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MEZZANINE LENDING

Mezzanine Loan Intercreditor Agreements: Suggestions for Future Market Realities

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The existing form of intercreditor agreement most commonly used between senior lenders and mezzanine lenders has been developed from the version developed by the Commercial Real Estate Finance Council (formerly the Commercial Mortgage Securities Association) and can be found on its website.

This form has become the template upon which most senior/mezzanine relationships have been based. It was adopted as ''market'' by the rating agencies and lawyers generally use it as the basis for describing the senior-junior relationship. Although it has been modified often to suit the desires and temperament of the players in the commercial mortgage-backed securities (CMBS) world, the concepts have remained as the common thread governing the intercreditor relationship.

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During normal marketplace conditions, the template served the parties well. It provided for the proper relationship between senior and junior ''secured'' creditors covering, among other things, proper subordination of payment, rights of cure, rights of first offer to purchase the senior loan by the mezzanine lender, and prohibitions against certain actions without joint creditor consent. The steady trickle of issues allowed servicers, (acting as the seinior lender on behalf of the bondholders), the mezzanine lender, and the borrowers to act in a deliberate manner in order to provide orderly resolutions to borrower requests and intercreditor issues when the occasional problem arose.

However, the present volume of problem loans has increased to a torrent. Servicers are inundated with requests from borrowers or are experiencing defaults that require attention. The staffing level of the servicers and

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the mezzanine lenders does not necessarily permit sophisticated approaches to the resolution of issues. Servicers and special servicers increasingly ignore provisions of carefully negotiated intercreditor agreements to the detriment of mezzanine lenders. Conversely, mezzanine lenders often attempt to influence transactions in ways that hinder the workout process, even when the value of their position is worth very little.

Following are suggestions for changes in approach to the intercreditor agreement that may expedite the workout process and facilitate the cure of some toxicity that is present in the commercial real estate lending market. These ideas are not necessarily radical and may well be beneficial.

1. Insert a modified form of control appraisal event and condition in the mezzanine loan intercreditor agreement. One of the significant problems in managing distressed real estate assets occurs when subordinate debt with little or no value attempts to assert its rights in the midst of a workout or proceeding. Notwithstanding the standstill provisions of the mezzanine loan intercreditor agreement, the mezzanine lender can effectively delay the senior lender from realizing on its collateral or performing a workout that is in the best interests of the property but adverse to the subordinate lender.

The A/B Note structure provides an instructive example of a method to avoid the ''underwater'' lender problem. In the A/B structure, the subordinate holder of the B Note has significant rights of control over the disposition of the investment. However, the documentation of the A/B note normally calls for a ''control appraisal'' event where a valuation of the B Note position is undertaken. If the B Note does not meet a threshold of value (typically 25 percent of its original face value), control of the investment shifts from the B Note holder to the A Note holder.

Although a similar parallel does not exist in senior lender/mezzanine lender relationships, certain features of the intercreditor agreement can be modified if the mezzanine lender does not have sufficient value in its loan. Rights to require a mezzanine lender's consent to certain actions of the senior lender can be eliminated and the right to control certain aspects of senior loan modifications can be altered. In particular, during a workout, the senior lender cannot increase the interest rate of the senior loan. If the mezzanine loan has no value, that prohibition is meaningless.

2. The mezzanine lender should have the right to accelerate the movement of a defaulted senior loan from the master servicer to the special servicer. Securitization can create its own special form of purgatory when a loan is in difficulty. The path from the master servicer to the special servicer can lead to unfortunate delays. For example, the pooling and servicing agreement governing the relationship among players involved in the senior loan structure permits the original (master) servicer to retain rights to treat borrower requests or default situations for a period of time before transferring the loan to the special servicer, which has the right to work out or exercise remedies.

The reason why the master servicer retains the loan for the full period permitted in the pooling and servicing agreement may be obscure to the borrower and mezzanine lender. But it frequently involves the servicer's obligations to pay principal and interest for a defaulted loan or the servicer's collection of fees until the loan is sent along to the special servicer.

The ability to accelerate the process would be useful to a mezzanine lender. Delay in servicing shifts can be harmful by changing circumstances and altering the subordinate lender's crucial decisions on whether to cure the senior default, on how to exercise mezzanine loan remedies, and on whether to foreclose the mezzanine position.

Potential criteria for the acceleration could be the reasonable possibility of deterioration of the value and quality of the mezzanine loan position or an imminent default, accompanied with a certificate from the mezzanine lender setting forth the facts that require accelerated transfer. In addition, if fees are the problem, a charge of some kind to compensate the master servicer (without being excessive or out of proportion to the mezzanine loan size) could be paid by the mezzanine lender.

In any event, delay in handling by the senior lender players is often a grave problem for the mezzanine lender. An appropriate remedy granted to the mezzanine lender in the intercreditor agreement context could advance the workout process or permit the mezzanine lender to make cure decisions in a measured and reasonable fashion. Since the exercise of mezzanine remedies are far from instantaneous, the ability to accelerate the servicing shift is of utmost importance to the mezzanine lender.

3. Include an event of default section in the intercreditor agreement. At present, the form does not contain a default or event of default section. Generally speaking, a default by one party to the intercreditor agreement affords no specific remedy to the other party, which is left only with the option of filing a breach of contract claim for damages. Since many defaults are discovered after the occurrence, equitable remedies are relatively meaningless and the breach of contract claim is arduous to pursue and provides no immediate relief to either the senior lender or the mezzanine lender.

At the same time, the system set up to manage the securitized loan process has become overwhelmed by the volume of non-performing loans and loans that have the potential to fall into default. There has been significant evidence that servicers have ignored the requirements of the intercreditor agreement with respect to the rights of the mezzanine lender, which in turn may attempt to circumvent certain provisions that apply to the senior lender.

Of particular note is a violation of the cash management regime. Often the imposition of a hard lock box by the senior or the locking down of a mezzanine collection account is the single most important early warning device to the other lender in the process. Cash management is not supposed to be modified without mutual agreement of the lenders. Yet either lender party can seriously prejudice the other if funds are wrongfully diverted to the borrower.

Certain immediate remedies inserted into the intercreditor agreement would be useful. Some possibilities are:

- extensions of time for a mezzanine lender to act if the servicer violates cash management agreements affecting the mezzanine lender, or if other conduct requiring mezzanine lender consent were violated;
- reciprocal shortening of time periods for mezzanine lenders that similarly violate the intercreditor agreement;

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■ loss of mandatory consent rights by either the senior lender or mezzanine lender if the conduct of the breaching party caused material detriment to the non-breaching lender;

■ modification of consent rights of the senior lender regarding certain amendment prohibitions contained in the intercreditor agreement; and

■ mandatory actions required of the controlling class of bondholders in the case of the most egregious breaches. (This is clearly the most radical suggestion and one that is most ''out of the market.'')

It is most interesting that the form of intercreditor agreement does not reference the servicing process. The term ''senior lender'' does not differentiate between various parties that play a role in managing the senior loan process. It would be refreshing to see the component players that make up the senior lender identified with a simple statement that the actions of one of the players binds the entire senior lender complement so that the mezzanine lender can rely on them. It is surprising that special servicers often do not acknowledge the actions of predecessor servicers in the chain of parties handling the loan.

4. Modify the 'Qualified Transferee' provision of intercreditor agreements with respect to the mezzanine lender when the loan meets requirements for transfer to the special servicer. The intercreditor agreement permits the senior lender to transfer its interest in the loan at any time without the consent of the mezzanine lender (subject to a right to purchase vested in the mezzanine lender under certain circumstances). However, the mezzanine lender is not permitted to transfer more than 49 percent of its beneficial interest in the mezzanine loan unless it either (i) is to a qualified transferee (as defined in the intercreditor agreement) or (ii) receives of a rating agency confirmation that accords the transferee the qualified transferee status notwithstanding whether or not the requirements of the definition are met. Essentially a qualified transferee must be an institutional investor.

When the workout events have occurred, the senior lender is barred by the real estate mortgage investment conduit (REMIC) rules from investing new money and the borrower will often not be in a position to find or raise new money at the pure equity level. The mezzanine lender may well be in the best position to infuse new capital into the deal. However, the qualified transferee provision severely limits the field.

The obvious reason for the provision is to maintain the integrity of the rating process as envisioned by the rating agencies. However, given the depth of the trouble in the commercial real estate world, this is presently far from an admirable goal. In a normally balanced world, the orderly transition and rating of pools would seem to benefit from this approach.

It is now obvious that the original system is broken (to what degree remains to be seen) and restrictions on the quality of investors as presently established makes no sense in the workout context. The qualified transferee definition could be altered to permit more than 49 percent of the beneficial interests of the mezzanine lender to be transferred so long as there is not a total transfer. It might also require the mezzanine lender (by definition a qualified transferee) to retain a significant investment (10 percent to 25 percent) and give such lenders certain control rights that go the heart of the stability of the process (i.e., control over consent to senior lender requests, etc.). However, the qualified transferee provision in today's frenzied and troubled market is simply too restrictive. It needs to be rethought and modified to permit new money into the troubled deal from sources likely to be willing to take the risk.

Conclusion. The present form of intercreditor agreement between a senior lender and a mezzanine lender lacks market reality in the face of the significant amount of activity and complexity in the commercial real estate market. The form accepted as ''market'' by the lending community and the rating agencies simply did not anticipate the almost total collapse of the securitized industry. It needs to be revitalized if the securitized industry wants to restore its place in the lending community. Not only is this a matter of trust, it is also a matter of necessity.