WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

RECENT CASE INTERPRETING SUBORDINATION PROVISIONS HIGHLIGHTS NEED FOR CAREFUL DRAFTING

A recent unpublished Minnesota appellate court decision involving subordination provisions highlights the need for careful drafting to avoid judicial misinterpretation of the intent of the parties. In First Choice Bank v. Riverview Muir Doran, LLC, No. A09-1337, 2010 WL 2161778 (Minn. Ct. App. June 1, 2010), the Minnesota Court of Appeals held that payments made to a junior creditor from a provider of an accommodation mortgage were subordinated to the claims of the senior creditor even though the intercreditor agreement between the junior creditor and the senior creditor (the "Intercreditor Agreement") appears to subordinate expressly *only* the claims of the junior creditor against the borrower rather than claims against the accommodation party. The court's holding was based upon the "unambiguous" language in the Intercreditor Agreement that stated that the junior creditor could not during any period of default under the senior debt "accept any payments under or pursuant to the Subordinate Loan Documents." The court believed that such language did not distinguish among the various sources of the payments.

The Facts and Decision

First Choice Bank (the "Senior Lender") and Riverview Muir Doran (the "Junior Lender") provided financing to JADT Development Group, LLC (the "Borrower") for a development project. Timothy O. Baylor and Doris P. Baylor (the "Guarantors") also executed a personal guaranty of the Borrower's loan to the Senior Lender. According to the decision, the Intercreditor Agreement between the Senior Lender and the Junior Lender provides, in essence, the following:

(1) The junior debt is subordinate in right of payment to the prior payment in full of the senior debt.

(2) During any period of default on the senior debt, the Borrower will not make any payments under or pursuant to the Subordinate Loan Documents (including but not limited to principal, interest, additional interest, late payment charges, default interest, attorney's fees, or any other sums secured by the Subordinate Security Instruments) without the Senior Lender's prior written consent. ("Payment Prohibition Provision")

(3) During any period of default, the Junior Lender will not ***accept any payments under or pursuant to the Subordinate Loan Documents*** (including but not limited to principal, interest, additional interest, late payment charges default interest, attorney's fees, or any other sums secured by the Subordinate Security Instruments) without the Senior Lender's prior written consent. Any such payments to the Junior Lender are to be held in trust for the Senior Lender. ("Acceptance Prohibition Provision")

(4) Until the principal of, interest on and all other amounts payable under the Senior Loan Documents have been paid in full, the Junior Lender will not, without the prior written consent of the Senior Lender, take additional collateral that is not presently provided for in the Subordinate Loan Documents. ("Collateral Acceptance Prohibition Provision")

(5) The Intercreditor Agreement defines "Subordinate Loan Documents" as the Subordinate Note, the Subordinate Security Instruments and that certain Environmental Indemnification Agreement dated as of the date of the Subordinate Note made by Borrower in favor of Subordinate Lender. "Subordinate Note" is defined as the Second Promissory Note dated as of March 18, 2005, made by Borrower to Subordinate Lender, or order, to evidence the Subordinate Loan. "Subordinate Debt" is defined as the indebtedness evidenced by the Subordinate Loan Documents. We note that the term "Subordinated Debt" does not appear to include any document executed by any accommodation party. Although the court's decision does not provide the definition of "Subordinate Security Instruments", the decision of the lower court provides the definition: "Subordinate Security Instruments" means (i) that certain Combination Second Mortgage, Security Agreement, Fixture Financing Statement and Assignment of Leases and Rents dated as of the date of the Subordinate Note made by Borrower to and in favor of Subordinate Lender and (ii) that certain Pledge and Security Agreement dated as of the date of the Subordinate Note made by Borrower to and in favor of Subordinate Lender. See First Choice Bank v. Riverview Muir Doran LLC, No. 27CV08-25664, 2009 WL 3815387 (Minn. Dist. Ct. June 2, 2009) (Trial Order). The term "Subordinate Security Instruments" does not appear to include accommodation mortgages provided by third parties.

After a default on the junior debt, the Junior Lender sued the Borrower and the Guarantors. Subsequently, as part of a forbearance arrangement, the Borrower caused a mortgage to be delivered to the Junior Lender by JADT Development Group II ("JADT II"). The mortgage contains a clause stating that the Borrower "has agreed to provide additional collateral to secure repayment of the [2005 promissory note]." Payments were made by JADT II to the Junior Lender and were applied by the Junior Lender to the repayment of the junior debt. Pursuant to the terms of the forbearance arrangement, the mortgage was released.

The Senior Lender claimed that the payments made by JADT II were made in violation of the Intercreditor Agreement and were required to be turned over to it by the Junior Lender. In particular, the Senior Lender asserted that the Junior Lender violated the Acceptance Prohibition Provision because it "accepted" payments that were applied to the payment of the junior debt.

The court rejected the Junior Lender's claim that the unambiguous contract language in the Intercreditor Agreement prohibits it only from accepting payments ***from the Borrower*** and does not prohibit the Junior Lender from accepting payments from the Guarantors or collateral from JADT II, a separate entity. The district court concluded that the prohibition contained in the Intercreditor Agreement is framed in terms of the Junior Lender's acceptance of payments on the junior debt. The prohibition on acceptance of payments is not tied to or dependent on the source of the payments.

The court rejected the claims of the Junior Lender that the Intercreditor Agreement was not drafted to prohibit it from receiving any payments whatsoever because the agreement contains no specific prohibition against payment from the Guarantor and the definition of Subordinate Loan Documents does not include guaranties. The court stated that the "Subordinate Loan Documents are those under which payments were required and were made, and a guaranty is a source of payment." The Junior Lender argued that the Payment Prohibition Provision, which clearly prohibits the Borrower (rather than third parties) from making payments when there is a default under the senior debt should be used to interpret whether the Acceptance Prohibition Provision should apply to payments from third parties. The court thought such an argument distorted the actual contract language.

Finally, although the collateral given by JADT II was owned by JADT II (and not the Borrower), the court held that the Junior Lender violated the Collateral Acceptance Prohibition Provision of the Intercreditor Agreement by accepting collateral from JADT II. The court held that the Collateral Acceptance Prohibition Provision applies regardless of whether the Borrower or a third party provides the additional collateral.

Some Observations

This court's decision raises some concern. When senior lenders and junior lenders intend to effect subordination of guarantees or mortgages provided by third parties, they typically do so expressly. The definition of "senior documents" in the subordination agreement will include both the loan documents to which the borrower is a party and the guarantee documents to which the guarantor or accommodation party is a party. Other provisions of the subordination agreement, particularly those that prohibit the borrower from making payments to the junior creditor while a default exists under the senior debt, will also expressly prohibit the guarantors or accommodation parties from making payments during such period. Neither of these provisions appears, according to the decision, to have been included in the Intercreditor Agreement. On the other hand, it is understandable why the court read "accept" as "accept from any person" rather than "accept from the Borrower." Yet the entire issue could have been avoided if the applicable provision had read "accept from the Borrower." In any event, the decision will be a threat to junior lenders only in the scenario in which there is no actual intent to subordinate claims against guarantors or accommodation parties of the junior debt. Often this isn't the case. Claims against every provider of collateral or credit to the junior lender will be subordinated expressly to claims of the senior lender against such persons.

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If you wish to obtain additional information regarding this case or intercreditor and subordination provisions generally, please contact William N. Dye (212-728-8219, wdye@willkie.com), William E. Hiller (212-728-8228, whiller@willkie.com), Leslie M. Mazza (212-728-8245, lmazza@willkie.com), Michael I. Zinder (212-728-8298, mzinder@willkie.com) or the partner with whom you regularly work.

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