In Case of First Impression, Illinois Appellate Court Holds That Senior Lender's Material Breach of Intercreditor Agreement Warrants Partial Subordination of Senior Debt

Intercreditor agreements are commonly used to define the relative rights of senior and junior lenders, especially should the borrower become distressed or file bankruptcy. Properly defining priorities between lenders is particularly important when both parties possess security interests in the same collateral because such agreements dictate which party is repaid first from the proceeds of the collateral upon enforcement of the lien and which party controls enforcement rights against the borrower and the collateral.

But what happens when the senior lender breaches the intercreditor agreement? Can the senior lender's entire position be subordinated to the junior lender as a result? In an interesting case of first impression in Illinois, the Illinois Appellate Court recently utilized equitable considerations to resolve such a dispute between parties to an intercreditor agreement.

In *Bowling Green Sports Ctr., Inc. v. G.A.G. LLC,*[1] borrower received a $3.4 million loan from senior lender and a $405,000 loan from junior lender. Senior lender and junior lender executed an intercreditor agreement whereby junior lender agreed that senior lender would be paid before junior lender, and that junior lender would not sue to recover its debt or seek to enforce its liens until borrower repaid senior lender in full. Senior lender agreed that it would not modify the terms of its loan or amend its loan documents without junior lender's consent. The intercreditor agreement also contained a potentially contradictory provision stating that the rights of senior lender thereunder would remain in full force and effect regardless of any change in terms relating to the senior lender's loan. Notwithstanding the provisions of the intercreditor agreement, senior lender subsequently modified its loan documents to increase the size of the senior loan by an additional $51,000 without obtaining the consent of junior lender.

Junior lender later filed a breach of contract action against borrower to recover its debt, despite the fact that the borrower still owed senior lender almost $2 million, contending that the intercreditor agreement was unenforceable as a result of the senior lender's breach. Senior lender filed a motion to dismiss junior lender's complaint, contending that, pursuant to the intercreditor agreement, junior lender's complaint was barred because junior lender had agreed not to sue borrower to recover its debt until senior lender's indebtedness was paid in full. Senior lender further asserted that its alleged breach of the intercreditor agreement was immaterial because the agreement provided that it was enforceable under all circumstances. The trial court dismissed junior lender's complaint with prejudice, finding that the intercreditor agreement precluded the junior lender from suing to collect until the senior lender had been paid in full, despite the senior lender's "material breach" of the agreement.

On appeal, the Second District Appellate Court rejected the arguments of both parties and held that although the intercreditor agreement remained effective, the $51,000 loaned by senior lender without the consent of the junior lender in violation of the agreement was to be subordinated to the debt owed to the junior lender. Although Illinois courts had yet to address this issue, the court noted that other states uniformly hold that consent from a junior lender is required where a modification of the senior lender's loan "prejudices the rights or impairs the security of any junior lender." A senior lender's failure to obtain such consent results in a modification being ineffective as to the junior lender and the senior lender relinquishing its priority with respect to the modified terms. Where the senior lender's actions have "substantially impaired" the junior lender's security interest, a court may *wholly divest* the senior lender of its priority status.

After considering decisions from other states where a senior lender's conduct had "substantially impaired" the security interest of a junior lender,[2] the appellate court held that the 1.5% increase in senior lender's loan was not a "materially significant" factor in borrower's subsequent inability to repay junior lender. Borrower still owed senior lender over $1.9 million, and the relatively slight increase in the senior loan did not "substantially impair" junior lender's rights as a junior lender and lienholder. As such, the court rejected as inequitable junior lender's argument that senior lender's failure to obtain the junior lender's consent to the increased senior loan warranted subordination of senior lender's entire debt. Instead, the appellate court opined that the minimal impairment to junior lienholder's rights could be remedied by denying senior lender priority only as to the incremental $51,000 loan. The court then affirmed the trial court's dismissal of the junior lender's suit, allowing junior lender to pursue recovery from borrower only after the outstanding principal on senior lender's loan to borrower was reduced to $51,000.

In *Bowling Green* the Illinois Appellate Court agreed with the view of certain other courts that, while appropriate only in "rare" cases, a senior lender's debt can be wholly subordinated if the senior lender substantially impairs the position of the junior lender by modifying the terms of the senior loan without junior lender consent (at least in the absence of intercreditor agreement provisions explicitly allowing such modification).

While the facts in *Bowling Green* warranted only partial subordination, senior lenders should be mindful of the risks of modifying senior loan terms without lender consent, or of materially breaching the terms of their intercreditor agreement.

For More Information

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1 2017 IL App (2d) 160656.

2 In *Koloff v. Reston Corp.*, 1993 WL 106062, the Delaware Court of Chancery rearranged priorities between senior and junior lenders where the senior lender had increased its loan to borrowers by more than nine times the original amount (from $2.2 million to $20 million) without junior lender's permission. In *Gluskin v. Atlantic Savings & Loan Ass'n*, 32 Cal. App. 3d 307 (Cal. Dist. Ct. App. 1973), the Court of Appeal of California, Second District, rearranged priorities between a senior and junior lienholder where the senior lender had substantially impaired the position of the junior lender by significantly reducing the face value of the loan, increasing the interest and shortening the maturity of the note from 30 years to 10 months.