

Priorities Matter – But That's Not All That Matters!

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By

Often, when the parties to a financing are discussing priorities or intercreditor arrangements, there tends to be a simplistic view taken of these agreements. Once the competing creditors have sorted out their respective priorities over the various pools or types of collateral, they tend to think that the terms of the agreement are essentially settled and simply need to be put into writing.

Intercreditor or priorities agreements are typically not that simple. Clearly, establishing each creditor's respective priority over the debtor's various assets is critical. However, as a practical matter, a failure to consider and address other factors relevant to the debtor could easily thwart a creditor's ability to successfully recover on its loan, should the lender need to enforce its rights and security in a default scenario.

Consider a situation where Lender A and Lender B both have loans outstanding to the same debtor (the "**Borrower**"). Lender A is the operating lender to the Borrower. Lender B is the term lender to the Borrower. In this case, let's assume that the Borrower is in the business of manufacturing patio furniture, formed from plastic resin in the Borrower's manufacturing facility. One of Borrower's furniture lines, manufactured under a popular designer's name through a licensing arrangement, has become increasingly popular. While both lenders have taken a security interest over all of the Borrower's property and assets, the Lenders have agreed that Lender B will rank in priority to Lender A over all equipment of the Borrower and that Lender A will rank in priority to Lender B over all other assets of the Borrower (including accounts receivables and inventory). The Lenders have reached agreement as to permitted payments prior to default and they've agreed as to the "waterfall" of payments to be made with any proceeds of enforcement. So, having established their relative priorities, you would think that the Lenders are now protected in a default scenario – right?

While the respective priorities have been agreed to, a prudent Lender will always take into account other considerations to facilitate, and maximize its chances for recovery. For example, Lender A (having priority over inventory and receivables) should consider building into the priorities agreement a usage provision that allows Lender A to use Lender B's priority collateral, the equipment used to manufacture the patio furniture, for a sufficient period of time so as to allow Lender A to convert raw materials (ie. plastic resin) into finished goods (ie. patio furniture pieces). Needless to say, Lender A's prospects of recovery are materially enhanced if it is liquidating finished inventory (finished patio furniture) as compared to selling containers filled with plastic resin! Equipment financiers are often open to such "usage" clauses, provided that agreement can be reached as to the period of use; they are remunerated for the term of usage and reimbursed for any damage done to their collateral during such usage period.

As an aside, Lender A should also consider obtaining an assignment of any licensing arrangement (or entering into a tri-party licensing arrangement) with respect to the Borrower's "designer" line of furniture. Licensing arrangements are often not assignable without the licensor's agreement. It would be unfortunate if Lender A ran into difficulties in trying to sell that product line in an enforcement scenario because of any licensing restrictions – particularly given the popularity of that particular product. Lender A should seek to obtain the licensor's agreement to the continued sale of the designer product in an enforcement scenario – even if the licensor wants to prescribe certain terms under which the sale of its endorsed product line could be conducted.

The above issues have been highlighted as illustrative examples of points prudent Lenders need to keep in mind in the above fact situation. There will of course be other issues to be addressed in the intercreditor arrangements of Lender A and Lender B. Additionally, different fact scenarios will give rise to different issues in a realization scenario. So, while determining relative priorities is definitely important, do not lose sight of other material considerations!

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

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