

## Recent Trends In Intercreditor Agreements

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This article discusses principal issues that arise when negotiating intercreditor agreements, or ICAs, for mortgage and mezzanine lenders, and also discusses recent trends in ICAs as well as predictions as to where such negotiations may be headed.

### Mezzanine Lending

The ICA is an integral document in any transaction in which there is more than one loan. In the context of commercial real estate, or CRE, transactions, this situation arises most frequently when there is one or more mortgage loans and one or more mezzanine loans. The relationship between the mortgage loan and mezzanine loan is governed by the ICA, which establishes, among other things, the subordination of the mezzanine loan to the mortgage loan and defines the rights and obligations of the respective lenders. Since the 2008 recession, mortgage lenders have taken a more cautious approach in originating loans and have often limited the amount of their loans to loan-to-value ratios of 50 to 60 percent. This development has forced many CRE borrowers to seek mezzanine loans as a way to fill capital stack gaps and avoid having to contribute additional equity into a deal, particularly in light of the relatively low interest rates that are being afforded to CRE borrowers, even with respect to mezzanine loans. In that context, mortgage and mezzanine lenders will frequently engage in extensive negotiations of the terms of the ICA, as each maneuvers to establish its respective rights and remedies.

### The ICA

#### *Necessity of the ICA*

The mortgage loan and mezzanine loan are secured by different collateral. The mortgage loan is secured by a lien on real property and the mezzanine loan is secured by a lien on the membership interests in the entity that owns the real property. However, since the value of the collateral securing both loans is derived from the underlying real estate, the rights and remedies of the lenders under the respective agreements affect each other, particularly in relation to uncured defaults and resulting foreclosure rights. As a result of the separate collateral afforded to each of the lenders and the direct contractual agreements established between the mortgage and mezzanine lenders in the ICA, mezzanine loans are often preferred over alternative subordinate financing structures, such as second mortgages.

In a typical CRE transaction with mortgage and mezzanine loans, the mortgage lender has a payment

priority over the mezzanine lender. The mortgage loan documents and the mezzanine loan documents will often be substantially similar to one another with respect to the rights and obligations of the respective borrowers and the treatment of the underlying real estate, but the loan documents themselves will not address the rights of the lenders with respect to one another. For this reason, the ICA, which is a separate contractual agreement by and among the lenders, is necessary.

### ***Rights and Obligations of the Lenders***

In a CRE transaction containing mortgage and mezzanine loans, the mortgage loan is advanced to the real estate owner in an exchange for a security interest in the form of a mortgage on the underlying real estate, while the mezzanine loan is advanced to one or more of the parent entities of the real estate owner in exchange for a pledge of the direct or indirect equity interests in the real estate owning entity. Mortgage lenders will generally enter such transactions only on the condition that they maintain certain rights and priorities with respect to their collateral, which includes having some level of control over the equity ownership of the real estate owning borrower and limiting the rights of third parties such as mezzanine lenders. Conversely, mezzanine lenders will accept a subordinate payment priority with the expectation that in exchange they receive certain protections and concessions in the ICA regarding their rights.

### ***Rights and Obligations of Mortgage Lender***

The most important benefit of the ICA for the mortgage lender is the subordination of the mezzanine loan and the mezzanine loan documents to the mortgage loan and mortgage loan documents. Typically, the ICA provides that all payments under the mezzanine loan and the obligations secured thereby are subordinated to the mortgage lender's right to receive payments. However, as is explained in more detail below, the mortgage lender generally must follow certain procedures with respect to the mezzanine lender in the event of a mortgage loan default as outlined in the ICA. The mortgage lender is usually obligated to provide notice of defaults to the mezzanine lender and must permit it the opportunity to cure the default prior to foreclosing on its mortgage and to allow, subject to certain limitations, payments to be made to the mezzanine lender from available cash from the real estate. The arrangement between the mortgage lender and the mezzanine lender is predicated on the belief that the mortgage lender is comfortable, due to previous operational experience and creditworthiness, that the mezzanine lender (or its permitted transferee) can operate the real estate successfully and keep the mortgage current and free from defaults.

### ***Rights and Obligations of Mezzanine Lender***

As discussed above, the primary obligation of the mezzanine lender is to subordinate its mezzanine loan to the mortgage loan and, in return, the mortgage lender gives the mezzanine lender the right to foreclose on the mezzanine collateral once it has met certain conditions, such as those discussed below. Additionally, some mortgage lenders will accede to mezzanine lenders request for certain consent rights, including the ability to approve particular leases, budgets, alterations to the real estate and the use of insurance proceeds and other condemnation awards for the restoration of the real estate.

### ***Mutual Rights and Obligations of Each Lender***

The ICA also typically contains certain rights and obligations that are mutually beneficial for each lender. The lenders each make certain representations, warranties and acknowledgements to the other, including an acceptance of each other's loan documents, representations regarding the existence and

status of such loan documents and the loans, and various other warranties, such as that the loan is not cross-defaulted with any other loans other than as set forth in the loan documents. The ICA also typically contains restrictions and protections with respect to the types of loan transfers that are permissible, which is important in the current market, in which both mortgage and mezzanine lenders often sell all or portions of their respective loans to third parties.

## **Key Provisions of the ICA**

### ***Cure Rights***

An issue of utmost importance to mezzanine lenders is protection of the value of its collateral and, in particular, notice and cure rights with respect to defaults under the mortgage loan. In recent years, mezzanine lenders have negotiated heavily (and often successfully) for extended cure rights in order to forestall mortgage lenders from exercising their foreclosure rights under their loan documents. In the case of nonmonetary defaults, an extended cure period often includes sufficient time for the mezzanine lender to realize upon its collateral and gain control of the underlying real estate.

Mortgage lenders will strive to keep their loans current by requiring monthly debt service payments by the mezzanine lender, but even then, they generally seek to limit cure rights with a variety of measures. Some will negotiate to restrict the number of times over the lifetime of the loan that the mezzanine lender can cure monetary defaults. Most require that the mezzanine lender, as a condition to a mezzanine lender's realization on its collateral, cure all mortgage loan defaults that can be cured without taking possession of the real estate. This can be problematic for the mezzanine lender as it effectively cuts off the mezzanine lender's cure period on the date of its foreclosure or bars the foreclosure until the cure is properly achieved. If some of the defaults by the mortgage loan borrower require the mezzanine lender to take possession of the real estate to cure while other defaults are in the process of being cured but do not require such possession, the mezzanine lender may find itself in a position where it is unable to timely realize upon its collateral and take possession.

### ***Mezzanine Loan Foreclosure***

Unlike a mortgage loan foreclosure, mezzanine loan foreclosure are governed by the Uniform Commercial Code. The UCC requires that all aspects of the foreclosure process be carried out in a "commercially reasonable" manner. The mezzanine lender and mezzanine borrower will often negotiate the manner in which the foreclosure may take place in the mezzanine loan documents. The advantage of a mezzanine foreclosure over a mortgage foreclosure is that a UCC foreclosure can typically be completed much faster. The mezzanine lender may conduct the UCC foreclosure either publicly or privately, and the winning bidder in the foreclosure sale essentially purchases the equity interests in the mortgage borrower.

The ICA defines the requirements for the mezzanine lender to realize upon its pledged equity collateral (which is typically 100 percent of the ownership interests in the mortgage borrower). Part of the requirements can be satisfied prior to or concurrently with the mezzanine lender's realization upon its collateral. Some examples include delivering a replacement carve-out guaranty from a replacement guarantor that meets the mortgage lender's creditworthiness requirements (such as minimum net worth), curing applicable defaults and delivering a certificate to the mortgage lender that such requirements have been fulfilled. The failure to properly satisfy such conditions will afford the mortgage lender the right to seek injunctive relief to prevent the mezzanine lender's realization upon its collateral until the requirements are met. The recent trend in litigation involving enforcement of ICAs has shown a

willingness of the courts to enforce the parties' specific contractual agreements, including the right of the mortgage lender to injunctive relief.

One important consideration for mezzanine lenders when negotiating these provisions in the ICA is to be sure that the ICA clearly excludes those defaults that are not susceptible to cure by the mezzanine lender, such as the failure by the mortgage borrower to repay the mortgage loan at maturity, from any requirements that exist with respect to the mezzanine lender's right to foreclose on its collateral. As an example of a borrower default that a mezzanine lender cannot cure, if the borrower failed to obtain consent of the lender prior to entering into a major lease in accordance with the loan documents, the mezzanine lender would be unable to cure such a default, even if it takes over operations of the real estate.

Additionally, the ICA may set forth certain requirements that the mezzanine lender must satisfy following a mezzanine foreclosure before the mortgage lender will allow the mezzanine lender to commence the foreclosure action. Some examples include delivering a certificate and new nonconsolidation opinion to the mortgage lender regarding the transferee of the equity interest following such foreclosure, once the identity of the transferee is known. Mezzanine lenders may want to persuade the mortgage lender to allow for the cure of certain defaults post-foreclosure. In some instances, mortgage lenders will permit this so long as (1) the nature of such defaults will not materially impair the value of the collateral, (2) such defaults cannot be cured with the payment of money and (3) the mezzanine lender has commenced curing the defaults prior to initiating the foreclosure action. Mortgage lenders will also require that, following the mezzanine foreclosure, the transferee appoint a qualified replacement real estate manager that is capable of overseeing the management of the property. While a UCC foreclosure is typically far easier and faster to accomplish than a mortgage foreclosure, the failure of the winning bidder in the foreclosure sale to satisfy the pre- and post-foreclosure requirements can lead to contention including enabling commencement of a mortgage foreclosure which could have a significant chilling effect on a mezzanine foreclosure. Therefore, it is incumbent on mezzanine lenders to be sure that they can meet all such pre- and post-foreclosure requirements in a timely manner.

### ***Replacement Guarantors***

In the context of a mezzanine foreclosure, a significant concern to mortgage lenders is replacing the existing guarantor for the mortgage loan. In a typical CRE transaction, the borrower is an entity whose only asset is the mortgaged real estate. As such, there are a variety of guarantees that a creditworthy affiliate of the borrower will provide in favor of the lender to cover events such as bad acts of the borrower, completion of a construction project and environmental liabilities. As a result, the mortgage lender will want to ensure that the successful bidder at the mezzanine foreclosure sale provides a creditworthy replacement guarantor (someone who meets the mortgage lender's minimum net worth and liquidity requirements) prior to the mezzanine lender effectuating the transfer of the equity interests and taking control of the mortgage borrower. In the context of multiple bidders at a UCC foreclosure, the mortgage lender will often require that, as part of the mezzanine lender's bidding procedures, a successful bidder sign and deliver a replacement guaranty, as a condition to the transfer. The mezzanine lender, on the other hand, will want to limit the liability of a replacement guarantor to acts first arising after the date that the collateral is transferred to the successful bidder.

### ***Purchase Rights***

Mezzanine lenders will also want the ICA to grant the mezzanine lender the right to purchase the

mortgage loan in the event of a default under the mortgage loan. The mortgage lender will argue that the purchase price of the mortgage loan should be equal to the outstanding principal balance, and all other unpaid amounts including default interest costs as well as any and all fees and other charges owed. The mezzanine lender should attempt to exclude interest in excess of the contract rate and as many fees as possible, such as late charges, exit fees, prepayment fees and yield maintenance fees.

Mortgage lenders will also seek other avenues to limit the mezzanine lender's purchase rights. One such limitation is to have the purchase right expire within a definitive period of time following the mortgage loan default, thereby restricting the time period in which the mezzanine lender can purchase the senior loan. The mezzanine lender should push back on this point as the purchase right can serve as an important protective option in the event that other alternatives (such as cure rights, workouts or a mezzanine foreclosure, all of which can take time to implement) have failed, and having this option remain available is critical to usefulness. In addition, the mezzanine lender should seek to obtain protections against the mortgage lender accepting a deed to the underlying real estate in lieu of a mortgage foreclosure since, at worst, the mezzanine lender can protect itself by bidding at a mortgage foreclosure sale. A compromise between the competing interests of the mortgage lender and the mezzanine lender with respect to the time frame during which the mezzanine lender will have the option to purchase the mortgage loan is that any such purchase option automatically terminates upon the earlier to occur of a transfer of the real estate pursuant to a foreclosure or deed in lieu thereof, and the curing of the default triggering the option to purchase the mortgage loan. In any event, mezzanine lenders should look to negotiate this provision to (1) require the mortgage lender to provide prior notice of its intention to accept a deed in lieu from the mortgage borrower and (2) provide an opportunity for the mezzanine lender to purchase the mortgage loan prior to the mortgage lender accepting the deed in lieu of foreclosure (or thereafter requiring the mortgage lender to convey the property to the mezzanine lender upon payment of the purchase price).

### ***Transfer Rights***

ICAs typically provide restrictions on the mezzanine lender's ability to transfer its interest in the mezzanine loan without the mortgage lender's prior approval. Some mortgage lenders even attempt to broaden this approach by limiting the potential group of transferees to those who, from a strict underwriting perspective, the mortgage lender is comfortable transacting with. The mortgage lender will negotiate for the inclusion of certain prohibited categories that will automatically disqualify any potential transferee that meets the proscribed criteria and the mezzanine lender will want to negotiate for the right to transfer to purchasers meeting certain preapproved criteria. The mezzanine lender should push back against any such restrictions by (1) limiting the qualifications required by the mortgage lender, as applicable, for the transferee to take title or for the replacement real estate managers, as defined in the ICA, to step in and (2) requiring the mortgage lender to set forth in the ICA certain easily verifiable objective criteria for any transferees, thereby affording the mezzanine lender a smoother and more predictable sales process. The mezzanine lender should also have the right to transfer a noncontrolling (i.e., up to 49 percent) interest in the mezzanine loan without mortgage lender consent.

### ***Extension Options***

To the extent that the loan documents permit the borrower to extend the maturity date of the mortgage loan, the mezzanine lender should negotiate for the ability, at its option, to extend the mortgage loan in the place and stead of the mortgage borrower in the event that the mortgage borrower is unable to meet the extension requirements set forth in the loan documents. Under such circumstance, the mortgage lender will often agree, that absent other defaults beyond the applicable

cure period, it will “stand still” and not initiate any enforcement action during a defined period after maturity provided that it receives a notice from the mezzanine lender that the mezzanine lender intends to realize upon its collateral and exercise the extension rights of the mortgage borrower and meet the conditions to such extension.

### **Considerations for Loans to be Securitized**

Pursuant to commercial mortgage-backed securities transactions, potential securitization of loans continues to remain a significant factor in the negotiation of ICAs. In particular, mortgage lenders will strive to include language that provides protection in the event they elect to securitize the mortgage loan and other protections meeting rating agency requirements. In order to streamline the negotiating process and facilitate the rating of securitized mortgage loans that were originated as part of a capital stack including mezzanine loans, the parties will often resort (even in the case of nonsecuritized mortgage financings) to some form of standardized language designed to meet the standards of rating agencies and CMBS investors. As an example of a typical CMBS requirement, in the event that the mezzanine lender forecloses on its collateral and takes over the operation of the real estate, it may seek to appoint a new property manager to oversee operations. In such event, the rating agencies will typically require that the ICA provide for rating agency approval or a rating agency confirmation in the event that the new manager for the real estate is appointed that does not meet the minimum requirements set forth in the ICA, regardless of whether the mortgage lender approves such replacement manager. Additionally, rating agencies will require the ability to approve a loan transferee that does not meet the minimum net worth tests or definition of qualified transferee as set forth in the ICA.

Mortgage lenders will seek to condition many mezzanine lender rights upon rating agency confirmation such as the transfer or financing of the mezzanine loan. Additionally, as is often the case in the current market, mezzanine lenders may elect to pledge the mezzanine loan to another bank or lender that provides it with a credit facility. Mezzanine lenders that intend to pledge their loan should therefore make sure that such a pledge is permitted by the terms of the ICA. The mortgage lender may consent to such a pledge on the condition that such credit line lender meets the required credit ratings applicable for securitizations.

### **Industry Developments**

Given the state of the current CRE market, the cautious approach exhibited by mortgage lenders in originating loans and limiting LTV size should continue to provide mezzanine lenders with ample lending opportunities. Furthermore, the recent trend to shy away from filling capital stack gaps with traditional methods such as subordinate mortgage financing is just one more component that has led to the emergence of mezzanine financing as the favored method for subordinate financing. By continuing to maintain an important role in the CRE transaction, mezzanine lenders should be able to gain more leverage in the negotiation of their rights and protections under the ICA.

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