New York Law Journal
Corporate Update
WWW.NYLJ.COM
An ALM Publication
VOLUME 249—NO. 64
THURSDAY, APRIL 4, 2013

SECURED TRANSACTIONS

Circular Lien Priorities: Tackling Three-Party Subordination

By
Alan M. Christenfeld
And
Barbara M. Goodstein

Lien subordination agreements are common in commercial transactions. Section 9-339 of the Uniform Commercial Code (UCC) generally permits a secured creditor with a prior security interest to subordinate such priority by agreement. Today we discuss the priority issues that can arise where three or more creditors claim a security interest in the same collateral and a recent Seventh Circuit case, *Caterpillar Financial Services v. Peoples National Bank*,[1] that discusses this infrequently-adjudicated problem.

Background

When two creditors with perfected security interests seek to agree on their relative lien priorities on common collateral and no other perfected security interests in that collateral exist, §9-339 is fairly straightforward. The analysis becomes more complex, however, when there is another secured creditor who will not be party to this agreement. The Official Comments to §9-339 make a pointed, and one might think obvious, remark that "a person's rights cannot be adversely affected by an agreement to which the person is not a party." In fact, many parties to lien subordination agreements fail to consider adequately the rights of other secured creditors in common collateral or recognize that courts may disagree on the effects of a lien subordination agreement on those intervening security interests.

Professor Grant Gilmore, one of the principal architects of the UCC, devoted an entire chapter of his seminal 1965 secured transactions treatise to problems created by circular lien priorities.[2] At the outset of that chapter, he distinguished a situation that he described as not involving "true circularity" at all: one in which three creditors, A, B and C, have security interests in the same collateral, with each entitled to priority in alphabetical order, and where A agreed with C to subordinate its lien in favor of C. Gilmore wrote that, if the proceeds of the collateral were insufficient to pay all three creditors in this situation, a portion of the proceeds would be paid to C (to the extent C's claim did not exceed A's), then B would be paid, unless A's claim exceeded C's, in which case A would be paid an amount equal to such excess prior to B being paid.[3] This result, which Gilmore said is "well-settled," has since been characterized as "partial subordination."[4] In partial subordination, as described above, the subordinating creditor and the other creditor essentially switch positions. The effect is the same as if A had assigned its position to C in an amount equal to the lesser of A and C's debt.

Despite Gilmore's endorsement of partial subordination, some courts have adopted a different approach that has been called "complete subordination." In complete subordination, A goes to the back of the line, and B and C each step up ahead of A, but C remains junior to B. Courts following the complete subordination rule have tended to focus (perhaps unduly) on the term "subordination."[5]

The leading decision in support of the "complete subordination" approach is *AmSouth Bank v. J&D Financial*.[6] In that case, the Alabama Supreme Court stated that "by definition, subordination contemplates a reduction in priority. Nothing in the definition contemplates raising a lower priority lienholder up to the position of the subordinating party."

ALAN M. CHRISTENFELD *is senior counsel at Clifford Chance.* BARBARA M. GOODSTEIN *is a partner at Mayer Brown.* JOHN LAWLOR, *a partner at Mayer Brown, assisted in authoring this article.*

The *AmSouth* court did suggest that if the senior creditor in that case had actually agreed to assign its senior claim to the junior creditor (or if the junior creditor had been subrogated by agreement to such claim), the resulting priority would have been different.[7]

The Official Comments to §9-339 make a pointed, and one might think obvious, remark that "a person's rights cannot be adversely affected by an agreement to which the person is not a party."

'Caterpillar'

Caterpillar, which the U.S. Court of Appeals for the Seventh Circuit decided exactly one month ago, was a diversity jurisdiction case governed by Illinois law. It involved a priority dispute among three secured creditors, only two of which were parties to a lien subordination agreement. The court examined whether to apply the rule that would achieve the result that Gilmore described as well-settled (i.e., the partial subordination rule) or the alternative rule (i.e., the complete subordination rule) to allocate proceeds of collateral upon enforcement.

In *Caterpillar*, there were three different secured loans to one debtor, S Coal, a coal company located in southern Illinois: (1) a $4 million loan made in 2005 from Peabody Energy (creditor A); (2) a $7 million loan made in 2006 from Caterpillar Financial Services (creditor B); and (3) a $1.8 million loan made in 2008 from Peoples National Bank (creditor C). Each loan was secured by the same mining equipment, and each creditor filed a UCC financing statement at the time of its respective loan. S Coal defaulted on all three loans.

At the time of the 2008 loan from C, C had negotiated a lien subordination agreement with A whereby A agreed to subordinate the priority of its security interest to C's security interest to permit the loan from C to be made and thereby bolster S Coal's financial condition. B was not party to this subordination agreement. Following S Coal's default, C foreclosed and sold the mining equipment for $2.5 million. After using the foreclosure sale proceeds to pay off its outstanding debt of $1.4 million, C sent B a check for the balance of the sale proceeds ($1.1 million). B then sued C in the U.S. District Court for the Southern District of Illinois, accusing C of (among other things) having converted the foreclosure sale proceeds in contravention of B's senior security interest. C claimed that it had a superior interest in the collateral by virtue of the lien subordination agreement. The district court found C liable for conversion due to C's inability to produce a copy of the security agreement purportedly executed by S Coal in favor of A (the first position creditor that had subordinated its security interest to C).[8]

The district court decision did not discuss the lien subordination agreement in detail. On appeal, however, the Seventh Circuit focused on "how a subordination agreement affects priorities if the agreement does not say." The Court of Appeals identified as the two possible choices (1) the partial subordination rule, which it described as the majority approach, under which the parties to the lien subordination agreement would simply swap their priorities (to the extent of the smaller of the swapping parties' debt); and (2) the minority "complete subordination" rule, whereby the subordinating creditor would drop to the back of the line. If the complete subordination rule had applied in *Caterpillar*, the order of priorities would have been (1) B, (2) C and (3) A, which the Seventh Circuit found made little sense: Why would the first- and third-priority creditors enter into a lien subordination agreement that made the second-priority creditor, which was not a party to the agreement, first?

Writing for a unanimous Court of Appeals panel, Judge Richard Posner supported application of the partial subordination rule, which would have resulted in the following order of priority: (1) C, (2) B and (3) A. In endorsing partial subordination, the court relied heavily on the fact that the middle creditor B (here, Caterpillar) was unaffected by the lien subordination arrangement between creditor A (Peabody) and creditor C (People's National Bank). But—and this qualifies as a really big "but"—the court determined that A's security interest was unenforceable. Despite having filed a financing statement, Peabody did not have a security agreement, authenticated by S Coal and providing a description of the collateral, as required by UCC §9-203(b)(3)(A). The court therefore held that, because People's claim for a first priority security interest was derivative of Peabody's security interest, and Peabody's security interest was unenforceable, People's lien could not jump ahead of Caterpillar's prior perfected security interest.

Observations

The decision in *Caterpillar* prompts a number of observations:

• The partial subordination rule sensibly allocates lien priorities consistently with the expectations of the creditors that are parties to the lien subordination agreement without harming any lienholder that is not a party to the subordination agreement. It harmonizes with Official Comment 2 to UCC §9-339, which states that a lien subordination agreement may not adversely affect the interest of any creditor that is not a party to the agreement.

The Seventh Circuit said that B's security interest would be "unaffected" by a swapping of lien priorities between the first and third lien creditors since such swap would be limited to the smaller amount of the secured debt of the two swapping creditors. In other words, after giving effect to the lien subordination agreement, B's security interest would be subordinate to the same amount of first priority secured obligations as would be the case if there were no subordination agreement.

• Although *Caterpillar* endorsed (correctly, in the authors' view) the partial subordination rule, it did so in dictum since the unenforceability of Peabody's security interest rendered application of the rule moot. This technicality does not, however, diminish the persuasiveness of the court's reasoning for favoring the partial, rather than the complete, subordination approach.

• *Caterpillar* is generally supportive of lien subordination agreements. The decision nevertheless suggests several areas of caution. For example, a junior secured creditor hoping to use a lien subordination agreement to elevate to a senior secured position should understand that its ability to do so is only as good as the senior creditor's security interest. Since the junior creditor stands in the shoes of the subordinating senior creditor, any defect in the senior creditor's security interest, whether in place initially (such as the failure to authenticate a security agreement, to describe the collateral adequately or to perfect the lien) or that may arise thereafter (such as a lapse in perfection due to a failure to timely amend a financing statement following a debtor's name change or a failure to continue a financing statement before it expires), can thwart the junior creditor's intention to move up in line.

• Although a junior creditor theoretically could mitigate the risk that a senior creditor's security interest has fatal defects by getting robust representations and warranties from the senior creditor, in practice senior creditors, especially financial institutions, reflexively refuse to make such representations and warranties. It is in the interests of the junior creditors as well as their counsel (who, for obvious reasons, would like to avoid unhappy clients) to ensure that appropriate diligence on the senior lien be performed before credit is extended in reliance upon the lien subordination. It is advisable, in particular, that a copy of the security agreement creating the first security interest be reviewed and that the current perfection of that senior lien be verified.

• Creditors who desire to enter into a lien subordination agreement should also be aware that complete subordination, though a minority rule, may be applied, depending on which jurisdiction's law governs priority. UCC §9-301 provides that the law of the debtor's "location" generally governs the priority of a security interest in collateral, and under UCC §9-307, a debtor that is a registered organization is "located' in its jurisdiction of organization. Thus, in cases involving more than two secured creditors where complete subordination may apply because the debtor is located in a jurisdiction that has adopted that rule, parties to a lien subordination agreement may wish to buttress the lien subordination by including in the agreement an express assignment of the subordinating creditor's secured claim. Better yet, if the common debtor is to be a newly-formed special purpose entity, the creditors may wish to ensure that they will be subject to partial subordination rather than complete subordination by requiring the debtor to be located in a jurisdiction that applies the majority partial subordination rule.

Conclusion

Caterpillar is an interesting case that brings circular priority—a topic usually relegated to law school exams—into the real world. Although it supported the majority "partial subordination" rule, the creditor seeking priority via a lien subordination agreement nevertheless failed to achieve that result because of fatal flaws in the subordinating creditor's lien. The case thus brings into stark focus a theme emphasized many times in this space—the need for creditors to conduct appropriate diligence before making loans. Although the matter to be investigated in *Caterpillar* was the lien of another creditor rather than the status or assets of the debtor, the omission of this essential step proved just as fatal.

1. 2013 U.S. App. Lexis 4366 (7th Cir., March 4, 2013).
2. G. Gilmore, Security Interests in Personal Property §39.
3. Id. at §39.1. Gilmore examined the following hypothetical: A, B and C have claims against debtor X or his property which are entitled to priority in alphabetical order: the classical example is that of first, second and third mortgages on Blackacre. A subordinates his claim to C's. There is a comforting unanimity, among courts and commentators, on the proper distribution of the fund:

 1. Set aside from the fund the amount of A's claim.

 2. Pay the amount so set aside to

 a) C to the amount of his claim;

 b) A, to the extent of any balance remaining after C's claim is satisfied.

 3. Pay B the amount of the fund remaining after A's claim has been set aside.

 4. If any balance remains in the fund after A's claim has been set aside and B's claim has been satisfied, distribute the balance to

 a) C

 b) A.

 Thus C, by virtue of the subordination agreement, is paid first, but only to the amount of A's claim, to which B was in any event junior. B receives what he had expected to receive: the fund less A's prior claim. If A's claim is smaller than C's, C will collect the balance of his claim, in his own right, only after B has been paid in full. A, the subordinator, receives nothing until B and C have been paid except to the extent that his claim, entitled to first priority, exceeds the amount of C's claim, which, under his agreement, is to be first paid. (citations omitted).

But see G. Nation, "Circuity of Liens Arising from Subordination Agreements: Comforting Unanimity No More," 83 B.U. L. Rev. 591 (2003).

4. See G. Nation, Circuity of Liens, supra note 3, at 594.
5. Id. at 595-97.
6. 679 So. 2d 695 (Ala. 1996). See also *Old Stone Mortgage & Realty Trust v. New Georgia Plumbing*, 236 S.E.2d 592 (Ga. 1977).
7. *AmSouth*, 679 So. 2d at 698, n.3 ("We note that there was no assignment or subrogation agreement in this case. Had there been, the resulting order of priority would have been different.").
8. *Caterpillar Fin. Servs. v. Peoples Nat'l Bank*, 2012 U.S. Dist. LEXIS 89427 (S.D. Ill., June 28, 2012).