The Arbitration of Intercreditor Disputes Among Financial Institutions

By Richard M. Gray

Lenders have historically resisted arbitrating disputes under credit agreements, instead preferring what they regard as more reliable results obtained in court. Because they view a borrower's obligation to repay loans with interest to be not only straightforward but also sacrosanct, they tend to be concerned that arbitrators might simply "split the baby." Also, in the belief that deep-pocketed financial institutions make unsympathetic defendants, they avoid subjecting themselves to claims of lender liability in a forum they fear may not apply the strict letter of the law. Whatever the merits of these concerns, they are unlikely to change soon.

Disputes Among Financial Institutions

However, it is important to recognize that these concerns relate to disputes with borrowers,[1] not with other lenders. Disputes among lenders under syndicated credit agreements used to be rare. Financing structures were simple, and syndicates of lenders consisted of relatively homogenous, same (or at least similar)-thinking, conflict-averse commercial banks that expected to do many deals together over time. Now, financing structures are more complex, often involving several classes of senior and subordinated creditors with different collateral packages. The universe of lenders includes diverse financial institutions—banks, hedge funds, CLOs and others—with differing views of how to work out a troubled loan and less interest in cooperating with other lenders solely for the sake of maintaining relationships. It is not unusual for a distressed debt investor to analyze credit documentation for ways to gain advantage over other lenders, including by acquiring a blocking or controlling position to gain leverage under the collective action provisions.[2] Tensions and the likelihood of disputes between creditors increase at times of financial distress.

There is currently increasing attention to and acceptance of arbitration as a means of settling financial disputes. The International Chamber of Commerce released a summary report on this subject in 2016[3] and is expected to release a more comprehensive analysis later this year. Other examples include the optional arbitration clauses adopted by the International Swaps and Derivatives Association (ISDA) and the Loan Syndications & Trading Association (LSTA) in some of their model documentation, and the growing prominence of the Panel of Recognized International Market Experts in Finance (PRIME Finance), which works in cooperation with the Permanent Court of Arbitration in the Hague to resolve disputes concerning complex financial transactions. Of particular interest, some U.S. bankruptcy judges recommend that parties in pending cases submit selected issues to arbitration for the sake of judicial economy.[4] This comes at a time of increasing acceptance of arbitration by bankruptcy courts, generally for "non-core" issues.[5]

Disputes Relating to Ratable Treatment

Although there are many areas of possible contention in intercreditor relationships, the most important are those that directly or indirectly affect the ranking of claims, including the ratable treatment of similarly situated creditors. Although ratable treatment is generally provided by the credit documentation at the time of signing, subsequent amendments[6] or tactical steps taken in connection with bankruptcy cases can give rise to disputes. For example, in *Prudential Ins. Co. of Am. v. WestLB AG, NY Branch*,[7] the court addressed a dispute between lenders under a common credit agreement following their successful credit bid for two ethanol plants in their borrower's bankruptcy. Title to each plant had been taken by those lenders, but preferential interests were allocated only to the subset of those lenders that agreed to provide exit loans to the bankrupt borrower. The lenders that had declined to provide the exit loans sued, complaining that the preferential interests violated the ratable treatment protections of the credit agreement, while the lenders who received the preferential interests defended those interests as separate compensation for providing the exit loans.[8]

Another case, one that attracted significant attention in the syndicated loan markets and continues to worry market participants, involved a credit facility for NYDJ Apparel, LLC. In that case, a lender used its controlling position under a syndicated loan agreement to effect an amendment that enabled it to provide new, super-priority loans and junior super-priority loans in exchange for its existing loans. The lenders holding the minority position were not offered the same opportunity, and their existing loans—which before the amendment had ranked equal with the loans of the controlling lender—fell to a third-place ranking. In November 2017, the minority lenders sued in New York Supreme Court, alleging violations of the credit agreement (including an implied covenant of good faith and fair dealing).[9]

Benefits of Arbitration for Intercreditor Disputes

The foregoing cases are just two examples of a trend of increasing friction among lenders. When the friction evolves into live disputes, the usual benefits of arbitration over litigation apply, but some benefits are worth emphasizing.

Cost and Speed: Although the circumstances of intercreditor disputes vary and the outcomes are fact-specific, many cases are more legally intensive than fact-intensive and therefore require less discovery. However, the questions of fact are frequently sufficient to survive a motion for summary judgment, which might tempt parties into more protracted and costly, but possibly unnecessary, discovery in a litigated proceeding. This could be avoided or mitigated in arbitration.

Expertise: Documentation for syndicated lending can be complex for the uninitiated, especially when the transaction includes multiple classes of creditors, collateral and one or more intercreditor agreements. The resolution of a single issue may involve many overlapping provisions and an understanding of how subtle differences in wording can reconcile apparently inconsistent clauses (or an understanding of how truly inconsistent clauses should be reconciled). One of the principal attractions of arbitration, of course, is the ability of the parties to select arbitrators with the requisite expertise.

Finality: The dollar amounts involved in loan transactions can be large, but they will rarely rise to the level of "bet the company" disputes for the lending institutions. Adverse parties will want to resolve disputes expeditiously without endless appeals, and then move on. The limited grounds for vacating arbitration awards gives them the ability to do so.

Pre-Dispute Arbitration Clause or Post-Dispute Submission Agreement

Any arbitration agreement would ideally be contained in the primary contract at initial signing, before any dispute arose. Obtaining such an agreement, however, would be difficult. That contract, usually a multi-party credit agreement, is signed by the borrower, the syndicate of lenders and their administrative agent. For the reasons stated above, lenders are unlikely to agree to arbitrate disputes with borrowers. While it may be possible in theory to craft a clause narrowly to cover disputes only among lenders, arbitration clauses with carve-outs can be tricky to draft in practice and subject to avoidance in application. Many transactions that involve multiple classes of creditors—first/second lien financings[10] are one example—have standalone intercreditor agreements that could contain arbitration clauses. But they are still integral parts of the overall financing with the borrower, and it would be difficult to know in advance whether or how a specific issue in any future intercreditor dispute might affect or be affected by the borrower's rights and obligations. Indeed, borrowers are often parties to intercreditor agreements for this reason. These considerations, as well as the relative novelty of arbitrating intercreditor disputes, help explain the absence of pre-dispute arbitration clauses in intercreditor arrangements for loan transactions.

Notwithstanding the absence of pre-dispute arbitration clauses, the author is aware through personal experience and anecdotal evidence of the arbitration of intercreditor disputes pursuant to post-dispute arbitration submission agreements. Even though—as the conventional wisdom goes—it is difficult for parties in an active dispute to agree on anything, there are good reasons to wait for a dispute to crystallize before parties agree to arbitrate. Financial institutions do have experience with arbitration in other types of cases, but there is not a long track record for this type of case. Proceeding slowly and cautiously on a case-by-case basis will give them the opportunity to become more comfortable with the arbitral process for these disputes. Also, it may be preferable to make a decision to arbitrate based on the nature of the specific issue and circumstances. Parties could make an assessment of how the resolution might affect the rights and obligations of the borrower and then decide whether to arbitrate or bring a lawsuit involving all parties. Parties could also consider the need for extensive discovery and whether it is important to establish judicial precedent on an important legal issue in order to avoid future, similar disputes in other transactions. Even if parties initially preferred litigation, they could subsequently change their minds and decide to arbitrate based, for example, upon their mutual assessment of an assigned judge's lack of expertise in the area.

Conclusion

Although there is evidence of a small, emerging trend to arbitrate intercreditor disputes between financial institutions, the novelty of arbitration for those disputes and the possibility of issue-specific concerns preclude any expectation of widespread pre-dispute arbitration clauses in the near future. When such disputes do arise, however, parties should seriously consider arbitration on a case-by-case basis.

Endnotes

1. These concerns are more acute for U.S. domestic borrowers. In the cross-border context, they may be outweighed by the easier enforcement of arbitral awards as compared to foreign judgments. The Loan Market Association (LMA) and the Asia Pacific Loan Market Association (APLMA), the leading industry organizations for loans syndicated in Europe and Asia, provide optional arbitration clauses in their model documentation for borrowers located in jurisdictions where enforcement of foreign judgments may be problematic.
2. The collective action provisions specify the minimum principal amount of loans required to be held by lenders to entitle them, among other things, to direct action by the administrative agent, to consent to amendments or waivers and to exercise remedies. A single lender that acquired a majority of the loans would have significant leverage.
3. *Financial Institutions and International Arbitration*, Report of the ICC Commission on Arbitration and ADR Task Force on Financial Institutions and International Arbitration (2016). The report describes arbitration in derivatives, sovereign finance, investments, regulatory matters, international financing, Islamic

finance, international financial institutions, development finance institutions, export credit agencies, advisory matters and asset management.

4. This practice is more modest than proposals to use international arbitration to further the goals of the Model Law on Cross-Border Insolvency, drafted by the United Nations Commission on International Trade Law (UNCITRAL). *See, for example,* Allan L. Gropper, *The Arbitration of Cross-Border Insolvencies*, 86 Am. Bankr. L.J. 201 (2012).
5. Alan N. Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy,* 15 Am. Bankr. Inst. L. Rev. 183 (2007); Arbitration Agreements and Bankruptcy: Which Law Trumps When? NABTalk, Journal of the National Association of Bankruptcy Trustees (Summer 2010).
6. The validity of amendments, particularly those relating to ratable treatment, can be the subject of disputes, especially as to whether an amendment adopted by a simple majority of lenders also required the consent of other lenders. Also, some credit agreements that provide for ratable treatment of all similarly situated lenders allow that treatment to be amended by lenders holding a majority of the loans, a result that could defeat the original purpose of the ratable treatment protection.
7. 2012 N.Y. Misc. LEXIS 4822 (N.Y. Sup. Ct. 2012).
8. The plaintiffs prevailed.
9. After the court denied the defendants' motion to dismiss, the credit agreement was amended again—this time to afford the minority lenders the same opportunity to exchange their lower ranking loans for higher ranking loans. The possibility of an appellate decision was thereby lost.
10. In these financings, two groups of creditors obtain liens over the same or overlapping items of collateral and agree by contract to their relative priorities.

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