the two creditors only and that it is not for the benefit of the borrower, any guarantor or any other third parties.

A lien subordination agreement also should provide that the two creditors specifically reserve their respective security interests and/or liens, and rights to assert such security interests and/or liens as against the borrower, any guarantor, and all other third parties.

7. **Financial Condition of Borrower.** A lien subordination agreement should charge the junior creditor with the responsibility of keeping itself informed of the financial condition of the Borrower and any guarantors. Sample language follows:

"Junior Creditor hereby assumes responsibility for keeping itself informed of the financial condition of Borrower and any and all guarantors of the Junior Creditor Indebtedness and of all other circumstances bearing upon the risk of nonpayment of the Junior Creditor Indebtedness that diligent inquiry would reveal and Junior Creditor hereby agrees that Senior Creditor shall have no duty to advise Junior Creditor of any information regarding such condition or any such circumstances."

8. **Successors and Assigns/Transfer of Interest.** The lien subordination agreement should provide that it is binding on and inures to the benefit of the parties' successors and assigns. A well-drafted agreement will further contain the parties' agreement that should

either creditor transfer its debt and security interest, it will require as a condition of such transfer, that the transferee execute and deliver to the other creditor a subordination agreement in identical form.

9. **Consent of Borrower.** It is desirable to require the borrower to be a party to the lien subordination agreement, in order to have the borrower contractually agree that it will observe the terms of the lien subordination agreement and not take any action contrary to the terms thereof, such as taking some action which is adverse to the senior creditor under the lien subordination agreement.

This article describes some of the standard provisions contained in lien subordination agreements. However, it is not intended to be a comprehensive summary of all provisions which should appear in lien subordination agreements. Furthermore, there is no "standard" lien subordination agreement which can be employed in any given situation. Each transaction setting is unique, and the lien subordination agreement must be carefully customized to meet the particular facets of each transaction.

This article and all of its contents (including sample provisions) is informational in nature and is not intended to constitute, nor should it be relied upon as, legal advice to any recipient.

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