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Be Careful Defining Subordinated Debt

If you're like most lenders these days, you'd like to have your debt repaid before any "related party" debt gets repaid. Let's suppose that you want to make a loan to ABC Company, which is currently indebted to its owner, John Smith, based on a loan John Smith made to ABC Company a few years ago. The loan agreement between you and ABC Company should contain a negative covenant prohibiting ABC Company from repaying any "related party" debts until the 91st day after your loan has been paid and satisfied in full[1]. To establish privity of contract with John Smith (so that you could sue him for any debt repayment he received in violation of the loan agreement's negative covenant), many lenders would require that John Smith enter into an "affiliate subordination agreement" with the lender. Such an agreement should define "subordinated debt" as any debt, liability, or obligation now existing or hereafter arising between the borrower (i.e., ABC Company) and the related party (i.e., John Smith) and specify that any and all "subordinated debt" shall be subject and subordinate to your loan—in payment, priority, collection, and in all other respects. You need not describe any existing "related party" debt with specificity in the affiliate subordination agreement, and to do so might be seriously detrimental to your position. Last month, the United States Bankruptcy Appellate Panel for the First Circuit confirmed the importance of broadly defining "subordinated debt" within a subordination agreement.

In *Riviera, et al. v. DCC Operating, Inc.*, the court concluded that a loan made to a company by an officer of the company after the date on which the company had entered into financing arrangements with its senior lender, was effectively subordinated to the senior lender's financing because "subordinated debt" was broadly defined within the applicable subordination agreement— effectively including existing debt, as well as later-incurred debt of the company. The officer argued that the subordination agreement was intended to address only existing debt owing to an officer of the company—not debt later incurred by the company to an officer thereof. The court disagreed with that argument—particularly since, at the time when the subordination agreement was first executed, no debt was then owing by the company to any of its officers.

[1] Although most lenders would require a 91-day period as a cushion to avoid preference issues, you should consider requiring the maturity of subordinated debt to be at least 6 months (or maybe one year) after your scheduled maturity date so that the subordinate debt does not hinder the ability to obtain take-out financing of your loan.

To subscribe to this newsletter, or if you would like more information on this topic or any other lending matter, please contact Matt Bergman (202-775-4722) or (BergmanM@dsmo.com).

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