Banking & Financial Services Report

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Three's a Crowd: Intercreditor Agreements that Work

-By Benjamin B. Fortkamp

Projects often require multiple sources of credit financing. When they do, a well-drafted intercreditor agreement can save a lot of headaches (not to mention litigation fees) if a dispute over lender priorities arises.

In the past, some lending institutions relied solely on lien priority in the real property and/or UCC records to govern the respective creditors' interests upon default or bankruptcy. In recent years, especially in light of the Great Recession and the losses suffered by supposedly secured lenders, the intercreditor agreement has become an invaluable tool to negotiate priorities and interests among lenders prior to the development of a worst-case scenario. A well-crafted intercreditor agreement will include, in no particular order, the following provisions:

Disbursement

Ambiguity is the enemy of the intercreditor agreement. The agreement should clearly state the manner and timing of all disbursements. With an acquisition-only loan, this will be clear from the onset and should be unambiguous on the HUD-1 settlement statement. If an acquisition-only loan is adequately underwritten and additional capital is still necessary, reflection may be prudent. In a multiple lender scenario, each lender's dispersal requirements should be spelled out in a way that is comprehensible to all parties. The amount and priority of each draw or dispersal should be identifiable on a schedule, and any contingencies should be enumerated. Additionally, the manner of the application of proceeds from a draw or dispersal should be unequivocal. If one lender's funds are to be applied toward acquisition only, and other lender's funds toward construction, it should be clear in the intercreditor agreement.

Insurance, Escrow, and Reserve Accounts

The intercreditor agreement should outline who among the creditors will take the initiative to collect all escrows for taxes and insurance premiums, so that when the bills are due, there is no finger-pointing or inexplicable arrearages. It is in all of the lenders' interests to have the project current on all tax liabili-

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About the Firm

In 2013, for the third consecutive year, Shapiro Sher Guinot & Sandler was named the top medium-size law firm in Maryland for Business & Transactions by Super Lawyers, a division of Thomson Reuters. The firm represents clients in numerous practice areas, including banking, bankruptcy, corporate, real estate, tax, and commercial litigation.

The firm's banking lawyers provide experienced counsel in connection with all aspects of commercial loans. Chaired by **Scott W. Foley**, the firm's **Banking & Financial Services Group** represents regional and community banks, credit unions, finance companies, pension funds, and other financial institutions in Maryland and throughout the Mid Atlantic.

The banking group advises financial institutions in commercial lending transactions; it also advocates for financial institutions in commercial loan workouts, restructurings, and bankruptcy proceedings. Because the group has extensive experience in the origination of loans and in workout situations, it is prepared to provide efficient representation at every stage in the commercial lending process. With decades of experience in the banking industry, Mr. Foley and the firm's other seasoned banking attorneys appreciate the potential hazards facing clients in the commercial loan process, and strive to protect lenders' interests throughout the lifecycle of the loan.

For more information, contact Mr. Foley at SWF@ShapiroSher.com.

-ties and insurance requirements, and while most lenders will defer to the first priority lien holder to collect the same, that may not always be ideal. Lenders may want to consider which lender is holding the operating account of the borrower, so that amounts to be held in escrow, such as tax and insurance payments, can be paid without the borrower's direction. Additionally, if one lender requires reserves or escrow accounts that the other lenders do not, it may want to hold those accounts separately, or simply withhold the reserve(s) from disbursements.

Lien Priorities

While the priority of liens may be spelled out in other loan documents, the intercreditor agreement provides yet another opportunity for lenders to set forth how claims should be prioritized. The agreement will often delineate provisions for the distribution of proceeds following a sale, transfer, or liquidation of the collateral, and can guide lenders in the event of casualty or condemnation. It is also an opportunity to carve out certain collateral that may be necessary to force a junior lender to bring more cash to the transaction to ensure viability. When the alternative is a borrower who will not be able to meet its debt-service requirements and potentially protracted collection litigation, substituting priority for some collateral may be prudent.

Regardless of the motive for the intercreditor agreement, lenders should clearly outline lien priorities, which lender will collect and distribute proceeds, and the order in which lenders receive remaining funds. It may be difficult to gauge from a pre-closing perspective, but lenders can also agree at what point to abandon the project and liquidate assets, or continue with the project and restore any sustained damage. If one lender wants to continue a defaulted or otherwise failed project, the intercreditor agreement should provide for a mechanism to do so.

Notice

Each lender should be well aware of the other lenders' activities with the project and the status of each of their respective loans. This is especially true when dealing with construction/rehabilitation loans, as each draw may be contingent upon one or more lenders' approval. Timely and compliant notice should be given to all parties to the intercreditor agreement whenever an actionable event occurs. Depending on the nature of the project, consider as penultimate events of default, denials or modifications of draw requests, cure standards, and stand-still periods. All notices sent to the borrower should also copy the other lenders and counsel, where applicable.

Among all of the loan documents at closing, an intercreditor agreement may be one of the most instructional in a multi-lender financing project. While the agreement can be tailored to suit the needs of each individual lender, clear and well thought out provisions for disbursement instructions, lien priorities, escrows, and required notices are arguably the most salient sections.

It is important to spell out these provisions with caution, because when the need to decipher the various interests comes to a head, a lender does not want to be at the mercy of a court. If a lender is arguing in court that it should have received notice of another lender's loan dispersal, or that it should have been paid proceeds in advance of another, the intercreditor agreement may have been hastily drafted. It makes much more sense to negotiate these terms well in advance, and avoid the risk and uncertainty of litigation.

Legislative Update: Maryland House Bill 274 and Senate Bill 708

Maryland House Bill 274 and Senate Bill 708 – Both houses of the Maryland legislature are considering similar bills (HB274 and SB708) that, if passed, could adversely affect all lenders, but particularly lenders with residential mortgage portfolios. The bills, which could go into effect as early as July 1, 2014, have two primary features. First, they would shorten the 12 year statute of limitations on certain sealed instruments in loans secured by residential, owner-occupied real property to 3 years. Second, with regard to all loans, the bills would require lenders to file a motion for a deficiency judgment following final ratification of a foreclosure sale within 180 days, down from the current 3-year requirement. Failure to file suit to collect and/or move for a deficiency judgment within these time limits would likely result in a lender being barred from recovering on a debt.