

Seventh Circuit Enforces Subordination Agreement: Junior Lender Must Disgorge Payments, Pay Prejudgment Interest

In *PPM Finance, Inc. v. Norandal USA, Inc.*, 392 F.3d 889 (7th Cir. 2004), the Seventh Circuit recently upheld the enforceability of a subordination agreement that provided that a Junior Lender must disgorge approximately \$3.8 million in subordinated note payments (the “Sub-Note Payments”) it received from a debtor in default to a Senior Lender. (Lord Bissell & Brook LLP represented the Senior Lender.) The Court found that the subordination agreement required disgorgement, even though: (i) the Senior Lender did not give notice to the Junior Lender that the common debtor was in default; (ii) the Senior Lender could have stopped the debtor from making the payments to the Junior Lender; and (iii) the Senior Lender made revolving loan advances that allowed the debtor to make the to-be-disgorged payments to the Junior Lender. In addition, the Seventh Circuit upheld an award to the Senior Lender of approximately \$684,000 in prejudgment interest on the disgorged payments.

The Subordination Agreement required the Junior Lender to disgorge any payments it received from a Common Debtor while the Common Debtor was in default to the Senior Lender. The Common Debtor ended up defaulting on its obligations to the Senior Lender. Despite these defaults, however,

the Senior Lender continued to make loans to the Common Debtor under a revolving credit agreement, knowing that the Common Debtor used some of the funds to make Sub-Note Payments to the Junior Lender.

In November 2002, more than one year after the beginning of the Common Debtor’s chapter 11 case, the Senior

[T]he Seventh Circuit refused to “read in” additional terms into the Subordination Agreement that the parties had not written themselves.

Lender sued the Junior Lender to recover the Sub-Note Payments. The district court granted the Senior Lender’s motion for summary judgment, finding that the subordination agreement unambiguously required the Junior Lender to remit the Sub-Note Payments to the Senior Lender. The Seventh

Circuit affirmed, rejecting the Junior Lender’s largely equitable arguments as being contrary to the Subordination Agreement.

AGREEMENT TO DISGORGE PAYMENTS ENFORCED

In a dispute about a subordination agreement, the first step under Illinois law is to determine whether the agreement is “subject to more than one reasonable interpretation.” The Junior Lender, arguing that the Subordination Agreement was ambiguous, asked the Court to read additional obligations into the Subordination Agreement. Specifically, the Junior Lender

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riers can magnify this risk in cases of offshoring.

Credit Risk. Finally, there are credit risks involved if the third party fails to meet its obligations, or becomes insolvent. As with other risks associated with outsourcing, this risk can be greater when outsourcing services are performed offshore.

The federal banking agencies also have noted the increased privacy concerns associated with outsourcing, particularly when dealing with third party contracting arrangements overseas. The Gramm-Leach-Bliley Act establishes continuing obligations with respect to monitoring customer privacy and protecting customer personal information. The federal banking agencies have taken this to mean that banks also are obligated to monitor the activities of those service providers to which banks transfer customer information. Furthermore, the agencies recommend that banks that outsource data to vendors should also be aware when those vendors have in turn subcontracted with a third party.

WAYS TO MINIMIZE THE RISKS OF BANK OUTSOURCING

The federal banking agencies recommend that a bank perform adequate due diligence prior to entering into a contract with a third party service provider overseas. Moreover, banks are advised to pay close attention to contract provisions which gov-

ern choice of law and forum selection. Provisions regarding privacy and confidentiality of bank records should be included in offshoring contracts.

The federal banking agencies have indicated that they will examine an institution’s outsourcing arrangement with foreign third party service providers if circumstances warrant. The agencies note that if the service provider is a regulated entity, then a regulator may arrange through the appropriate foreign supervisor to obtain information related to the services provided, and if significant issues emerge to examine those services.

The federal agencies also place responsibility on the bank’s board of directors and management to ensure that the bank effectively oversees any relationships with foreign third party service providers. The agencies recommend, and in some instances require, ongoing oversight by the board of third party service providers.

While banks are increasingly looking to reap the rewards of outsourcing, it is important that banks stay abreast of (and take effective steps to address where appropriate) the legal and compliance risks associated with third party relationships, both in the U.S. and overseas.

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the SAR may not be the only evaluation required. Some issues may be unresolved, and some new questions may arise from information revealed in the SAR. In addition, the lender or its consultant may have good cause to believe that the SAR did not address certain key issues; it is not uncommon for consultants to occasionally disagree about what is necessary to complete an evaluation. Perhaps the SAR did not cover groundwater contamination for adjacent lots. If the lender is

uncomfortable financing the risk without the information, the lender may require additional evaluation.

In the next issue of the Lord Bissell & Brook *Banking & Bankruptcy Law* Newsletter, we will take a look at environmental insurance, another method by which lenders can mitigate the risk of loans related to brownfield sites.

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asserted that the Senior Lender was under an obligation to notify the Junior Lender of the Common Debtor's default. Because the Senior Lender failed to give such notice, the Junior Lender argued, the Senior Lender was barred from recovering the Sub-Note Payments under the Subordination Agreement.

Finding the Subordination Agreement unambiguous, the Seventh Circuit refused to "read in" additional terms into the Subordination Agreement that the parties had not written in themselves. Notably absent from the Subordination Agreement was a senior default notice provision. In fact, the Court found that "nothing in the subordination agreement required [the Senior Lender] to notify [the Junior Lender] of [the Common Debtor]'s default." 392 F.3d at 893. Because the Senior Lender had no obligation to notify the Junior Lender of the default, and the Subordination Agreement also clearly provided that the senior debt must be paid in full before payments could be made on the subordinated debt, the Senior Lender had a right to recover the Sub-Note Payments from the Junior Lender.

RIGHT TO DISGORGE NOT WAIVED

The Junior Lender also argued that the Senior Lender waived its right to disgorge payments from the Junior Lender by providing post-default loans to the Common Debtor, part of which the Common Debtor, in turn, used to pay the Junior Lender, even though the Common Debtor had defaulted under its Credit Agreement with the Senior Lender.

The Seventh Circuit concluded that the Senior Lender's issuance of the post-default loans to the Common Debtor did not constitute a waiver of its right to disgorge the Sub-Note Payments from the Junior Lender for two reasons. First, the Subordination Agreement contained a broad anti-waiver provision that required any waiver to be in

writing and signed by the parties. Finding the anti-waiver provision enforceable, and that the parties had not entered into a written waiver, the Court rejected the Junior Lender's waiver argument.

Second, the Court found that "[the Senior Lender]'s post-default loans to [the Common Debtor] were not inconsistent with its later efforts to recoup that money [from the Junior Lender] pursuant to the agreement." *Id.* at 895. The Court relied on a section of the subordination agreement that explicitly authorized the Senior Lender to make additional loans without affecting either party's obligations under the Agreement.

PREJUDGMENT INTEREST AWARDED

The Illinois Interest Act provides that a creditor shall be awarded interest at the rate of five percent per year for all moneys after they become due on any "instrument of writing." 815 ILCS 205/2 (2002). Finding the Subordination Agreement to be an "instrument of writing," the Seventh Circuit upheld the district court's award of approximately \$684,000 in prejudgment interest to the Senior Lender.

CONCLUSION

When negotiating and drafting a subordination agreement, senior lenders should pay heed to the Seventh Circuit's helpful guidelines and:

- ◆ Identify all substantive rights and duties of the parties clearly in the subordination agreement.
- ◆ Include a broad anti-waiver provision.
- ◆ Provide that advancing additional loans to a debtor, even a debtor in default, does not alter the respective rights or obligations of the senior and subordinated creditor.
- ◆ Be aware of state statutes that award prejudgment interest.

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