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AVOIDANCE AND TURN-OVER PROVISIONS IN INTERCREDITOR AGREEMENTS

Intended to effectuate the conceptual objective of the parties, avoidance and turn-over provisions common in intercreditor agreements can lead to what may seem as a curious outcome. Should a party to an intercreditor agreement bear a financial loss due to the action (or inaction) of its counterparty? In this piece, the author examines competing views as to how intercreditor agreements allocate the consequences of a senior lien defect and offers alternatives to the status quo.

By David Ebroon *

Commercial lenders financing different tranches of debt to a common borrower typically enter into an intercreditor agreement, which sets forth the relative rights, priorities, and obligations among such lenders. The principal purpose of an intercreditor agreement is to establish the hierarchy of claims and the order of repayment among the lenders prior to, as well as in the event of, a borrower's default or insolvency proceeding.

Senior and junior lenders that have been granted liens to secure the repayment of their loans typically agree that the liens of the junior (or second lien) lender are contractually subordinated to the liens of the senior (or first lien) lender with respect to the proceeds of common collateral, regardless of when such liens arose. As such, if the borrower defaults, the second lien obligations stand behind first lien obligations in terms of the right to

collect proceeds of the common collateral supporting such obligations — a notion referred to as 'lien subordination'.¹

In the context of lien subordination, intercreditor agreements commonly include the following:

¹ Although intercreditor agreements take various forms, lenders may agree that — other than with respect to certain 'permitted payments' (including, most notably, scheduled interest payments) — the senior lender must be paid in full prior to the junior lender receiving any principal repayment of its loan. In the case of a default by the borrower under the senior credit facility, junior lenders would be subject to a 'block' on all such permitted payments. Taken together, these concepts are referred to as 'payment subordination'.

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