Reuters Legal News

Don't go chasing waterfalls: intercreditor agreements in the context of agency mortgage servicing rights

By Andrea N. Nixon, Esq., Michele C. Maman, Esq., and Thomas J. Curtin, Esq., Cadwalader, Wickersham & Taft LLP

JUNE 14, 2023

With fears of an impending recession and rising interest rates, the probability that mortgage borrowers may experience financial hardship is on the rise. The economic landscape may result in more mortgage borrowers struggling to satisfy their monthly principal and interest payments, which may increase strain on servicers of mortgage loans in an already capital intensive business function.

During such uncertain times, it is prudent for financial institutions lending money to servicers to examine their lending practices (including the use of intercreditor agreements) to avoid undertaking undue risk.

When a debtor files for bankruptcy, any property in which the debtor has an interest is generally marshalled and distributed to creditors under a chapter 11 plan that gets approved by the Bankruptcy Court. These assets are generally distributed to creditors pursuant to a priority scheme dictated by the Bankruptcy Code, whereby secured creditors are generally paid first (up to the value of their collateral) followed by unsecured creditors, and thereafter equity holders.

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However, under section 510(a) of the Bankruptcy Code, a subordination agreement "is enforceable in" a chapter 11 case "to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). Thus, intercreditor agreements (*i.e.* subordination agreements among multiple creditors to the same debtor) can commandeer the priority scheme that otherwise would apply in bankruptcy.

At the heart of most intercreditor agreements are two key provisions: (i) "waterfall" provisions that govern the application of collateral proceeds; and (ii) "turnover" provisions that require creditors to hold proceeds in trust and then remit excess proceeds they have received in violation of the applicable waterfall provision.

Each of these provisions plays a critical role in the context of credit facilities where a servicer is the debtor and where the underlying collateral is what has been coined as such servicer's "indivisible, conditional, non-delegable right and obligation" to perform servicing with respect to a mortgage loan for an agency in accordance with the servicing contract between servicer and the related agency (the "Agency MSR").

The law on intercreditor agreements is quickly developing, as are intercreditor agreements in the context of Agency MSR financing. The efficacy of such agreements may be tested given adverse economic conditions for mortgage borrowers and servicers.

The related agency will require the delivery of an acknowledgement agreement among the lender, the servicer, and the agency as evidence of such agency's consent to such financing (the "Acknowledgment Agreement"). The terms of such Acknowledgment Agreement may require that (i) a lender subordinate its interest in the Agency MSR to the agency and (ii) such agency be made whole from the collateral proceeds of all such servicer's Agency MSR, without regard to whether the Agency MSR serves as collateral to the related lender or any other lender.

Moreover, lenders often seek to enter into intercreditor agreements with respect to such Agency MSR in order to address, among other things, what happens if the agency disproportionately makes itself whole from the disposition of proceeds of the Agency MSR in a way that is adverse to one or more lenders. These agreements may also specify the parties' rights in collateral, and the obligation of lenders to remit proceeds that are wrongfully obtained.

In the context of Agency MSR financing, a bankruptcy court may be left to consider two subordination agreements (e.g., the Acknowledgement Agreement and the intercreditor agreement) that may usurp the priority of payments that would otherwise apply in the bankruptcy case. Notably, however, the enforceability of these agreements could be called into question if the collateral at issue is insufficient to pay the secured debts of the servicer.

For example, disputes may arise between creditors concerning the proper allocation of bankruptcy distributions, with certain creditors attempting to enforce the contractual waterfall or turnover provision. But waterfall and turnover provisions may sometimes be limited to the application of collateral proceeds.

If bankruptcy distributions are determined to not qualify as collateral proceeds, then a court could hold that the waterfall and turnover provisions are inapplicable and that the Bankruptcy Code will govern those distributions. *See In re Energy Future Holdings Corp.*, 773 Fed. Appx. 89 (3d Cir. 2019); *In re MPM Silicones*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014). Consequently, the alleged priority rights of a creditor based on the applicable intercreditor arrangement could be deemed unenforceable in bankruptcy depending on the circumstances.

Waterfall and turnover provisions are critical for the Agency MSR and pari passu lenders alike because they specify the manner and conditions of distributing collateral proceeds. Thus, subordinated lenders should pay careful attention to how collateral proceeds are defined in their intercreditor agreements, and waterfall provisions should be drafted broadly in scope to apply to all bankruptcy distributions, if indeed that is the lenders' intent.

If collateral proceeds are defined narrowly or if the waterfall provision is dependent on the satisfaction of certain conditions precedent (such as the exercise of remedies by an agent) then a court could decline to enforce such provisions or find them inapplicable with respect to certain bankruptcy distributions. *See In re Energy Future Holdings Corp.*, 773 Fed. Appx. 89 (3d Cir. 2019).

The law on intercreditor agreements is quickly developing, as are intercreditor agreements in the context of Agency MSR financing. The efficacy of such agreements may be tested given adverse economic conditions for mortgage borrowers and servicers. Given the prospect for potential bankruptcies for servicers, lenders should carefully review their intercreditor agreements to ensure that their agreements are responsive to recent precedent. Absent those measures, distributions in the context of a mortgage servicer bankruptcy could end up being governed by the Bankruptcy Code, not the intercreditor agreement and Acknowledgment Agreement agreed prepetition.

About the authors

Andrea N. Nixon (L) is a special counsel in the capital markets group of **Cadwalader, Wickersham & Taft LLP** in New York. She can be reached at andrea.nixon@cwt.com. **Michele C. Maman** (C) is a partner and **Thomas J. Curtin** (R) is a special counsel in the financial restructuring group at the firm in New York. They can be reached at michele.maman@cwt.com, and thomas.curtin@cwt.com.

This article was first published on Reuters Legal News and Westlaw Today on June 14, 2023.