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Secured Real Estate Financing: Inter-Creditor Agreements - A Standstill With A Time Limit Is Not A True Standstill

Date: March 01, 2017
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Original Newsletter(s) this article was published in: Blaneys on Business: March 2017

When developing real property, sometimes it is necessary for a borrower to obtain funds from more than one lender. Where this happens, a priority structure likely will be created among the lenders participating in the transaction. Often times, on the insistence of the lender in top priority position (the “prior lender”), a ‘priority’ or ‘subordination’ agreement will be required from any “subordinate lender" who ranks behind the prior lender.

The main provisions in this type of agreement are the following:

1. the subordination by the subordinate lender in favour of the prior lender of the subordinate lender’s security interest in the property; and

2. the postponement by the subordinate lender in favour of the prior lender of its right to be repaid (i.e. the subordinate lender agrees that it cannot be repaid on its loan until the prior lender’s loan is repaid).

One of the key issues addressed in this type of agreement is what happens when the borrower defaults. The lenders may agree, for example, that they will give each other notice of default by the borrower and an opportunity to cure the default. A recent typical requirement of a prior lender respecting default by the borrower is that the subordinate lender not take any enforcement action without the prior lender’s consent. In other words, the subordinate lender has to “stand still” and wait to see what the prior lender will do.

Types of enforcement action would include issuing demand notice or intention to enforce security, appointing a receiver or manager, commencing power-of- sale proceedings or taking possession of the property.

From the prior lender's perspective, if the borrower is in default, the prior lender wishes to be in control and does not want the subordinate lender, or anyone else for that matter, to dictate what enforcement actions will be taken. The prior lender therefore requires a standstill agreement from the subordinate lender.

The subordinate lender, on the other hand, may not want to wait for an indefinite period before being entitled to take some enforcement action. For example, if the prior lender were to do nothing for an extended period of time after default, this might prejudice the subordinate lender by reason of the accumulation of interest on both loans or other amounts that come due. So, sometimes the subordinate lender will request that a time limit be applied to the standstill provisions (e.g. 90 days). If there were a time limit in place, however, then the prior lender could potentially lose control of enforcement proceedings once the time was up. So, the standstill without a time limit (i.e. a "true" standstill) is not a position the prior lender should relinquish easily.

If necessary, one way for a prior lender to compromise in this type of situation is to include a provision along the following lines:

"If the prior lender fails to initiate any enforcement action within ninety (90) days after the delivery of a notice of default under the subordinate lender's security, the subordinate lender may take any and all such actions without the prior lender's consent provided that it gives prior written notice to the prior lender specifying the proposed enforcement action to be taken by the subordinate lender".

This language is different than language that simply states that the standstill period ends 90 days after default, which would entitle the subordinate lender to enforce on its security any time thereafter regardless of what, if any, enforcement action the prior lender had taken. Instead, under this proposed language, if the prior lender receives notice from the subordinate lender that there has been default under the subordinate lender's security (which, of course, would also amount to a default under the prior lender's security), then the prior lender can wait 89 days before commencing any enforcement. And, if the prior lender does commence enforcement within such 90 day period, then the subordinate lender must remain in standstill mode.

Whether or not any kind of compromise to the true standstill agreement is agreed to by the prior lender will depend on, among other things, the type of subordinate loan involved. Generally, the closer the subordinate loan is to "subordinated equity" (e.g. a loan from a borrower-related entity), the less likely it is that the prior lender should agree to any compromise.

Other issues addressed in the priority and standstill agreement may include the following:

1. How much of the prior lender's loan ranks ahead of the subordinate lender's loan?

2. Are there rights to cure defaults? i.e. can a lender cure a borrower's default under the other lender's loan?

3. What are the repayment rights among the lenders? i.e. can a lender repay the other's loan when such lender has issued a demand notice to the borrower for full repayment?

4. Is the subordinate lender entitled to receive interest or any other payments/fees from the borrower while the prior loan is still outstanding?

5. What type of enforcement action is captured by the standstill provisions? e.g. can the subordinate lender issue demand notices without the prior lender's consent?

Because there is typically much to negotiate among the lenders when a priority structure is in play, it is important to start working on this type of agreement at the outset of a real estate financing transaction. The borrower should also be a party to a priority and standstill agreement, if only to acknowledge its terms.

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