

Mezzanine Loans and the Intercreditor Agreement: Not Etched in Stone

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Mezzanine lenders should not overlook the opportunity to enhance their rights when negotiating intercreditor agreements with senior lenders. The authors discuss the areas in which senior lenders may be willing to make concessions in order to close an attractive deal in a very competitive market for both senior and mezzanine loans.

The mezzanine loan market offers real estate lenders the potential for superior returns, balanced, of course, by significantly higher levels of risk. While the reward for the higher risks had been returns from the high teens to above 20 percent, mezzanine lenders now find themselves competing for lower returns as an increasing number of lenders have entered the market. At the same time that competition among lenders has increased, the housing and, to a lesser extent, commercial construction industries have suffered as once-hot real estate markets around the country have been hit by a slowdown due to rising interest rates and overbuilding. Total housing starts in 2007, for instance, were forecast to be the lowest level in a decade, according to the National Association of Realtors, as home builders deferred new construction to support the prices of their remaining inventory.¹ The slowdown in construction has left more lenders competing for deals with qualified borrowers and worthwhile projects. Simply put, there is more money chasing mezzanine returns in the current market than there may exist good customers.

Amid the heightened competition, mezzanine lenders may feel that they do not have leverage to improve

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the terms of their intercreditor agreements with senior lenders. In a market flush with money, however, senior lenders also are feeling pressure from competitors as well as from the compression of spreads over interest rate indices. In this environment, senior lenders may often show flexibility in negotiating an intercreditor agreement, particularly where mezzanine lenders have legitimate concerns. Depending on the nature of the deal, the identity of the borrower, the parameters of a project and its economics, senior lenders will have a varying range of tolerance for negotiating terms. In order to close a lucrative deal, senior lenders may be willing to offer concessions to mezzanine lenders who convincingly argue their position. That is an opportunity that mezzanine lenders should not ignore.

This article discusses current trends in pricing in the mezzanine market, key clauses of the intercreditor agreement, and areas where mezzanine lenders should look to improve the terms of those agreements in order to preserve their flexibility in dealing with the borrower and to better manage the risk of their investment.

Mezzanine Lending and Current Trends in Pricing

Because senior lenders customarily make loans only

up to a certain percentage of the total value of the property, known as the loan-to-value ratio, mezzanine loans offer an additional source of financing for acquiring, developing or redeveloping various projects. Over the years, the portion of the total value of a project which senior lenders are willing to lend has risen and is now typically up to 80 percent, although the loan-to-value ratio can reach higher than that in some cases. Mezzanine lenders normally provide about 10 percent of loan-to-value above the senior loan threshold. However, with certain senior construction loans the calculation may be based on a loan-to-cost calculation that may be substantially lower than the 80 percent noted above, especially for riskier projects, and the mezzanine loan-to-cost could rise above the customary 10 percent. In addition, senior lenders generally look for a debt service coverage ratio (i.e., the ratio of net operating income of the property to the debt service payable on the loan for a period) of at least 1.15:1. Mezzanine lenders may accommodate a debt service coverage ratio of as low as even 1.05:1 (taking total senior and mezzanine debt into account).

The mezzanine loan provides property owners with a source of additional financing, allowing them to reduce the level of their own equity investment needed to fund the project or, in the case where there is an existing mortgage loan with a lock-out provision or a costly defeasance payment, to take capital out of a stabilized project, especially where the mortgage loan prohibits second mortgage financing. While senior lenders generally prefer that property owners keep a significant amount of their own money at risk (typically 10 percent or more), in this very liquid market some projects have been able to obtain combined financing at full value. Typically, mezzanine loans are available only for larger projects, those having a value over \$10,000,000, with mezzanine loan amounts in excess of \$1 million. However, many mezzanine lenders will not make a mezzanine loan unless it is substantially larger, due to the complexity of the underwriting of the loan and the required documentation. Mezzanine loans are used to finance many types of real estate projects, including acquisitions of existing, stabilized properties, and particularly for projects involving condominium and townhouse construction, condominium conversion and rehabilitation and repositioning of underutilized properties. Mezzanine loans for new construction and substantial renovations, however, carry increased risk because if the project fails, the mezzanine lenders may be left with a half-finished project or even nothing.

While senior loans are secured by a mortgage covering the property itself, mezzanine loans usually are secured not by a collateral interest in the property, i.e., a mortgage or a deed of trust, but only by a pledge of equity interests in the property-owning entity, typically a limited liability company. Accordingly, if the property is worth less than or equal to the amount of the senior loan, then the mezzanine loan collateral would be worthless.

The mezzanine loan has additional risk as the mezzanine lender is generally entitled to be paid the principal of the mezzanine loan only after the senior lender is fully repaid. Furthermore, in many mezzanine loans only a portion of interest may be currently payable, with the balance accrued and payable at the maturity of the loan, often expressed as an “IRR catchup” which gives the mezzanine lender a specified internal rate of return over the life of the loan. Therefore, as mezzanine lenders shoulder more risk, mezzanine loans may become more expensive for the borrowers. Nevertheless, although rates were as high as 18 percent to 20 percent a few years ago, rates have declined somewhat since. Returns of up to 18 to over 20 percent, however, are still common on new construction and other highly speculative, “value-added” transactions, sometimes with a floor equal to a multiple of 1.5 times the amount advanced if the mezzanine loan is repaid early. On mezzanine loans for more stabilized, income-producing properties, returns are more often in the range of 10 percent to 12 percent. Mezzanine loans typically carry origination fees of one percent to over two percent and sometimes a one percent exit fee. Mezzanine loans also may be priced at spreads above the London Interbank Offered Rate (“LIBOR”) of around 500 to 1,000 basis points. In contrast, senior loans for construction are typically priced with returns of 200 to 300 basis points over LIBOR, together with an origination fee of up to one percent and possibly an exit fee of 25 to 100 basis points, and having a term concurrent with the construction period, often around two years. Senior loans for stabilized properties may be priced with similar origination fees, and at either a fixed rate currently in a range of 100 to 120 basis points over the relevant five-, seven- and 10-year Treasury Index or a floating rate (typically 150 to 200 basis points over LIBOR), and having a wide range of terms, but typically between two years and 10 years.

While overall mezzanine loan volume is difficult to track, industry insiders point to strong growth within the market. *Retail Traffic* magazine, for instance, reported in 2006 that an average of 30 percent of loans in the Fitch-rated CMBS issues contained a mezzanine tranche, more than three times the level in 2001.²

Behind the downward pressure on rates for mezzanine loans is the simple attraction of higher returns amid the lackluster performance in recent years in other markets, such as equities. As more lenders have entered the mezzanine market, competition to make loans in a slowing real estate market has driven rates lower. Given the higher level of risks in mezzanine loans, the decline in returns makes it imperative for mezzanine lenders to actively manage and limit those risks by seeking out the best terms in the intercreditor agreement in negotiations with the senior lender.

The Intercreditor Agreement

In order to obtain mezzanine financing, a borrower

typically must obtain approval of the senior lender. This is more easily accomplished when the senior and mezzanine loans are being made simultaneously. The agreement between the senior lender and the mezzanine lender is called an intercreditor agreement. Governing the relationship between the mezzanine lender and the senior lender, the intercreditor agreement spells out the terms and conditions that both parties will adhere to so long as both loans are outstanding.

The intercreditor agreement normally will address issues such as:

- The collateral which is permitted to secure a mezzanine loan.
- When a mezzanine lender may accept payments from a borrower.
- The instances in which either party may modify their respective loan documents.
- The remedies that may be exercised upon a default of either loan.
- The right of the mezzanine lender to purchase the senior loan.
- The right of the mezzanine lender to receive notice of senior loan borrower defaults and an opportunity to cure those defaults.

A standard form of the intercreditor agreement has come into more widespread use in recent years, and has helped to reduce costs by eliminating redundant negotiations over typical conditions. Mezzanine lenders, however, should not look at a standard form as set in stone, but rather as a starting point to enable them to tailor the terms to the specific needs of a given project in order to better manage their own risks. This is especially important where an agreement on one project may serve as the model for future deals, particularly because mezzanine lenders seek to develop long-term relationships with senior lenders who are eager to work with high-quality mezzanine lenders.

Collateral for the Mezzanine Loan

Mezzanine loans typically are secured not by the real property but by a pledge of the ownership interests in the property owning entity, which is the borrower under the senior loan. Whether it is formed as a limited liability company or a limited partnership, 100 percent of the equity interests in the entity that owns the real property is pledged as security for the repayment of the mezzanine loan. In the event of a default under the mezzanine loan, the mezzanine lender may foreclose upon the pledged equity interests and take over ownership and control of the property owner. As pledged equity interests are personal property, mezzanine lenders may expeditiously foreclose upon pledged interests using a non-judicial Uniform Commercial Code foreclosure process. If governed by Delaware law, which is commonly the case, notice of foreclosure may be as short as 10 days and the auction must merely be

conducted in a commercially reasonable manner. In contrast, a real estate foreclosure action is typically conducted in court and may take upwards of one and a half years or more in many states. Prior to foreclosing, a mezzanine lender may (but is not obligated to) cure the borrower's monetary defaults under the senior loan. After foreclosing on the interests in the property owner and assuming control of the borrower and the property, the mezzanine lender may then be able to also cure any non-monetary defaults under the senior loan for which possession is required. The value of this pledged collateral is dependant on mezzanine lenders ensuring that there are not multiple pledges of interests in the property-owning entity, and that only one person or entity owns all of the membership or other interests in the property owner. To that end, mezzanine lenders typically prefer that all the ownership interests be held by a single special purpose entity, with such ownership interests evidenced by membership or partnership certificates issued by the property-owning entity.

While the pledge of membership interests in the property-owning entity is usually the main security, there are other options for mezzanine lenders. In some cases, mezzanine lenders may be permitted to obtain a second priority mortgage on the property as additional security, which affords the mezzanine lender a higher level of security than a pledge alone. Second priority mortgages are not typical and are granted only in a minority of situations. Those projects may include new construction of condominiums or townhouse or sale of lots for condominiums or townhouses, where the collateral diminishes over time as sales are made and as the senior mortgage is released from the units that are sold. Such cases provide mezzanine lender with greater justification for a second mortgage so that it may monitor sales and make sure that it is paid whatever it is entitled to upon the sale of units or lots after the first mortgage is paid off. Although there are exceptions, it is much harder to obtain an agreement to allow a second mortgage on the property in other types of projects.

Guarantees as Additional Collateral

Along with the pledge of equity interests as collateral, mezzanine lenders typically seek guarantees from a creditworthy entity or individual(s) that serve as credit enhancement. Because the borrower has more opportunity to impair the value of the collateral in a mezzanine loan, these guarantees are usually greater in scope than the limited guarantees for the senior loan. For instance, full recourse may be triggered not only by a voluntary or collusive involuntary bankruptcy filing but also by bad faith interference with the mezzanine lender's exercise of its remedies, unauthorized transfers of interests in the property or pledged equity interests or a refinancing or unauthorized modification of the senior loan.

Because there is a great deal more trust needed be-

tween the parties in the mezzanine loan, mezzanine lenders seek one or more individuals (typically the principals of the borrower) or entities of significant worth and responsibility to guarantee the loan and indemnify the mezzanine lender in the event of dishonest actions on the part of the borrower. Furthermore, in the case of mezzanine loans for condominium and townhouse construction, condominium conversions or rehabilitation, as such loans carry the additional risk that the project might not be completed, mezzanine lenders often receive guarantees of completion of the project and payment of the project costs from the guarantors.

One of the items typically covered by the intercreditor agreement, then, is the extent to which a mezzanine lender is permitted to accept payments from a guarantor. Senior lenders will be concerned that payments made to the mezzanine lender by a guarantor may deplete the guarantor's resources and hinder his or her ability to make payments under the guarantee for the senior loan should that become necessary. That leaves mezzanine lenders with a range of options in negotiating these terms with the senior lender. In the strictest case, the terms may include an absolute restriction against accepting payments from the guarantor until after the senior loan is repaid. Mezzanine lenders, however, should seek a more flexible agreement that would permit them to accept payments so long as there have been no demands made under the guarantees under the senior loan, or to accept payments so long as they do not reduce the net worth of the guarantor below a certain threshold. Besides addressing the issue of accepting payments from the guarantor, an even bigger question is whether the mezzanine lender may accept payments from the borrower itself.

Payments From the Borrower

In the most conservative intercreditor agreements, other than regular installments of interest (which are typically made from an interest reserve), the mezzanine lenders may not accept any other payments from the borrower to pay down the mezzanine loan until the senior loan is paid off in full. Less restrictive intercreditor agreements may allow the mezzanine lender to accept prepayments or repayments of the mezzanine loan so long as those payments come from an external source and not from the property itself. In other instances, especially in connection with sales of condominiums, townhouses and lots, once the minimum release prices required under the senior loan have been paid to the senior lender, the intercreditor agreement should permit the mezzanine lender to require that the excess of the net sales proceeds above such minimum release prices be used to pay down the mezzanine loan.

Control Over Construction and Condominium Conversion

In projects involving new construction or where there

are otherwise substantial construction and upgrade costs, the senior loan documents will spell out provisions governing the use of the proceeds of the senior loan and the mezzanine loan, as well as the borrower's required equity in the project, procedures for approving "change orders," the funding of cost overruns, required retainage, approval of construction plans, the project schedule, the contractors and design professionals and other details of the construction, as well as timing of advances of the senior loan for repayment of "hard" and "soft" construction costs. The mezzanine lender should attempt to maintain some control over the construction and costs, as cost overruns may need to be paid by the borrower, adversely impacting the ability of the borrower to repay the mezzanine loan.

In addition, in condominium conversions the senior lender will generally have the right to review and approve the condominium offering plan, the declaration of condominium, the obligations of the sponsor to perform work, including common area renovations and upgrades to the condominium units, and the minimum sale prices. Reductions in sales prices or increases in sponsor costs and obligations may jeopardize the ability of the borrower to repay the mezzanine loan. Senior lenders may, however, resist granting such rights of consent, and the negotiations may be controversial.

The Right to Modify Loan Documents

A key issue in negotiating the intercreditor agreement is setting out the changes that each lender may make to their respective loan documents and the circumstances under which those changes may be made. Senior lenders typically will seek to retain the right to modify their documents. Mezzanine lenders, however, should be aware that if the senior lender seeks to make certain categories of modifications of the senior loan documents, these modifications may enhance the senior lender's position while diminishing the value of the collateral under the mezzanine loan or otherwise adversely affecting the mezzanine loan and the borrower's ability to repay the mezzanine loan. Therefore, the mezzanine lender should seek to ensure that such changes cannot be made to the senior loan documents without its consent.

Usually, intercreditor agreements include reciprocal clauses that govern the loan document modifications which the parties may not make without the other's consent. Generally, a senior lender will agree in the intercreditor agreement not to take the following actions without the mezzanine lender's consent:

- Increase the principal amount of the senior loan. There are, however, exceptions in which the senior lender or the mezzanine lender may increase the size of its respective loan without seeking the other's consent. One exception is for "protective advances" made by the senior lender to preserve the property, such as for emergency repairs which the borrower fails to make. Another exception is for

the accrual of interest, in which unpaid interest is added to the principal amount.

—Increase the interest rate or change hedging or interest rate cap agreements.

—Accelerate the maturity date (except in case of default).

—Increase the rate of amortization.

—Modifications to the casualty and condemnation clauses that would require the borrower to use the proceeds of insurance from a casualty or any award from a condemnation to repay the senior loan before being applied to the restoration of the property. Because the borrower may not be able to secure outside sources of financing for restoration after the senior loan is repaid, the property may be in a state where it is neither producing income nor readily marketable because of the unrepaired damage, adversely affecting the ability of the borrower to repay the mezzanine loan.

—Modifications to the cash management arrangement. Senior lenders generally require all revenues of the borrower to be paid into a blocked account that follows a strict waterfall of how that money may be used. Typically, the cash would first be used to pay senior lender's costs and expenses, then to the payment of interest and scheduled amortization of the loan principal, then to fund reserves for insurance, taxes and required repairs, and finally to the borrower. The mezzanine lender should require that any funds that would otherwise be released to the borrower under this waterfall would, so long as the mezzanine loan is outstanding, instead be paid to mezzanine lender, and that there is no deviation from this waterfall.

—The addition of a "kicker" or contingent interest, which would reduce the value of the collateral left for the mezzanine lender.

—In projects involving new construction or substantial construction and upgrade costs, modifications to the provisions of the senior loan documents regarding changes to the construction plans, the project schedule, the project budget, borrower's required equity in the project, procedures for approving "change orders," the funding of cost overruns, required retainage, the approved contractors and design professionals and the timing of advances of the senior loan for construction costs.

—In a condominium conversion or offering, modifications to the provisions of the senior loan documents regarding changes to minimum "release prices," the condominium offering plan, the declaration of condominium and the sponsor's obligations.

—Expansion of the events of default. Additional events of default increase the likelihood that the borrower will default and cause an acceleration of

the senior loan, which would require the mezzanine lender to pay off the senior loan in full or eventually have its collateral interest extinguished or reduced in foreclosure.

A caveat to the foregoing is that senior lenders will be more resistant to restrictions on their ability to modify the senior loan documents after the occurrence of a default under the senior loan, and will seek to retain the ability to impose changes unilaterally. This, however, is open to negotiation, for instance, with respect to increasing the principal amount of the senior loan and other critical loan terms, and the intercreditor agreement should spell out which changes require the consent of the mezzanine lender even after a senior loan default.

Default Under the Mezzanine Loan

In the event of a default under the mezzanine loan, senior lenders will generally try to prevent the mezzanine lender from foreclosing, because the senior lender may wish to keep the original borrower.

A range of compromise positions exist in negotiating this clause in the intercreditor agreement. The most restrictive position will be that the mezzanine lender is not allowed to exercise any remedies until the senior lender is paid in full. Mezzanine lenders should negotiate for, at the very least, the right to proceed with a foreclosure of the pledge of interests in the property owner, especially if, after a limited time period, the senior lender fails to cure, on behalf of the borrower, the mezzanine loan default. The mezzanine lender should also negotiate the right to seek payments from the guarantors of the mezzanine loan, provided that any such enforcement would not cause a violation of any liquidity or net worth covenants of such guarantors under the senior loan.

Moreover, if there is an event of default under the senior loan, and the senior lender is exercising its remedies, including the institution of an action to foreclose the mortgage, then the mezzanine lender should also be able to exercise any and all remedies under the mezzanine loan documents, especially foreclosure of its pledge of equity interests in the property owned.

Default Under the Senior Loan

In the event of a default under the senior loan, there typically is little controversy in the general terms. Virtually every intercreditor agreement will require the senior lender, at a minimum, to give notice of the default to a mezzanine lender and accept a cure of that default from the mezzanine lender. Where it becomes more controversial is in negotiating the permissible actions in the following three categories of default:

- Those that are monetary.
- Those that are curable and non-monetary.
- Those that are incurable and non-monetary.

For curable monetary defaults, the object of the negotiations is to agree whether the mezzanine lender will be granted additional time within which to make a cure, and if so, the amount of additional time beyond that which is extended to the borrower. Where the borrower has no grace period, senior lenders typically agree to a certain period of time for the mezzanine lender to cure the default, usually ranging from five to fifteen days.

Non-monetary defaults that are curable include situations in which a borrower fails to maintain and repair the property as required under the senior loan documents. For curable non-monetary defaults the mezzanine lender should negotiate a tolling of the cure period for enough time to enable the mezzanine lender to foreclose on the interests in the property owner, thereby taking control of the property owner and the property so that it can then effectuate a cure.

The third category, incurable non-monetary defaults, includes the filing for bankruptcy by the borrower or unpermitted transfers, which are defaults which cannot be cured by a mezzanine lender. If a senior lender chooses not to exercise its remedies, the mezzanine lender should seek an accelerated pay-off of its loan. The mezzanine lender may also, although this is more controversial, seek the right to step into the shoes of the senior loan borrower once the bankruptcy proceeding is completed, and, if possible, to keep the senior loan outstanding.

If a senior loan default is not cured by the mezzanine lender, the senior lender may commence a mortgage foreclosure action. The mezzanine lender would be named as a third-party defendant if it holds a second mortgage, in which event the mezzanine lender may make a claim in such action to assure its payment priority ahead of the borrower. Another scenario is that if the borrower is unable or unwilling to repay the senior loan upon an acceleration, the borrower may file for bankruptcy, and in that case a mezzanine lender may submit a claim. However, the mezzanine lender generally would not be allowed to accept any payments under the bankruptcy proceeding until the senior lender is paid off in full.

Right to Pay Off or Purchase the Senior Loan at Par

In the event of a default under the senior loan, a foreclosure on the property could wipe out the borrower's interest in the property and, therefore, absent the mezzanine lender holding a subordinate mortgage, the security for the mezzanine loan. The mezzanine lender should seek the ability to not only cure the default but also to pay off the senior loan at par and without payment of any onerous prepayment or yield maintenance penalties, late charges or interest at a default rate. While the senior lender may object to giving up the right to payment of the remaining interest due under

the senior loan, or yield maintenance, mezzanine lenders should avoid any provisions that would make prepayment even more burdensome, whether by a lockout period during which prepayments are prohibited or by payment of late charges and default interest.

While the typical intercreditor agreement will permit a mezzanine lender to buy the senior loan at par, especially in cases where the mezzanine lender is an institution in the business of making senior loans and has substantial assets, a key issue will be whether an event of default must first take place, or whether the right to purchase may be exercised at any time.

Rights to Sell the Loans

Another area for negotiation is the instance in which either the senior lender or the mezzanine lender may try to sell or assign its interest in its loan to another party. The senior lender generally will try to restrict the right of the mezzanine lender to sell or assign the mezzanine loan, or, in the most severe cases, prohibit a sale entirely. The mezzanine lender, however, should seek to preserve its flexibility to sell the mezzanine loan or participation interests therein and its ability to pledge the mezzanine loan. The compromise position typically involves restricting such transactions to those involving a "qualified transferee," which may include insurance companies, banks, savings and loan associations, colleges, universities, nationally recognized commercial credit corporations, investment banks having an investment grade senior debt rating, real estate investment trusts, real estate mortgage investment conduits, pension funds, mutual funds and governmental entities, and which may be required to meet minimum capital requirements and possess expertise in similar real estate transactions. Mezzanine lenders should also have the unqualified right to assign the mezzanine loan to any of its affiliates or any successor by merger or acquisition.

The mezzanine lender should also seek to restrict the right of the senior lender to sell, assign or participate in the senior loan to only a qualified transferee, but this request may be met with resistance.

Conclusion

In today's competitive marketplace, both senior and mezzanine lenders find themselves under pressure to close deals with well-qualified borrowers on promising projects. While senior lenders have a great deal of leverage in negotiating the terms of an intercreditor agreement, they also realize that many projects will require mezzanine financing to move forward. That provides motivation for senior lenders to be more flexible in negotiating terms with mezzanine lenders. Mezzanine lenders should take advantage of the opportunity that the competitive market for senior loans provides them to obtain more flexible terms in an intercreditor agreement. Mezzanine loans carry enough risk

as it is, and the terms of an intercreditor agreement with the senior lender may be used to manage and mitigate those risks. For both parties, the aim should be to see worthwhile projects through to a successful conclusion and thus earn a return that compensates them adequately for the risk that they have accepted in extending financing.

¹ National Association of Realtors, “Gradual Rise Projected for Home Sales,” Press Release, January 10, 2007.

² David Bodamer, “Make Way for Mezzanine,” *Retail Traffic* magazine, January 1, 2006. http://retailtrafficmag.com/mag/retail__mezzanine.