

## SUBORDINATION

Subordination is a legal term meaning to submit yourself to the legal control or authority of another. If your note maker's bank asks you to subordinate the maker's payment of your note to the maker's payment of the bank's note, the bank is simply asking you to stand in line behind the bank in order of repayment by the maker. But what does this really mean?

Many banks take the position in their standard subordination agreements that you cannot receive any payment of principal or interest on your note until the bank's note is repaid in full. Others allow for the repayment of interest on your note, but not principal, until the bank is completely repaid. Still others agree that you should be entitled to receive interest and principal payments on your note so long as the note maker is not in default on any of its obligations to the bank. This position might sound fair to you, but let's explore what can happen with that interpretation of subordination.

Defaults under any note come in two varieties: payment defaults and non-payment defaults. The bank will want to preclude the note maker's payments to you if any default should occur. In the spirit of fairness, you might be inclined to agree. However, agreeing to this bank position invites trouble. Any shortage, however minimal, in the monthly payment to the bank is a default. Any failure to deliver a required report is a default. Any failure to achieve a required financial ratio is a default. Any failure to comply with a loan covenant is a default. All of these defaults, whether intentional or unintentional, can be used by a bank to prevent your note maker's payments to you even though they may have no bearing whatsoever on the bank's actual ability to collect its loan from your mutual note maker. What should you do?

Take the position that repayment of your note is not subordinated to non-payment defaults. This position will secure your payments if the bank's covenants are breached, required reports are not delivered and mandated ratios are not maintained. Further, you should require that repayment of your note is subordinated only to those payment defaults which are so serious that the bank chooses to call the maker's note for immediate repayment in full. In this manner, you may be sure that the only way you won't be repaid is if the bank really believes that it won't be repaid and calls the maker's note. You avoid nonpayment scenarios arising over bank-required covenants, reports, ratios and insignificant payment shortfalls. Your note payments are only at risk if the bank truly believes, and acts on its belief, that the note maker will be unable to repay its bank loan.

This exact negotiation played out in May, 2012 for my seller client and its Newco buyer, whose acquisition of my seller was funded with \$17 Million in private equity cash and \$2.5 Million in Newco notes. Newco insisted that my seller subordinate repayment of its notes to anticipated Newco bank debt. We in turn insisted that subordination be defined to mean only payment defaults resulting in the bank's acceleration of all Newco bank debt for immediate repayment. Newco ultimately agreed. But Newco's bank later demanded, as a condition of its loan to Newco, that my seller agree that it would receive no principal and interest payments so long as the bank was owed any money whatsoever. We refused, citing our definition of subordination previously agreed to with Newco. The bank persisted, and the conflict was ultimately resolved when Newco's guarantor agreed to repay the Newco notes in order that Newco might obtain the

desired bank loan. My seller could easily have found itself in the position of having all of its note payments deferred for however long Newco's bank was owed money. When the first of my seller's two notes became due, the bank waived the subordination provision (probably at the insistence of a very deep-pockets guarantor) and allowed Newco to discharge its debt to my seller in full. The outcome could have been quite different. My seller achieved its objective of having its note paid in full and on time.