Chapter 7

The Modern Intercreditor Agreement: Legal Terms and Issues

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7.1 Introduction

When this Chapter was published in the preceding edition to this book in 2012, the main focus of the discussion on intercreditor agreements was the A/B intercreditor as such senior/junior lender arrangement was, and for the most part continues to be, the most relevant document setting out the relationship, rights and obligations of senior and junior lenders where the senior loan is placed into a CMBS transaction. Given the lack of new CMBS transactions at that time and that any such new CMBS deals were being structured on a simpler basis (i.e. single loans, single borrowers and backed by stronger performing real estate assets) if compared with the more vibrant and active period before the GFC, the issues discovered from working out stressed CMBS transactions, the losses that many B lenders faced in the market and the simpler structure of CMBS transactions overall, legitimately resulted in a fairly obvious conclusion that A/B intercreditors were perhaps not as necessary as they had once been before.

This conclusion, that can fairly be said was shared by the marketplace overall, resulted in very little notice of the A/B intercreditor in favour of the senior/mezzanine intercreditor, the latter more relevant in the market place and accompanied by the introduction of new specialist alternative lenders in the marketplace providing that extra space of necessary capital that traditional senior lenders were no longer able or willing to finance. This point was acknowledged to such a degree in the market place that the Commercial Real Estate Finance Council (CREFC) and Loan Market Association (LMA) produced guidelines and, in the latter case, a template intercreditor agreement between the period 2012 and 2014 which relegated any discussion of the A/B intercreditor to the back of the room.[1] Rightly so, the senior/mezzanine intercreditor was the main discussion point, the most useful document to concentrate on in practice and an attempt to standardise the basic framework of such an agreement was undertaken by the LMA as referred to above.

So whilst the senior/mezzanine intercreditor remains the more relevant and commonly used transaction document out of the two, the A/B intercreditor has, as discussed in the previous two Chapters, resurfaced at the time of writing. The reason for this may well be due to the flexibility it provides—it does not require that the pricing and tranching of the loan be set out at the time of the origination of the underlying loan, it does not require the more cumbersome borrower group structure to be organised and maintained and it may well be just a lot quicker to put in place. This Chapter will look at intercreditor agreements in both their senior/mezzanine and A/B variants. For these purposes, as in the previous two Chapters, references to ''senior loan'' will be used interchangeably to refer to the senior or ''A'' interest in a whole loan, the actual whole loan itself or, in the context of a senior/mezzanine structure, the senior component of that arrangement, whilst references to a ''junior loan'' may refer to either a ''B loan'' or ''B tranche'' of a whole loan or a subordinated interest to such whole loan, be it a mezzanine or other interest. The use of the term ''junior loan'' may also be deemed to include references to more subordinated tranches in a whole loan in the context where there are more than two tranches of debt. Naturally, where the distinction is of paramount importance to differentiate a senior/mezzanine arrangement from an A/B whole loan structure, this will be highlighted. What this Chapter is not intended to discuss are intercreditor agreements in the context of subordinated loans, debt or equity provided by companies related to the underlying borrowers and which would otherwise be expected to be fully subordinated to the interests of third party lenders financing the transaction save to mention that senior/mezzanine intercreditor arrangements will typically also accomplish the purpose of setting out the subordination of such intragroup debt to third party financing.

7.2 Basic principles

When discussing intercreditor agreements in the context of CRE transactions, practitioners tend to differentiate between intercreditor agreements establishing the rights of lenders in either a senior/mezzanine lending arrangement or as lenders in a whole loan scenario. The former consists, in simple terms, of at least two distinct loans being made to two separate entities in a borrower group where the senior loan is made to the property owning vehicle, or immediate parent thereof, which obligations are secured

[1] However, the LMA in August 2016 in recognising the market's move to contractual subordination published a template intercreditor agreement. Further CREFC-Europe published guidelines in 2016 on contractual subordination intercreditor agreements.

by, among other things, a mortgage over the relevant property while the mezzanine loan is made to a holding company (typically at least two steps removed from the ownership of the senior borrower vehicle) which will be secured by the same security securing the senior loan as well as by (again, among other things) ''independent'' security which only benefits the mezzanine lenders over the equity interests in the mezzanine borrower. The latter involves discussing the rights of lenders in respect of the same loan to which such lenders are parties, made to the same borrower or borrowers and secured by the same security package which loan is tranched, usually with no visibility of the borrower as to the arrangement, setting a contractual subordination between of a junior tranche to a senior tranche of such loan.

As to the reasons why lenders and/or borrowers will prefer using one form of deal structure over another will be due to various reasons but these will take into account the requirements of the lenders in terms of their respective security packages and enforcement rights thereupon, the complexity and cost of operating multiple layers of special purpose vehicles necessary to set up a senior/mezzanine loan structure, the availability of a mezzanine lender at the outset of the transaction to clearly define the sizing and pricing of the transaction, speed of execution and whether a CMBS exit is being contemplated for the senior portion.

Figure 1: Typical Senior/Mezzanine Structure

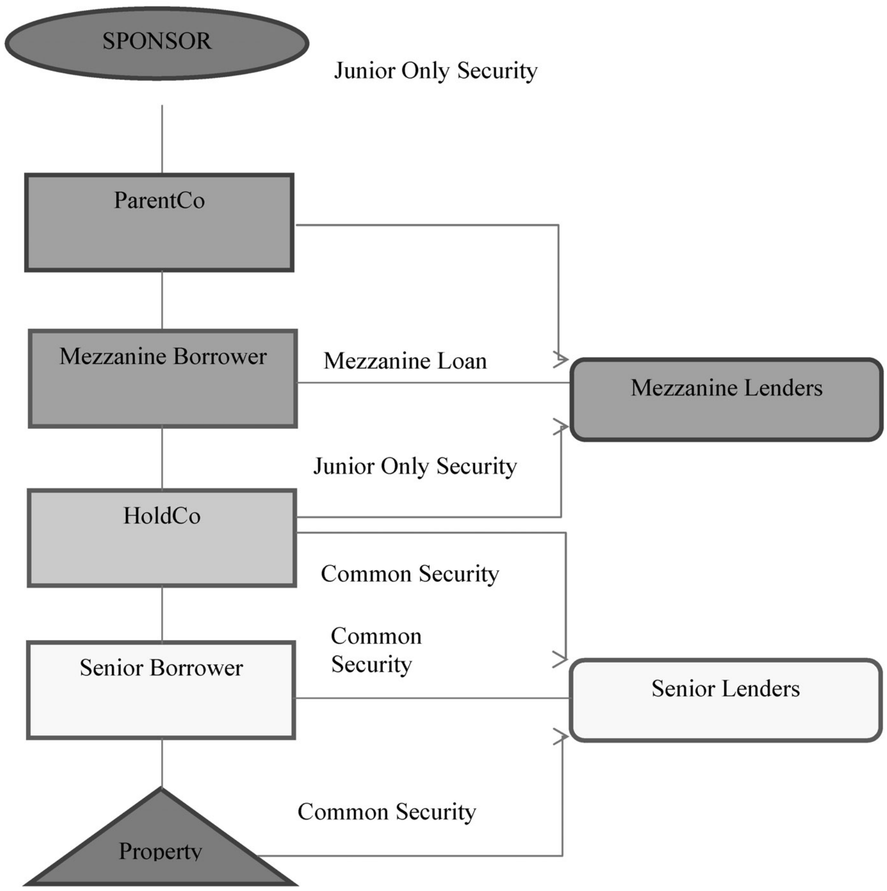
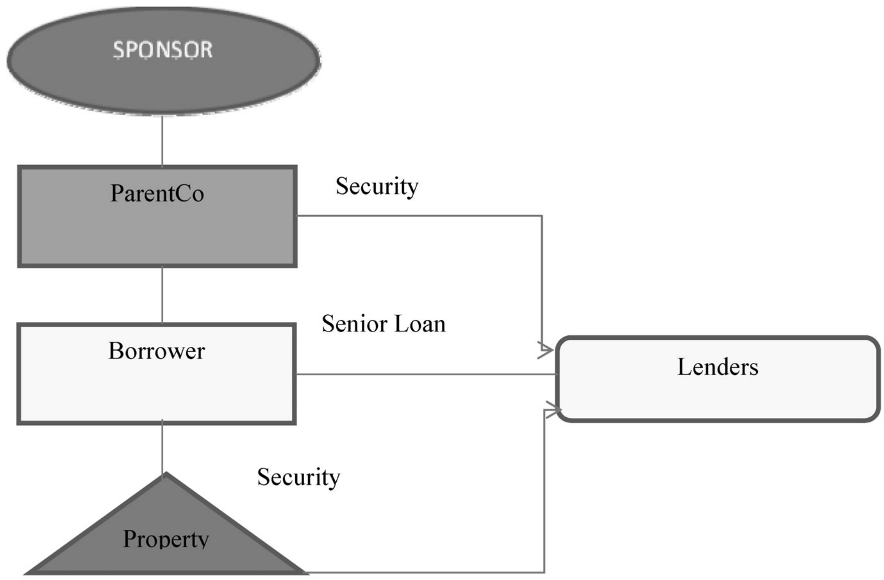


Figure 2: Typical A/B Structure



Apart from the differences resulting from the senior/mezzanine model being based on the existence of two separate debt obligations at different levels in the borrower group structure with the consequential operational considerations that such entails when compared to a whole loan A/B structure, historically one of the most distinguishing features of the senior/mezzanine structure has been the possibility for mezzanine lenders to have the possibility to pre-empt enforcement by the senior lenders on the occurrence of a mezzanine loan event of default. This would be possible as the occurrence of an event of default under the mezzanine loan will, in certain circumstances, occur before there is an event of default under the senior loan primarily as a result of the occurrence of a financial covenant breach at the mezzanine loan level, without it being so severe as to trigger the equivalent senior loan financial covenant, or the unavailability of cash to pay amounts outstanding under the mezzanine loan after having paid regular payments under the senior loan in full.

If that mezzanine loan event of default occurs prior to the occurrence of a senior event of default, the usual position under an intercreditor agreement between the senior and mezzanine lenders will, whilst prohibiting the mezzanine lenders from exercising any enforcement rights over any security given for the benefit of the senior lenders (including the mortgage over the related property), allow the mezzanine lenders to exercise enforcement rights over security given exclusively for its benefit. Typically this will consist of share security over, and security over intragroup loans made to, the mezzanine borrower which would allow the mezzanine lenders to take control of the mezzanine borrower and, by virtue of the same, control the senior borrower effectively becoming the new owner of the borrower group structure.

7.3 Priority of payments

7.3.1 Introduction

One of the primary purposes of an intercreditor agreement is to set out the respective lender's right to cashflow generated from the underlying loan.

In a senior/mezzanine structure this will either usually refer to the separate payment waterfalls incorporated into the senior loan and the mezzanine loan taking into account that the related intercreditor agreement will set out the subordination of the mezzanine lenders' position to the senior loan or the intercreditor agreement will set out the full waterfall applicable to distributions under each of the senior and mezzanine loan. These will usually be subject to certain exceptions as there will likely be circumstances where the mezzanine lenders will be entitled to receive certain payments before the senior loan has been paid in full. This may include disposal proceeds in connection with the sale of properties under the loan, proceeds received in connection with the enforcement of the junior only security, payment of funds received from the equity intended to pay down the mezzanine loan, current interest due and payable and, to the extent the principal amount of the senior loan exceeds the principal balance of the senior loan at the time of the origination of the senior loan, it would be usual for that difference (or an amount in excess of a pre-agreed amount or percentage) to be subordinated to the mezzanine lenders' position. As each of the senior and mezzanine loans will set out what amount is due to each of the lenders and the obligors will be a party to the senior/mezzanine intercreditor agreement, the borrowers will have full visibility on what amounts are due to each of the lenders as well as when and in what circumstances they will be paid.

In an A/B intercreditor, the relevant whole loan agreement will set out a payment waterfall that should ensure that costs associated with the running of the income producing property securing the loan and the operational costs of the borrower (usually a special purpose vehicle (SPV)) are met and, if applicable, any hedging costs relating to any borrower-level swaps, are paid in priority to the distribution of any amounts to the loan finance parties. Following payment of such expenses and any fees, costs and expenses due to the relevant agents of the loan, together with amounts available to pay principal and interest due under the loan, will be paid to the lenders, although the underlying whole loan agreement will usually not set out how those amounts are to be distributed amongst the lenders. In this respect, it is therefore not necessary for the borrower to be privy to the arrangements between the lenders, and the actual rates to be paid to each of the lenders can be set out in separate fee letters agreed between such lenders.

The allocation of amounts due to be distributed under an intercreditor agreement (be it under a senior/mezzanine intercreditor, by reference to the senior and mezzanine loan, or under an A/B intercreditor agreement, where the relevant waterfall will likely be contained in the same A/B intercreditor agreement) will, in common practice, hinge on whether certain triggering events have occurred. A senior/mezzanine intercreditor agreement will usually refer to a payment stop event preventing payments flowing after discharging amounts due under the senior loan from being paid to the mezzanine lenders. On the other hand, in an A/B intercreditor, there will likely be separate waterfalls that would apply depending on whether certain material events of default are in occurrence in respect of the related loan. Usually, these payment stop events, in the case of a senior/mezzanine intercreditor agreement, or material events of default, in an A/B intercreditor agreement will encapsulate, at a minimum: (a) a default in the payment of interest, principal and other amounts due on the senior loan (in a senior/mezzanine structure) or whole loan (in an A/B structure); (b) a default under certain covenants linked to the cashflow coverage or the loan to value ratio again in respect of the senior loan or whole loan depending on the intercreditor; and (c) certain insolvency events relating to the borrower and related obligors under the senior loan or whole loan, as the case may be. Other than the preceding, additional events can be and are commonly included as well, though this will be subject to negotiation between the lenders due to the effect that such events have on the distribution of amounts and ultimately, on the scenarios in which the junior lenders will be absorbing a loss, since the junior loans in such arrangements provide credit enhancement for the more senior positions in the related loan. A junior lender will also seek to ensure that it has the right to cure, where possible, as many of the events will either constitute a payment stop event for purposes of the senior/mezzanine loan intercreditor or may trigger a waterfall switch for purposes of the A/B intercreditor as further discussed below.

The above, in the context of a senior/mezzanine structure, needs to take into account that due to the existence of two separate loans and waterfalls under the underlying loan documentation that, save for certain exceptions as discussed above, payments will be sequential. The senior loan obligations will be discharged on any given interest payment date before the mezzanine lenders are entitled to receive payment. The exceptions to this will be negotiated, but will typically include the application of disposal proceeds, for instance, where prior to a payment stop event may be distributed on a pari passu and pro rata basis. There may also be cash trap or cash sweep events in the senior loan waterfall which will usually apply to surplus funds available under the senior loan waterfall after regular amounts due under the mezzanine loan are paid. From a mezzanine lender's perspective, it may well be necessary to include a consent right over the release of such cash trapped amounts particularly if such release is made at a time where amounts due to the mezzanine lenders have not been paid in full.

Furthermore, if a payment stop event occurs in a senior/mezzanine structure, cash that would have otherwise been paid to the mezzanine lenders may either be swept to amortise the senior loan or may be diverted and escrowed for a certain period of time. A usual scenario is that such escrowed amounts will be held and trapped on successive interest payment dates for say two interest periods and if in the intervening period there is an acceleration event under the senior loan, then such cash may be applied towards repayment of the senior loan. If such a payment stop event is cured or corrected, then such escrowed amounts will be released to the mezzanine borrowers.

7.3.2 Waterfalls

7.3.2.1 Senior/mezzanine waterfalls

A senior/mezzanine intercreditor will refer to the senior and mezzanine waterfalls contained in the underlying loan agreements. It is also possible, as discussed above, that the senior/mezzanine intercreditor will incorporate a single waterfall instead as an amalgamation of what would have been included in each of the senior and mezzanine loans and this will dispense with the need of incorporating separate waterfalls in the loan documents. In either case, the form of the waterfall or waterfalls, as the case may be, will be a standard sequential waterfall (either taken alone or together) accommodating the payment buckets necessary to deal with the payments under the loans. In the event of separate waterfalls in each of the senior and mezzanine loans, the senior loan will contain a bucket allowing for payments to be made to the mezzanine lenders by transferring an amount necessary to make such payments directly to the related mezzanine loan account.

The ordinary sequential nature of the waterfalls where amounts owing to in respect of the senior loan will be paid in priority to payments due under the mezzanine loan may be subject to certain exceptions agreed between the lenders. Primarily, there may be agreement that mandatory prepayment proceeds received in connection with a disposal of properties may be distributed pro rata between the lenders. Also certain prepayment events affecting lenders individually (i.e. mandatory prepayment due to illegality and/or increased costs) may be agreed to be paid to the affected mezzanine lender outside of the usual subordination of the mezzanine lender position. There may also be circumstances where the lenders have agreed that amounts available by the related mezzanine borrower's equity may be paid to the mezzanine lenders without those funds being applied first to discharge any senior amounts due. Naturally, this is not an exhaustive list and will be subject to agreement between the lenders.

Other exceptions to the usual senior/mezzanine subordination relate to the amounts by which the senior loan balance may increase if compared to the original senior loan balance at origination. This includes property protection loans or cure loans and the concept of a senior headroom. Property protection loans or cure loans are usually included in loan agreements to allow the lenders to make certain payments that the borrower should but has not paid. These will typically include amounts due under headleases, insurance policies, hedging arrangements, taxes and other costs related to the preservation or protection of the security granted to the lenders. When advanced by a lender, these amounts will accrue interest (at the same rate as amounts advanced as principal by the lenders and, sometimes, the pre-agreed default rate) and will be expressed to be repayable by the borrower on demand. If advanced by the senior lenders, these amounts will usually be expressed to be repayable in advance of ordinary principal and interest due to the senior lenders.

Given that the advancing of such further amounts will increase amounts due under the senior loan which will be paid in priority to amounts due under the mezzanine loan, mezzanine lenders will attempt to control the advancing of those amounts to the borrower as well as limit the quantum that would rank senior to their position. Mezzanine lenders will (i) seek to ensure that the purpose for which those amounts may be advanced are clearly set out and limited; (ii) consider negotiating with the senior lenders to have a first refusal right to make those advances instead of the senior lenders; and (iii) attempt to cap the total amount of any such advances to the borrower by setting a maximum amount or percentage (usually 5–10% of the balance of the senior loan at origination) that could be advanced by the senior lenders with any excess over that maximum amount being agreed to be subordinated to the mezzanine loan position. In the event the mezzanine lenders procure a right to advance such property protection loans, those amounts could be advanced to the mezzanine borrower and funnelled down to the senior borrower by way of intragroup loans, the mezzanine lenders would pay the same to the senior lenders as a cure or the senior lenders in the first instance would make such advances which would then be acquired by the mezzanine lenders by making a payment for those advances to the senior lenders (subject to certain limitations arising from the acquisition of such senior advance).

To the extent the senior waterfall contains a cash trap or cash sweep, care would need to be taken by the mezzanine lenders to ensure that the triggers for either of the above would not result in monies not being made available to keep the mezzanine loan payments current. Ordinarily, it would be expected that such cash traps or cash sweeps would apply after the bucket in which an amount necessary to pay mezzanine loan amounts then due has been extracted from the senior loan waterfall to the mezzanine loan waterfall.

Lastly, the senior/mezzanine intercreditor will set out the triggers which stop payments being made to the mezzanine lenders. Usually these will include payment defaults, financial covenant breaches and insolvency of the senior obligors under the senior loan. When such payment stop event occurs, it is usual for the amounts that would otherwise been payable to the mezzanine lenders to be extracted from the waterfall and placed into escrow. Once in escrow, the relevant provisions will ordinarily provide that such amounts will be released to the mezzanine lenders or released through the waterfalls once the relevant payment stop event has ceased to be continuing (and, in some instances, for a certain additional period of time beyond that date to provide for a stabilisation period). In the event there is cash trapped in the related escrow account on an acceleration of the loan, such cash would be available to pay down the senior loan. It is also not uncommon to see a limit placed on the amount of time such diverted funds may be held in the escrow account or on the continuance of the payment stop event trigger if the senior lenders have not taken enforcement action within an agreed period of time. It may also be the case that amounts due in respect of the mezzanine loan which are otherwise trapped may have to be released to the mezzanine parties before the payment stop trigger ceases to be continuing, such as in the case of ordinary agency fees due under the mezzanine facility agreement.

7.3.2.2 A/B pre-default and post-default waterfalls

An A/B intercreditor agreement will usually set out a pre-default waterfall and a post-default waterfall. The pre-default waterfall will determine the allocation of payments before certain events of default have occurred. The post-default waterfall will set out the allocation of payments after such events have occurred.

There may be some variation to a typical pre-default waterfall from deal to deal (e.g. junior loans which have some element of amortisation may rank in priority to amortisation on senior loans) but a typical pre-material default waterfall is set out below:

> ''For so long as no Material Event of Default is continuing, on the later of the date that amounts are distributed in accordance with the Credit Agreement or the date that payments are due with respect to any Hedging Arrangement that relates to such amounts, such amounts shall be distributed as between the Finance Parties (in replacement to the order set out in the Credit Agreement) as follows:
>
> - *first*, in or towards any payment due under any **Hedging Arrangements** (whether or not periodic payments or payment as a result of termination, provided that such termination is not due to a default of or termination resulting from the related swap counterparty);
> - *secondly*, in or towards payment of all fees, costs and expenses due and payable to the **Security Trustee** and its agents under the Finance Documents, (including all fees and expenses of the **Servicer and Special Servicer** as agents of the Finance Parties pursuant to the terms of the Servicing Agreement) and all amounts expended in connection with the preservation

of the rights of the Finance Parties under the Finance Documents, including the preservation of the Property as security for the Whole Loan;

- *thirdly*, in or towards payment of **interest due and payable** (after taking into account any Cure Payment made in respect of a Non Payment of such interest) to the **Senior Lende**r under the Credit Agreement (including the portion of Break Costs (and income earned thereon) up to the amount necessary to make a complete payment of interest on the Senior Loan at the Senior Loan Rate for the related Interest Period);
- *fourthly*, in or towards payment of **interest due and payable to the Junior Lender** under the Credit Agreement (including the portion of Break Costs (and income earned thereon) up to the amount necessary to make a complete payment of interest on the Junior Loan at the Junior Loan Rate for the related Interest Period);
- *fifthly*, in or towards **payment to the Senior Lender and the Junior Lender, pro rata,** according to the amounts due to each of them, **of principal due and payable** in respect of the Senior Loan (after taking into account any Cure Payment made in respect of a Non Payment of such principal) and the Junior Loan respectively;
- *sixthly*, in or towards payment of **Default Interest** received on the Whole Loan to the Senior Lender and the Junior Lender, pro rata, according to the outstanding principal on the Senior Debt and the Junior Debt as of the beginning of the related Interest Period;
- *seventhly*, in or towards **reimbursement** on account **of any Cure Payments** made by the Junior Lenders pursuant to this Deed;
- *eighthly*, in or towards payment to the Senior Lender and Junior Lender, pro rata, other than to the extent such amounts are paid above, of **all other costs, fees and expenses due and payable** under the Finance Documents; and
- *ninthly*, in or towards payment to the **swap counterparty** with respect to any Hedging Arrangement entered into with respect to the Whole Loan **in relation to termination payments** when the swap counterparty is the defaulting party or reason for termination.
- *Notwithstanding the above*, if there are insufficient collections to pay all amounts of principal and interest due and payable to the Senior Lender and the Junior Lender (or any of them) in accordance with this Clause, the full amount of such shortfall shall be allocated to the Junior Loan.''

In contrast to the above, upon the occurrence of a relevant triggering event, a post-default waterfall typically provides that payments due to the lenders are to be distributed sequentially, in order to ensure that higher ranking lenders receive their payment in full, prior to any amounts leaking out, to pay amounts due to the more subordinated classes of lenders. The intercreditor agreement position here may be different than under the underlying loan agreement, as the occurrence of the material event of default, for these purposes, may or may not involve an acceleration of the whole loan. Therefore, the post-default waterfall trigger may cause available proceeds to be applied to pay off lenders in full, whilst such amounts may not necessarily be presently due and payable under the whole loan itself.

Alternatively, it is not uncommon to see waterfalls that provide a staggered approach whilst a material default is continuing (e.g. a payment default) but, prior to acceleration of the whole loan, amounts received from the borrower would be applied firstly to pay amounts due and payable to the A loan whilst amounts that would subsequently be due to the B loan or more subordinated classes of lenders would be placed into an escrow account. The period during which such amounts may be retained in such an escrow account will usually be limited, pending either the acceleration of the loan, or the cure of such default by the junior lenders. If the loan is accelerated, or the default is not cured, amounts in the escrow account would be applied towards payment of amounts due in respect of the A loan, with any excess flowing to the more subordinated positions. If, however, the whole loan is not accelerated within a certain period (a period which is subject to negotiation but, as an example, it may be 90 days to match an interest period), then such escrowed amounts together with any accrued interest in the escrow account would be released to be applied against the B loan, or more subordinated positions in the debt stack. Such retention periods are usually structured to motivate the A lender to assess the impact of the relevant default and to determine whether it should seek to accelerate the whole loan and enforce the related security. However, from a junior lender perspective, such may be seen as an attempt by the A lender to build up a reserve to the detriment of the junior lenders.

An example of a sequential post-default waterfall is set out below:

> "For as long as a Material Event of Default is continuing, on the later of the date that amounts are distributed in accordance with the Credit Agreement or the date that payments are due with respect to any Hedging Arrangement that relates to such amounts, such amounts shall be distributed (in replacement to the order set out in the Credit Agreement) as follows:
>
> - *firstly*, in or towards payment of any amounts due under any **Hedging Arrangements** entered into with respect to the Whole Loan (whether or not periodic payments or payments as a result of termination, provided that such termination is not due to a default of or termination resulting from the related swap counterparty);
> - *secondly*, in or towards payment of all costs, fees and expenses due and payable to the **Security Trustee** under the Finance Documents (including all fees and expenses of the **Servicer and Special Servicer** as agents of the Finance Parties pursuant to the terms of the Servicing Agreement) and all amounts expended in connection with the preservation of the rights of the Finance Parties, including the preservation of the Property as security for the Whole Loan;
> - *thirdly*, in or towards payment of **interest due and payable to the Senior Lender** under the Credit Agreement (including the portion of Break Costs (and income earned thereon) up to the amount necessary to make a complete payment of interest on the Senior Loan at the Senior Loan Rate for the related Interest Period);
> - *fourthly*, in or towards repayment of **all principal outstanding on the Senior Loan** (whether such amount is due or not);
> - *fifthly*, in or towards payment to the Senior Lender of the **Senior Lender's** pro rata portion of all other **costs, fees and expenses** due and payable under the Finance Documents;

- *sixthly*, in or towards payment of the **Senior Lender's** pro rata portion of **Default Interest** received on the Whole Loan based on the outstanding principal on the Senior Debt as compared to the Whole Loan as of the beginning of the related Interest Period;
- *seventhly*, in or towards **reimbursement** on account **of any Cure Payments** made by the Junior Lender pursuant to this Deed;
- *eighthly*, in or towards payment of **interest due and payable to the Junior Lender** under the Credit Agreement (including the portion of Break Costs (and income earned thereon) up to the amount necessary to make a complete payment of interest on the Junior Loan at the Junior Loan Rate for the related Interest Period);
- *ninthly*, in or towards repayment of all **principal outstanding on the Junior Loan** (whether such amount is due or not);
- *tenthly*, in or towards payment of the **Junior Lender's** pro rata portion of **Default Interest** received on the Whole Loan based on the outstanding principal on the Junior Debt as compared to the Whole Loan as of the beginning of the related Interest Period; and
- *eleventhly*, in or towards payment to the Junior Lender of the **Junior Lender's** pro rata portion of all other **costs, fees and expenses** due and payable under the Finance Documents; and
- *twelfthly*, in or towards payment of any amounts due under any **Hedging Arrangements** entered into with respect to the Whole Loan in relation to termination payments, when the swap counterparty is the defaulting part or reason for termination.''

7.3.3 Hedging[2]

The above A/B waterfalls contemplate that lender-level hedging, benefiting all, is in place in respect of the loan. If hedging is exclusively in place at the borrower level, then the loan agreement waterfall will usually deal with its payment in priority to payment of amounts due to the lenders under the loan. If, in contrast, no lender level hedging is to be entered into for the benefit of the junior loan, then the CMBS waterfalls would have to deal with the allocation of amounts payable to the related hedge counterparty. Typically in CMBS, there will at least be a basis swap to address the mismatch between the dates on which interest and principal are due on a loan and the date on which proceeds are to be distributed to CMBS bondholders under the CMBS and the floating interest rate mismatch that may arise as a result. Accordingly, if a lender-level swap pays on any date, after which amounts are due on the underlying loan, the actual date of distribution of such amounts, for the purposes of the intercreditor agreement, should reflect that latter date as the date of distribution of amounts under the intercreditor agreement.

A hedge counterparty will expect that the main hedge payments due to it rank at the top of the waterfall. In the context of CMBS, this is important, as the CMBS bonds will require having adequate hedging arrangements in place, as a default in the payment of such amounts will not only result in the

[2] See further Ch.12.

probable termination of the underlying hedging arrangement and break costs due to such hedge counterparty, with the corresponding reduction in proceeds available to be distributed to bondholders, but also in the impossibility of bringing in a replacement hedge counterparty if required. However, not all payments due to a hedge counterparty will rank in priority. If break costs are due to a hedge counterparty, for reasons which are imputable to such hedge counterparty (e.g. termination event under the related hedging arrangement in respect of a hedge provider or the failure by the hedge provider to meet its obligations under the related hedging agreement following a ratings downgrade), such amounts will be expected[3] to be subordinated to amounts due to the lenders.

7.3.3.1 Case law in the US and England

Three cases, two in the US Bankruptcy Court in the Southern District of New York and one in the UK's Supreme Court, in each case relating to the bankruptcy of Lehman Brothers and its affiliated companies, in and around September 2008, have evidenced that US and English law disagree on the validity of such subordination clauses or ''flip clauses'' when triggered by the filing of insolvency proceedings of the related hedge counterparty.

The first, *Lehman Bros Special Financing v BNY Corporate Trustee Services Ltd (Re Lehman Bros Holdings, Inc)*[4] related to two series of credit-linked synthetic portfolio notes issued by an Irish SPV (Saphir) created by Lehman Brothers under the so-called Dante Program. At issue was whether Lehman Brothers Special Financing (LBSF), as credit default swap provider to the transaction, had been validly subordinated under the provisions of the transaction documents, which were expressed to be governed by English law, in respect of its entitlement to distributions in the collateral (being certain triple-A rated bonds) securing the transaction upon the filing of its voluntary case under US bankruptcy law, specifically Ch.11, in October 2008.[5] Prior to an event of default under the related hedging arrangement imputable to LBSF, LBSF would have been entitled to payment of proceeds produced by the collateral in priority to certain bondholders (in this case *Perpetual Trustee Company Ltd*), who would otherwise have been due such amounts as payment due under the related bonds. Upon the occurrence of such an event of default, the priority of payments would be ''flipped'' and the calculation of the amount due to LBSF as a result of the termination of the hedging arrangement would vary, each favouring *Perpetual* to the det-

3 For instance, see *Swap Criteria for European Structured Finance Transactions*, DBRS, June 2011, pp.17–18.
4 422 B.R. 407 (Bankr. S.D.N.Y. 2010).
5 Lehman Brothers Holdings, Inc (LBHI) bankruptcy filing in September 2008 was also an event which was capable of triggering an event of default under the credit default swap, as LBHI was the credit support provider and its bankruptcy filing was an express event of default. However, this distinction is immaterial for purposes of the above as each of LBHI's and LBSF's bankruptcy filings predate the date on which the hedging arrangements were notified to have been terminated on behalf of Saphir.

riment of LBSF. As there was no issue of triable fact, Judge Peck heard the matter as a motion of summary judgment and concluded, among other things, that the ''flip'' to the priority of payments as a result of the insolvency of LBSF breached US bankruptcy law[6] and any attempt to enforce such provisions would violate the automatic stay provided for under the US bankruptcy law. Interestingly, this motion for summary judgment was being heard contemporaneously with proceedings brought by *Perpetual* in the English courts and Judge Peck noted that ''[i]n applying the Bankruptcy Code to these facts, this Court recognises that it is interpreting applicable law in a manner that will yield an outcome directly at odds with the judgment of the English Courts.'' For purposes of the US litigation, the case was subsequently settled before appeal to the US District Court and accordingly, the decision is ultimately only persuasive for the purposes of whether it is a binding precedent for future litigation.

Similarly, *Lehman Brothers Special Financing v Ballyrock*[7] related to a hedging arrangement entered into between LBSF and the issuer in a CDO transaction, Ballyrock. Under the related master agreement and indenture, LBSF would have been entitled to a priority ranking in the related waterfall if amounts were due to it as a result of the termination of the hedging arrangements, except that if such termination was due to LBSF or Lehman Brothers Holdings Inc (LBHI), as credit support provider under the hedging arrangement, among other reasons, due to either having instituted or having instituted against either of them bankruptcy proceedings. The termination payment would be subordinated to the payment of bondholders and capped in the amount of $30,000. Accordingly, upon LBHI's bankruptcy filing in September 2008, Ballyrock exercised its right under the hedging arrangement to call for an early termination date, under all transactions entered into in respect of the hedging arrangement and a termination payment due to LBSF of approximately $404 million was determined. Ballyrock subsequently liquidated its assets and after distribution of

6 Specifically under each of: (1) s.355(e)(1) of the US Bankruptcy Code, which reads: ''Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.'' (11 USC (2011) s.365(e)(1)); and (2) s.541(c)(1)(B) of the US Bankruptcy Code which reads in part ''... an interest of the debtor in property becomes the property of the estate ... notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law ... that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property''. (11 USC (2011) s.541(c)(1)(B)).

7 *Lehman Bros Special Financing Inc v Ballyrock ABS CDO 2007-1 Ltd and Wells Fargo Bank, N.A., Trustee (Re Lehman Brothers Holdings, Inc)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2010).

amounts due to the bondholders proposed to further distribute a remaining amount of $137 million to bondholders on the next scheduled payment date. Upon the announcement of the proposed distribution of such amounts, LBSF filed a complaint against Ballyrock for a declaratory judgment to obtain, among other measures, a judgment that such proposed distribution would be in violation of applicable bankruptcy law. On a motion to dismiss such complaint, Judge Peck again found that, also citing *Lehman Bros Special Financing v BNY*, the flip clause was susceptible to being interpreted[8] as an ipso facto provision that could not be enforced to deprive LBSF of its rights on account of its bankruptcy filing. Furthermore, there was a detailed discussion of the safe harbour provisions in US bankruptcy law then set out in *Lehman Brothers Special Financing v BNY*. Such provision allowed, notwithstanding a bankruptcy filing, a swap participant to exercise any contractual right it may be entitled to under the terms of the related hedging arrangement to liquidate, terminate or accelerate a hedging arrangement upon a bankruptcy filing of the other party[9] Judge Peck, in his judgment, made it clear that such safe harbour was to be construed to permit termination and not, as in this case, to subordinate a right to payment but for the bankruptcy filing.

In *Belmont Park*,[10] the UK Supreme Court heard the final chapter in the *Perpetual* case saga. Rather than being based on carefully worded legislation, applicable English law relevant in this case hinged primarily on English common law and the ''anti-deprivation rule'' under English insolvency law. The Belmont group were a series of bondholders, other than *Perpetual*, who owned bonds in other series of bonds issued by Saphir. Following decisions by the High Court and Court of Appeals favouring the bondholder view that the ''flip'' clause was valid and worked to subordinate LBSF's expectation of payment from proceeds realised on the related collateral, Lord Collins, in his leading judgment, found that it is ''desirable that, so far as possible, the courts give effect to contractual terms which parties have agreed'',[11] that ''there is a particularly strong case for autonomy in cases of complex financial instruments such as those involved

[8] Given that the matter heard was in the context of a motion to dismiss filed by Ballyrock, a full hearing at trial on the matter would subsequently determine whether such the enforcement of such clauses would violate US bankruptcy law.

[9] Specifically, s.560 of the US Bankruptcy Code, which reads in part: ''[t]he exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title . . .'' (11 USC (2011) s.560).

[10] *Belmont Part Investments PTY Ltd v BNY Corporate Trustee Services Ltd and Lehman Bros Special Financing Inc* [2011] UKSC 38.

[11] Citing Lord Neuberger in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160; [2010] Ch 347 (CA) at [58].

in this appeal''[12] and specifically, the transaction (and the ''flip'' clause) had been entered into in good faith and there never had ''been any suggestion that those provisions were deliberately intended to evade insolvency law''.[13] Furthermore, Lord Collins considered that it was ''possible to give a policy [the anti-deprivation rule] a common sense application which prevents its application to bona fide transactions which do not have as their predominant purpose, or one of their main purposes, the deprivation of the property of one of the parties on bankruptcy.''[14]

Consequently, the practical lesson to be learnt as a result of the above cases is that, whilst the ''flip'' in a waterfall triggered as a result of an insolvency filing of the party otherwise entitled to payment is valid under English law, care should be taken to verify whether the jurisdiction in which main bankruptcy proceedings may be brought against that party will also recognise such clause. Given that US courts may steer towards finding such clauses in breach of US bankruptcy laws, parties may wish to minimise any adverse impact by, where possible, entering into such arrangements with counterparties subject to, for example, English law where possible.

7.3.4 Losses due to shortfalls

The primary goal of either form of intercreditor agreement is to ensure subordination of, in the case of a senior/mezzanine structure, the mezzanine debt to the senior debt or, in the case of an A/B structure, the junior tranche to the senior tranche. One area where this is important is, in the context of an A/B structure, allocation of losses. In a senior/mezzanine structure, the analysis is considerably simpler as due to the application of both a senior and mezzanine waterfall (or, in the alternative, an integrated waterfall as discussed above) the sequential application of available cash flow will result in a clear conclusion that in most payment scenarios the senior loan will be paid in priority and the mezzanine lenders will ultimately face the first risk on insufficient cash flow being available to pay both debt obligations. As the borrowers in such senior/mezzanine structure will have visibility as to what is due to each lender, the failure to pay any amount due will be a payment default of the related borrower.

In an A/B structure, the pre-material default waterfall sample included at section 7.3.2.2, the last paragraph of that clause ensures that the intended credit enhancement that the B loan represents, in favour of the A loan, is preserved in the circumstance where there is a shortfall in available proceeds, even when the pre-material default waterfall applies. This may occur, for instance, following a work-out or restructuring of the loan where the loan, after having been paying under the post-material event of default waterfall, reverts to the pre-material default position but, for instance, the

12 [2010] Ch 347 (CA) at [103].
13 [2010] Ch 347 (CA) at [109].
14 [2010] Ch 347 (CA) at [104].

amount payable by the borrower under the loan has been reduced. This paragraph ensures that when a payment is to be made in respect of each of the A loan and B loan where the B loan would, save for the shortfall, have been entitled to any payment in priority to the A loan (as in the case of the sample pre-material default waterfall above), available proceeds are first allocated to meet amounts owing in respect of the A loan, with the B loan absorbing the loss. This may be applicable even in a situation where the borrower is current on all amounts it is obliged to pay under the whole loan which is a different conclusion that what would arise under a senior/ mezzanine structure were the payment deficiency would be imputable to a payment default by the related borrowers.

7.3.5 Interest rate creep/payment shortfalls

A diminution of the amount of principal outstanding on an A/B senior loan may have a negative impact on the availability of proceeds, to meet amounts due under more subordinate tranches. As noted above, lenders in the debt stack will agree to an interest rate on their participations that will be calculated based upon the overall rate payable by a borrower under the whole loan. Senior (or A) lenders, given their ranking in the waterfall and their priority in respect of recoveries from proceeds generated by the underlying collateral, will agree to a rate of interest that matches the level of risk they are agreeing to in the transaction. Correspondingly, subordinated (or B) lenders will invest and accept subordination only if they are paid a rate commensurate to their own position's level of risk.

An example of what is called ''rate creep'' can be explained by assuming a whole loan in the amount of £100 million is entered into at a rate of 9% per annum. The whole loan is subsequently tranched into an A loan in the amount of £70 million at a rate agreed between the lenders of 6% per annum and a B loan in the amount of £30 million at a rate of 16%. If the A loan is hyperamortised in priority to the B loan in, for example, £5 million that results in a weighted average on the combined A loan and B loan of approximately 9.07%, which means that the whole loan interest rate payable by the borrower under the loan agreement would no longer be able to sustain the B loan rate. This scenario may occur if the post-default waterfall triggers occur, which results in hyperamortisation of the A loan, in priority to the B loan and then the waterfall shifting back, as a result of a cure of the event, to the pre-default waterfall. Another example may be if part of the A loan is wiped out or forgiven. One way to address this issue is to ensure that the A loan rate is expressed to be net of the B loan rate. In the second example, the consent rights typically afforded to the B lender will require that prior to any change to the amount of any payment due under the loan, the prior written approval of the B lender be obtained.

There are no clear cut solutions to the resulting issue caused by such payment imbalances. Traditionally, such losses have been absorbed by junior lenders as described above. It is now not uncommon to see the junior interest rate being set out in the A/B intercreditor agreement as the lesser of the junior interest rate agreed between the senior and junior lender at the time the junior lender acquired its interest in the whole loan and an interest rate that would match the amount of available cashflow available to pay junior interest after application of the A/B waterfall. This yields the same result of the junior lender absorbing the loss and the junior lender potentially being paid less than the pre-agreed interest rate. One attempt to minimise the impact of the payment imbalance on the junior loan is by using default interest payable by the borrower under the whole loan to allow junior lenders to ''catch-up'' at least part of the amount that would be due to them, which in any event is an imperfect solution as it is unlikely that any default interest payable by the borrower would be sufficient to allow the junior lenders to recoup the full amount of pre-agreed interest. On the other hand, a clear solution would be to make the tranching of the loan and the ''A note'' and ''B note'' interest rates visible to the borrower ultimately making the borrower liable to pay the full amount of interest on the ''B note'' in the event of a shortfall. This may be accomplished by making the borrower a party to the A/B intercreditor agreement or by factoring the tranching of the loan into the terms of the whole loan itself, which would evidently be subject to negotiations between the parties including whether the borrower would be willing to accept that the pricing for the whole loan may not necessarily match the original all-in interest rate that it may have thought it had agreed.

7.4 Amendments, waivers and consents

7.4.1 Entrenched rights v control valuation

In Europe, there are two general approaches to resolving the issue relating to the amount of control given to subordinated lenders. The first, requiring that either any amendments, waivers or consents, or those relating to an enumerated list of specified actions in respect of the whole loan, cannot be taken without the consent of the subordinated lenders, which are commonly denominated ''entrenched rights''. Any actions outside that list would be taken by the servicer, special servicer or senior lender as relevant. Rating agencies have traditionally not favoured the existence of entrenched rights in a CMBS context.[15] The second, subjecting any subordinated lender approval rights in respect of any amendments, waivers or consents relating to an enumerated list of actions to a ''value out'' provision (a ''control valuation event''). Under such a provision, if the underlying properties

15 ''It is common for the junior lender to have consent rights with respect to issues that will affect the characteristics and/or credit quality of the loan. However, Fitch expects that these consent rights to be structured such that they do not interfere with the day-to-day management of the property, servicing of the loan and, in particular, the timing of the enforcement process. Where amendments can be undertaken only in case all (senior and junior) creditors agree, the question is whether these consent rights grant too much power to the junior creditor.'' *Fitch Ratings*; pp.4–5.

securing the whole loan have depreciated in value to cover both the senior debt and a specified portion of the related subordinated debt, then such approval rights would be disapplied. An example of a control valuation provision is provided below:

> ''A 'Control Valuation Event' will occur if at any time, the Market Value of the Property is less than the aggregate of: (i) the A Debt then outstanding to the A Lender; and (ii) twenty-five per cent of the B Debt outstanding to the B Lenders at the date of this Deed.''

Hence, if the value of the property, as determined by a valuation obtained pursuant to the terms of the intercreditor agreement, securing the whole loan falls below the full amount of the A loan plus 25% of the B loan, at the time the intercreditor agreement is entered into, the B lender will cease to be able to exercise the relevant control rights. Such calculations will be based on valuations obtained at the times or upon the occurrence of certain events, as set out in the intercreditor agreement. This may or may not coincide with the timings for obtaining valuations under the underlying loan agreement. In fact, such valuations at times cannot be used for the purposes of determining whether a control valuation event is in existence. If a control valuation event is determined to exist, the affected lender will usually have the right to obtain, or instruct the servicer or special servicer to obtain, another valuation at the cost of such lender. The servicer or special servicer may then have the discretion, to be exercised in accordance with the servicing standard, as to which valuation to use for determining the existence of a control valuation event.

The position described above in connection with A/B intercreditor agreements is not vastly different to the position in senior/mezzanine intercreditors, particularly when contemplating that all or part of the senior loan in such structure is placed into a CMBS. More often that not, when a CMBS is not contemplated for the senior loan, the rights of mezzanine lenders in connection with a modification or consent of the terms of the senior loan would be entrenched. This means that the mezzanine lenders would have to affirmatively consent to a modification of the terms of the senior loan which is likely would have a material impact on the mezzanine loan be it in connection with an alteration to the amounts that rank senior to the mezzanine loan or to the operation of the borrower group or properties. In order to ensure that any amendments or consents that may be permissibly given by the senior lenders with or without the consent of the mezzanine lenders are capable of being implemented without further consequence, it would be usual for the mezzanine lenders to be dragged along with a consent or amendment permissibly given by the senior lenders under the terms of the senior loan agreement and intercreditor agreement so that such item would not cause an event of default under the terms of the mezzanine loan.

However, such purported amendments or consents given in respect of a senior loan, where it is intended that all or part of such senior loan will be placed in a CMBS, will be subject to a value threshold having the same effect as a control valuation event as described above in connection with A/B intercreditors. This will result in the mezzanine lender express consent rights over modifications or consents made by the senior lenders under the senior loan being switched off once the value of the underlying property has fallen below the amount of the senior loan and a buffer.

7.4.2 Common actions requiring consent

An intercreditor agreement may provide for a combination of both methods described above, i.e. a set of entrenched rights or rights subject to a control valuation event and a list of items in respect of which the facility agent or, if applicable, the servicer or special servicer would be required to consult the relevant subordinated lender on in any event.

Whilst the list of actions that will require the consent of the junior lenders will naturally be subject to intense negotiation and vary from deal to deal, there are a few that form a very basic list from which negotiations usually start. A sample list is provided below relating specifically to an A/B structure but which can be extrapolated for a senior/mezzanine structure:

> ''The [Agent, Servicer or Special Servicer] may not amend or waive any term of any Finance Document or exercise or refrain from exercising any consent, approval, discretion or determination, contained in any Finance Document having the same commercial effect in a manner or to an extent which would or could result in:
>
> (a) any change to the date of payment of any amount to a Lender under the Finance Documents;
> (b) a reduction in the Margin or a reduction in the amount of any payment of principal, interest, fee or other amount payable to a Lender under the Finance Documents;
> (c) a change to the currency of any amount payable under the Finance Documents;
> (d) an increase in, or an extension of, a Commitment;
> (e) any change to the basis upon which a payment is calculated in accordance with the original provisions of that Finance Document;
> (f) any amendment, waiver or supplement to a Financial Covenant or an Event of Default under the Credit Agreement;
> (g) a release of an Obligor;
> (h) a release of any Security other than in accordance with the terms of the Finance Documents; or
> (i) any change to the right of a Lender to assign or transfer its rights or obligations under the Finance Documents . . .''

The first four items listed above will impact the junior lender's economics in the transaction and will naturally be an area that the junior lender will wish to ensure is not amended without its consent. For the reasons provided in section 7.4.1, the junior lender will also wish to limit any amendments to the economics relating to the senior piece, or any amendment under paras (e) and (f) which can result in a change to the applicable waterfall or lead to the acceleration or enforcement of the loan, that may have an impact on the junior lender's rights to payment (including cash flow). Paragraphs (g) and (h) address the credit quality of the asset and (i) ensures that the lender may exit the transaction on the originally agreed terms, if so desired. Other items are commonly negotiated and added on to the list on a case-by-case basis (i.e. relating to the administration and quality of the underlying property or further events that may result in a change to the applicable waterfall which may result in proceeds being cut off from the junior lender). These will vary depending on the transaction and the bargaining power of the related parties. However, care should be taken to ensure that such actions that may be required for the day-to-day management of the property are not unduly restricted or subject to the delay that a formal approval or consultation process will entail, particularly in a post-default scenario where the servicer or special servicer will be required to take a more active role.

If compared with a sample list of items requiring mezzanine lenders' consent under a senior/mezzanine intercreditor, similar areas of coverage and areas of difference may be identified mainly accounting for the difference between the A/B and senior/mezzanine loan structures where, in the latter case, there are two separate loan agreements entered into with borrowers at different levels in the borrower group structure:

''(a) increase the Loan Margin or provide for additional margin to be payable (except to the extent that such increase or addition is contemplated by the Finance Documents);

(b) change the basis on which interest, fees or commission are calculated under the Facility Agreement, unless the relevant change: (i) is contemplated by the Finance Documents; (ii) is minor or administrative and not prejudicial to the Mezzanine Lenders; (iii) does not increase the overall cost to the Obligors of the Secured Liabilities; or (iv) relates to reasonable fees or charges in connection with amendment, waiver or consent requests;

(c) increase the principal amount of the Facility;

(d) increase the overall cost to the Obligors of the Secured Liabilities;

(e) change the currency of any amount payable under the Finance Documents;

(f) change the timing of payments under the Facility Agreement (including (i) any change to the definition of the term 'Interest Period' in the Facility Agreement or (ii) an extension or reduction of the term of the Loan);

(g) change the provisions relating to hedging or the definition of 'Majority Lenders' in the Facility Agreement;

(h) cause existing financial covenants, events of default or defaults contained in the Facility Agreement to be more onerous on the Obligors or introduce new financial covenants to the Facility Agreement;

(i) change, or grant to consent to an amendment to, the provisions governing the disposals that are permitted under the Finance Documents which would make such disposals more onerous for the Obligors or to amend the Release Price payable for a permitted disposal, unless a Loan Event of Default is continuing and the disposal otherwise is a Distressed Disposal permitted under the Intercreditor Agreement;

(j) change, or grant consent to an amendment to, the provisions governing the type or proportion of insurance proceeds, expropriation proceeds and recovery proceeds which must be applied in prepayment of the Loan;
(k) change, or grant consent to an amendment to, the negative pledge, the provisions restricting the payments of dividends or other distributions or the insurance covenant contained in the Facility Agreement;
(l) change, or grant consent to an amendment to, the provisions of the Facility Agreement governing the ability of affiliates of the Obligors to purchase participations in the Secured Liabilities;
(m) release any Loan Security other than expressly permitted pursuant to the terms of the Facility Agreement or the Intercreditor Agreement;
(n) amend or waive or provide a consent in respect of the accounts or priority of payment provisions of the Facility Agreement unless it is contemplated by the Finance Documents or a minor or technical change or correction which is not prejudicial to the Mezzanine Lenders;
(o) result in a cross default of the Secured Liabilities to any default under any Mezzanine Facility Liabilities or subordination of the Secured Liabilities to any indebtedness;
(p) permit the Finance Parties to acquire any direct or indirect equity interest in a Mezzanine Borrower or any additional interest based on cashflow or appreciation of the Properties;
(q) without prejudice to any permitted Distressed Disposals, release, waive or compromise any Mezzanine Borrower Liabilities;
(r) consent to a change of control pursuant to the terms of the Facility Agreement; and
(s) change or release the guarantee or indemnity under the Facility Agreement other than as permitted under the Intercreditor Agreement with respect to a Distressed Disposal.''

As in the case of the A/B intercreditor discussion above, the list of amendments in this senior/mezzanine sample can be subdivided into items:

(i) protecting the mezzanine lenders' economics in the deal. For example, paragraphs (a), (b), (c), (d) and (e) are conceptually the same as the items covered in the first four paragraphs of the A/B intercreditor list above. This is expanded to cover other items that would have a similar economic effect by extending the related interest period or term of the senior loan (paragraph (f)), changing the hedging requirements (paragraph (g)), changing financial covenants particularly in the case where there are cash traps or cash sweeps that could prevent amounts being available to pay mezzanine obligations (paragraph (h)), which would have an impact on the amount of any prepayments (paragraphs (i) and (j)) which amounts may be subject to distribution to the lenders other than sequentially as discussed in section 7.2.3.1 above or which would impact either the availability of funds for the mezzanine borrower to pay the mezzanine loan (paragraph (k) or the actual priority of payments (paragraph (n));
(ii) preventing unexpected triggers for an event of default under the senior loan which would have a detrimental effect on the mezzanine

lenders having a period of time between a mezzanine event of default and a senior event of default to take steps to minimize issues at the borrower or property level (paragraph (h) and (o));

(iii) protecting the availability of the common security and the continuance of the mezzanine debt (paragraphs (m), (q) and (s)) and any interference with the availability of any mezzanine only security to the mezzanine lenders (paragraph (p)); and

(iv) changing the relationship with the borrower by either permitting a change of control (paragraph (r)) or allowing the borrower or affiliate thereof to become a lender (paragraph (l)).

In a senior/mezzanine intercreditor, a similar set of consent rights will be afforded to senior lenders in respect of proposed amendments or consents granted by the mezzanine lenders under the mezzanine loan. These will be principally aimed at restricting the mezzanine lenders from agreeing with the mezzanine borrower modifications that could have an adverse impact on the cash flow of the group by increasing the amount of the mezzanine obligations.

In each of A/B intercreditors and senior/mezzanine intercreditors, it is common for the consent requirements discussed above to be subject to a snooze/lose provision whereby if the party whose consent is required prior to the implementation of the proposed amendment or consent has failed to respond by a particular time, such lenders' deemed consent to the proposal will be considered approved. Further, if the proposed amendment/consent is given in respect of a senior loan in a senior/mezzanine loan structure, it will usually be provided that such amendment or consent is deemed also given in respect of the equivalent provision in the mezzanine loan by the mezzanine lender.

7.5 Cure rights and purchase option

7.5.1 Cure rights

As noted in the previous two Chapters, cure rights are an important feature for junior lenders, in order to avoid, in the case of A/B structures, a switch of the pre-material default waterfall to the sequential post-default waterfall or, in the case of senior/mezzanine structures, the occurrence of a payment stop event and, in each case, to halt the taking of enforcement action by the senior lender. In addition, such a feature will normally prevent the transfer of the whole loan or senior loan (as the case may be) to special servicing, as will be further discussed below. These rights will usually allow the junior lenders to remedy a payment default and certain other defaults that are by their nature capable of being remedied. The precise list of defaults that the senior lender will agree that the junior lenders may cure will be negotiated on a case-by-case basis, but in addition to a payment or monetary default, it is not uncommon for the junior lenders to be also permitted to cure financial covenants (i.e., loan to value or debt service covenants set out in the loan agreement). Defaults which cannot be remedied by a payment may, at times, be included, though they would in practice be very difficult to cure if at all. Regardless, insolvency defaults would be excluded and to the extent that defaults other than those that can be cured by payment are included, they will usually be events that may be corrected by the borrower, after the fact, such as a breach of representation or undertaking to perform certain actions.

The amount of the cure payment to be made on the occurrence of a payment default will include not only the amount of the shortfall but to the extent, in the context of a CMBS, the issuer, as A lender or senior lender, has obtained an advance or has made a drawing under the securitisation liquidity facility. The cure payment will also be made to include any related interest and other amounts, including any break costs, that will be payable by the issuer on such advanced or drawn amounts on the following interest payment date. It is possible that the intercreditor agreement provides for the payment of certain additional amounts, though a junior lender will naturally wish to minimise the number of costs that may be chargeable as part of the cure payment.

7.5.2 Exercise of cure rights

The procedure followed in respect of the exercise of cure rights will usually commence upon the agent, servicer or special servicer becoming aware of the curable default and the giving of a notification to the junior lender, entitled to make such cure, within a predefined period of time. To the extent that the cure is being made under an A/B intercreditor agreement, the junior lender will make the cure directly to the senior lender without the borrower necessarily being aware. If, however, the cure is made pursuant to a senior/mezzanine arrangement, the cure will either be expressed to be a direct cure payment made by the mezzanine lender to the senior lender or the amount of the cure will advanced or deemed to have been advanced by the mezzanine lender to the mezzanine borrower which in turn will make the advance down the intragroup loan arrangements in place to the senior borrower to put it in funds to make the cure. In the latter case, it will be a fresh advance under the mezzanine loan which will increase the amount of the mezzanine liabilities. In the former, such cure may ultimately require a subrogation by the mezzanine lenders making the cure to the senior loan amounts that have been paid and which will continue to be outstanding as between the senior lender and the senior borrower.

If the curable event is a payment default, the junior lender will generally be permitted to make a payment, in an amount equal to the payment shortfall due to the senior or more senior lenders, or, in the case of an A/B structure, if such payment default only results in a shortfall to that junior lender, or those other junior lenders which are subordinated to it, but there is enough cash to pay the senior amounts due in full, waive on its own behalf and on behalf of any other lenders which are subordinated to it, such shortfall as between the lenders. In the latter case, such waiver would not waive amounts due by the borrower and those amounts would continue to be due by the borrower but would, for the purposes of the intercreditor, be considered waived in order to prevent such event from constituting a material event of default leading to the consequences discussed above. If, on the other hand, such event is a financial covenant default, this may be required to be cured by making a prepayment of the loan/senior, in the case of a loan to value covenant breach, in an amount equal to such amount as would be necessary to ensure that the covenant is subsequently observed. Alternatively, if the event is a debt service or interest cover covenant, it may be provided that such default may be cured by depositing an amount that would cure such default in a controlled escrow account or obtaining an irrevocable letter of credit, payable on demand from a bank or other financial institution meeting certain ratings thresholds, which would provide additional security for the whole loan/senior loan albeit this choice is more common under A/B structures. Ultimately, if a subsequent material event of default occurs which is not, or is incapable of being cured, whether by its very nature or as a result of cure rights having been exhausted, such escrowed amounts would be available, or such letter of credit could be called, to pay down the whole loan in accordance with the post-material default waterfall. If the financial covenant is subsequently rectified, which may require that compliance with the covenant be maintained for a certain number of consecutive interest periods, any escrowed amounts would be released to the paying curing lender. In senior/mezzanine structures it is more typical for cures to be expressed as a prepayment or repayment of the senior loan.

Cures are typically required to be made within a prescribed period of time. This period will be negotiated between the lenders, but will account for the nature of the default and the impact any delay caused by the cure process would have on the senior lender. In addition, lenders who need to undertake internal processes to source the cash in the amounts required to make such cures will build in enough time to ensure that such rights can be effectively exercised. Further, any payment cures, other than any escrowed amounts as discussed above, will be reimbursed to the paying lender in accordance with the priority of payments of the applicable waterfall(s). Such reimbursement will be made after all amounts of principal, interest, expenses and other items due to the more senior lenders have been paid.

No enforcement action will be permitted to be taken during the period afforded to the junior lender to cure the related default save, if agreed, in the event that immediate action is required to preserve or protect the senior lenders' position. The intercreditor agreement would not necessarily provide a grace period or equivalent upon the occurrence of any other event of default which is not subject to junior lender cure right. In order to address any concerns with the length of time afforded to the junior lender to cure the default, the intercreditor agreement may provide that the junior lender would have a reduced period to notify the agent that it will be making a cure and then have an extended period in which to complete the cure. If the junior lender fails to respond or notifies that it will not be making a cure, the period during which no enforcement action would be permitted would be shorter than if such period was intended to provide the junior lender some time to actually effect the payment or other cure. From a ratings perspective, excessively long grace periods would be considered as detrimental to the credit quality of the senior debt.

7.5.3 Limits on number of cures

In order to avoid a scenario in which recoveries under the loan would have been greater had the loan and the related security been enforced earlier, rather than waiting whilst the loan was continuously being cured, junior lender cure rights are usually limited both in the number of consecutive cures that can be effected as well as in the total number of cures that would be permitted during the life of the transaction. Usually cures will either be permitted, in the case of an A/B structure, no more than twice in consecutive interest periods and between four and six times during the life of the deal, which will vary, among other reasons, according to the length of the term of the transaction or, in the case of a senior/mezzanine arrangement the number of times that the senior borrower has the ability under the terms of the senior loan agreement to effect a cure plus one or two additional times. The number of times a cure may be effected by a junior lender will be subject to negotiation between the lenders.

7.5.4 Purchase option

It may be considered that a purchase option granted to the junior lenders to acquire the more senior loans, upon the occurrence of a material event of default or payment stop event, is mutually beneficial to both categories of lenders, in that the senior lenders would be repaid the loan at par and the junior lender is able to preserve or gain control of the related loan in circumstances where its right to cashflow may be halted due to a shift to the applicable waterfall, the occurrence of a payment stop event or it ceases to be able to exercise consent or consultation rights as a result of the occurrence of a control valuation event or equivalent trigger. However, it is often not a practical solution for a junior lender, due to the likely problems surrounding the performance of the loan and the amount of the purchase price that would have to be committed to effect the acquisition. For these reasons, it is not an option that is commonly taken up by junior lenders.

The option is often triggered on the occurrence of the same trigger events that will cause a shift to or stop to the payments under the applicable waterfall in related intercreditor agreement. There may be circumstances where the junior lender may be able to have included, within the purchase option trigger events, additional items that may result in a decrease in available cash flow to the junior lenders (e.g. increased costs resulting from the transfer of servicing from a primary servicer to a special servicer) or its loss of consent or consultation rights.

The purchase price will usually be determined by the agent, servicer or special servicer and will normally include:

- the outstanding principal amount of the loan being acquired;
- all accrued and unpaid interest, fees, costs and expenses and other amounts owed to the selling lender;
- any funding break costs of the selling lender;
- any amount, including fees, costs and expenses and VAT chargeable thereon due to the servicer and/or special servicer in respect of the loan;
- any interest or other finance charges (including, break costs) payable or which would be due on the next interest payment date by the senior lender with respect to any advance or drawing made by a liquidity facility provider or otherwise in connection with the loan; and
- the reasonable costs and expenses incurred by the selling lender as a result of the acquisition.

Whether default interest and prepayment fees are included in the above will be negotiated on a case-by-case basis, but it is fairly common for such items not to be included. Further, if there is lender level hedging arrangements in place, in respect of the senior loan being sold, relevant hedging termination costs would be included in the above list if such hedging arrangements are not being transferred across to the purchasing junior lender.

7.6 Enforcement

As noted in the previous Chapter, the rights of a junior lender to instruct enforcement action are set out in the intercreditor agreement. Any enforcement rights also depend on the security the junior lender holds in respect of the loan. For example, if the junior lender is a B lender under the whole loan, it would be expected that the junior lender and the senior lender would share an interest in the security whilst, if the junior lender's position is that of a mezzanine-type lender, it may have its own separate subordinated security package ranking behind the senior security.

Ordinarily, intercreditor agreements as used in European CRE financing transactions, will either provide the junior lender with no right to cause an enforcement, or a limited right of enforcement. In the former case, the rights granted to the junior lender to cure a specified list of defaults, or to acquire the senior loan upon a material event of default (for which see above) would be argued by a senior lender as representing sufficient protection for a junior lender, faced with a probable enforcement scenario. In the latter case, the junior lender could be prevented from taking any such action through a control valuation type of event. Such tests would ensure that the value of the underlying property is sufficient to cover a full recovery of the senior loan plus an addition buffer, normally determined to be 125% of the senior loan. Further, a junior lender would be prohibited from taking any steps to accelerate the relevant junior loan or enforcement action until the expiry of a standstill period provided that the senior creditor has not itself accelerated the senior loan or commenced any enforcement action.

The length of any standstill period, applicable to the junior lender, would vary depending on the nature of the default in question, such as a payment, financial covenant or other default. These periods are typically heavily negotiated between the parties but it is usual, particularly pre-2007, to see periods oscillating between 90 and 150 days from loan default. On expiry of the standstill period, if the relevant default remained outstanding or, the security trustee or special servicer had not taken any enforcement action and provided always that a control valuation event had not occurred in respect of the relevant junior loan, the junior lender would be entitled to take or instruct the relevant agent or special servicer to take enforcement action.

Absent any right of the junior lender to instruct enforcement action, the senior lender would commonly be able to direct enforcement action. Any such instructions from the senior lender would remain subject to any cure or purchase option rights and timetables, in respect thereof, to which the junior lender would be entitled. During such periods, the senior lender would not be entitled to take enforcement action as discussed above. Usually, when exercising such rights, the senior lender would not be obliged to take into account the interests of the junior lenders, when instructing the relevant party to take enforcement action. In some transactions, the junior lender may be able to have an indirect influence on the enforcement process, by being able to terminate and propose the appointment of its preferred special servicer. Certain conditions will be attached on the identity of any such proposed special servicer will be discussed in Chapters 9, 10 and 11, though this right ensures, that for so long as the junior lender has enough equity in the deal, it will be able to have some degree of influence on the management of a specially serviced loan. This power to terminate and appoint a special servicer, will typically be provided in situations where the whole loan is being serviced on behalf of both the senior and junior lenders. However, the inclusion of such a right and additional consent and consultation, as discussed above, may be afforded to the junior lenders in circumstances where the junior loans are not being serviced.

Although the above scope of junior lender enforcement rights is commonly seen in Europe, there may be some variations to the above depending on the transaction in question. For example, certain transactions may provide the junior lender with the power to require the disposal of properties at any time, once enforcement of the whole loan has commenced, if any such disposal proceeds would be sufficient to repay the senior loans. The principle behind these types of variants is to afford the junior lender with a greater voice in the process, where there is enough value in the transaction to repay the senior loans and any additional costs in full.

One of the distinguishing features of the senior/mezzanine intercreditor arrangement has been the ability of the mezzanine lender to be able to enforce its own separate security to gain control over the mezzanine borrower and, by virtue of the same, the senior borrower and obligors. As in a senior/mezzanine structure there are two distinct loans made at two different levels in the borrower group structure, the mezzanine lender would obtain security interests over its borrower and share in the security granted by the senior borrower to the senior lender. This sharing of security would either take place by way of having the same security interests securing both the senior and mezzanine loan obligations (where the intercreditor would specify the priority of recovery of the senior loan over the mezzanine loan) or by way of separate security where the senior lenders would benefit from a first priority security interest and the mezzanine lenders from a second priority interest. However, the mezzanine only security over the mezzanine borrower would only benefit the mezzanine lenders.

As, in the case of financial covenants, there are instances where the mezzanine loan could potentially be in default prior to the occurrence of an event of default under the senior loan (for example and in addition to the occurrence of a financial covenant default, the occurrence of a payment default under the mezzanine loan whilst enough cash had been available to ensure that outstanding amounts owing the senior loan on a given payment date had been paid in full). This earlier trigger, if compared with the timing of the occurrence of a senior event of default, allows the mezzanine lender to be able to enforce the mezzanine only security and gain control over the mezzanine borrower. The senior/mezzanine intercreditor agreement would specify the circumstances in which such mezzanine only security enforcement could take place, what steps would have to be taken by the mezzanine lender following it gaining control of the mezzanine borrower and the consequences that would flow as a result to the rights of the mezzanine lenders under the intercreditor agreement.

The senior/mezzanine intercreditor agreement would typically provide that the right of the mezzanine lenders to exercise the enforcement over the mezzanine only security could take place following a mezzanine event of default and may be subject to a pre-agreed consultation period between lenders. The effect of the acquisition of the mezzanine borrower shares will require that the mezzanine lender or any agreed transferee, within a prescribed period, complies with any senior lender ''know your customer'' diligence requirements as well as cures any outstanding senior loan events of default outstanding and it would be agreed that the resulting change of control of the borrower group would not in itself result in a breach of the terms of the senior loan. Given that the mezzanine lender following such acquisition will be both in control of the borrower group and the mezzanine lender for purposes of the senior/mezzanine arrangements, it would be expected that the senior lenders would require that certain rights granted to the mezzanine lenders under the intercreditor agreement be disapplied (such as any consent rights in respect of any proposed amendments or waivers of the terms of the senior loan documents, cure rights exercisable by the mezzanine lenders to cure any senior loan curable defaults and any rights to instruct the enforcement of the common security).

Whilst traditionally this mezzanine only security enforcement feature has been associated with senior/mezzanine loan structures it is, at the time of writing, being more frequently proposed in A/B structures which raises issues as to how this can be implemented into a whole loan structure where the security afforded by the borrower would, in principal, secure the entirety of the whole loan debt. As in contrast to a senior/mezzanine arrangement, the A/B structure relates to a whole loan there are structural issues as to how a separate component of the security package (a share security) can be enforced by a B lender without triggering the enforcement of the entirety to the whole loan debt. If this feature is proposed in connection with a A/B structure, care would need to be taken by the lenders to ensure that it works within the way the loan has been originated and, from a B lender's perspective, whether in fact it could in practice be exercisable without triggering unanticipated consequences.

7.7 Transfer restrictions

During the GFC it became increasingly common that borrowers or affiliates of borrowers, in an attempt to maximise opportunities raised by financial institutions, needed to address relevant regulatory capital requirements, raise liquidity and dispose of loan assets. Such parties sought to purchase and/or pay off positions in related loans at a discount (so-called DPO),[16] in order to reduce leverage and influence loan administration processes, including prospects of enforcement. Such a trend has also been seen in secondary market trading of whole loan CMBS, where positions have been acquired to exert control over the appointment of special servicers and the consequent influence such would have over the administration and enforcement process of a non-performing loan.

Historically, limitations on the parties to whom a junior lender or senior lender have been able to transfer part or the entirety of the position in a loan have been typical and would be included as a restriction on transfer in an intercreditor agreement. These have typically followed Loan Market Association (LMA) standards, where the transferee is expressed to be a financial institution, or by way of the inclusion of either a general but narrower description of the type of entities to which such interests could be

[16] See Ch.5.

transferred and/or the inclusion of a ''black list'' of lenders to which transfers would be prohibited. Such restrictions have been aimed at addressing the potential misalignment of objectives between lenders, whose motivations are influenced by other interests, than ordinary lenders ultimately concerned in achieving a full recovery of proceeds due to it under the loan.

In order to address concerns of undue influence of sponsors, borrowers and their affiliates in the day-to-day administration of a loan, post-GFC transactions have sought to restrict the rights which such parties may be entitled to exercise upon an acquisition of the loan. This is dealt with under the related documentation by providing for the:

- disapplication of voting rights in approving any consent, waiver, amendment or any other matter;
- removal of any right to attend any meetings between the other lenders when dealing with matters pertaining to the loan;
- removal of any right to receive any communications or notices prepared for the benefit of the other lenders;
- exclusion of any benefit in the security package securing such loan;
- cessation of any entitlement to receive certain payments (e.g. tax gross-up payments or increased costs); and
- excluding the amount held by such lender from any computations used to determine the identity of the requisite proportion of lenders constituting a majority position.

upon such party acquiring an interest in the loan. This is also relevant for purposes of the enforcement of mezzanine only security where the mezzanine lender acquires control over the borrower group as described in section 7.6 above. Furthermore, upon the securitisation of the loan any such acquisition by a related party would be prohibited. Similarly, post GFC whole loan CMBS deals have also gone a step further by treating any bonds held by the sponsor, borrower and their affiliates as if they were not outstanding and, accordingly, carrying no rights for the purposes of any quorum required to pass a resolution of bondholders, computing the necessary majorities required to approve a written resolution and giving instructions to the relevant note trustee.

7.8 Negotiating intercreditors from an investor's perspective

Having discussed the technical aspects of intercreditor agreements above and how, in particular, junior lenders might approach the negotiation of these documents and what such parties try to achieve through these discussions, will now be discussed. What follows is not meant to give an exhaustive view on how to negotiate the finer details of the above, but more to give a framework to the practitioner.

Typically, the vast majority of what is documented in an intercreditor agreement will only come into play when a transaction starts going wrong and there are issues relating to the borrower's performance of its obligations. When the deal is performing, a lender will usually only be concerned about when and in what amount it will get paid and accordingly there is no great need to look beyond what is expressed in the payment waterfall. However, the vast majority of what is contained in a typical intercreditor agreement will deal with theoretical outcomes, once things start to go wrong. It is therefore paramount to have a clear idea of what parties are trying to achieve in terms of rights at the outset of the negotiation. This will depend on the asset type, the leverage and also on the other parties involved in the negotiation and the way parties anticipate they might react in a default situation.

Taking the sections above in order, the following is a non-exhaustive list of commercial issues worth consideration for each category.

7.8.1 Waterfall

In an intercreditor, the key thing to consider, aside from the initial ordering of payment, are the events that can cause this ordering to change. Typically these are linked to events of default, but the precise parameters are often up for discussion. For instance, as a mezzanine lender, one should always push to restrict the events that can cut off such lender's cashflow to certain limited events of default. In practice, from a mezzanine lender's perspective, a mezzanine lender's position is best protected if it is subject to any payment stops only upon the occurrence of a Material Event of Default (Payment Default, Financial Covenant Default or Insolvency Event). It is also common for the mezzanine lender to push for the mezzanine coupon to still be paid when a cash trap event is triggered as opposed to the occurrence of an Event of Default. On the other hand, if a senior lender, the converse applies. Other points to note are where the hedging payments rank. This will depend on the relative negotiating power of the hedge provider. The particular payments to consider are hedging breakage costs, as these are the most volatile as exemplified by the period 2008 to 2012.

7.8.2 Hedging

The main argument is typically whether the swap should rank senior or pari passu with the senior lender. It is widely accepted that the swap would rank senior, but one would expect this might change given the issues caused by long dated super senior swaps in the structures being worked out at the time of writing.[17] The other points of discussion are usually where

[17] See further Ch.12.

termination payments rank and when the swap counterparty itself defaults. From a junior lender perspective, there is usually no real position to take here, unless it is to use it as a giveaway point for something else.

7.8.3 Servicing

This is very much transaction specific and the main discussions are typically around the level of fees. If the CMBS market is ever properly resurrected to pre-2007 levels, one would anticipate a lot of discussion around the powers of servicers, as discussed in Chapters 9, 10 and 11. There has been a lot of difficulty caused by the lack of clear guidelines for servicers, in particular, at how servicers look after the interests of different lenders with different priority rankings. At the time of writing, the agency role contemplated in most modern intercreditors provide for as little discretion as possible, as this usually completely controlled by the majority (senior) lenders.

7.8.4 Entrenched rights

The basic principle is that all classes of lender are going into a transaction on a set of pre-agreed terms and these terms should not be varied on an ongoing basis, given that this changes the credit profile for the other parties to the transaction. Senior lenders have attempted to modify these clauses, in order to have the discretion to vary the term of their senior loan. From a junior lender perspective, the only power a typical junior lender can accept to give to a senior lender, in these situations, is limited to extensions and or certain waivers, e.g. senior lenders may be permitted to be more lenient if they so decide without junior lender consent. A junior lender should not accept any rights for a senior lender to make their loan more onerous for the borrower, without junior lender consent as that takes the parties closer to a senior default with the usual anticipated consequences. Another mechanic that has been resurrected is the concept of control valuation events that can switch off a junior lender's rights. This should be restricted due to the potential volatility of third party appraisals and should not be necessary if the remainder of the entrenched rights clause is structured well.

As a junior lender one should expect that the overall structure and profile of the senior position should not change throughout the life of the deal in a way to make the deal more risky for the junior lender. This is achieved by restricting the senior lender's ability to increase economics, tighten covenants, change the amortisation profile or charge increased fees on a bilateral basis with the borrower. Other restrictions should be added to prevent the modification of the security and release pricing arrangements over the underlying collateral.

7.8.5 Cure rights/purchase options

These are key rights in the context of a default as they allow the junior lender to keep the loan alive and avoid being ''cut off/out'' by the senior lender if they believe that there is value left in the asset for the junior loan. The key is to ensure that there are sufficient cure rights available and to distinguish between junior lender cure rights from those afforded to the borrower under the underlying loan documents, if at all possible. This will allow junior lenders more time to fix a problem. If these cure rights are deficient, it may become necessary for junior lenders to buy out the senior loan. This is usually done by auctioning a purchase option. This option is usually linked to a default. In this regard, from a junior lender perspective, the key point is to make sure any prepayment or exit fees are waived in the case of the purchase option being exercised.

From a practical standpoint it is important to make sure that any arrangement agreed above can be made to work within the constraints applicable to the junior lender in approving and drawing capital as the sums needed to cure can be material. This is dealt with by agreeing the time periods that the junior lender has to both signify their intent to exercise an option to cure or to buy out but also the time period they have to complete on the payment/acquisition. It is also important to secure additional cure rights above and beyond the borrower's for a junior lender. This allows a realistic prospect of being able to control and step in to a distressed situation if a borrower runs out of cure options.

7.8.6 Security package and enforcement

This is the most important part of the intercreditor agreement, as this will govern how recoveries are made and who can control that process. In the market that exists at the time of writing, it appears to be widely accepted that the senior lender has unfettered rights to enforce on their security package, which principally in senior/mezzanine loan structures, will usually include a first ranking mortgage and first ranking share pledge on the asset holding company. The key from a junior lender perspective is therefore to seek, at the time of the structuring of the transaction, a senior share pledge at a company higher up in the structure, with the ability to enforce on that share pledge, without needing the consent of the senior lender and without triggering a change of control event for the senior loan. The ability to enforce can be achieved by setting covenants on the junior loan to be more sensitive than the senior loan covenants, such that a junior loan default is triggered before a senior loan default. It is also key to make sure that the senior loan does not cross default with the junior loan for this mechanic to work properly. The last things to avoid are senior lender attempts to tie obligations to cure senior events of default to the enforcement of this separate share pledge.

If all the above points are achieved, a junior lender should have structured a position where they can step into the equity with minimal disturbance to the senior financing in place, which is a precious commodity in today's senior debt-constrained marketplace as it goes to the heart of the ability for, particularly, a mezzanine lender to be able to step in and control a distressed situation and ultimately attempt to control the outcome.

These mechanics are tricky to set up and are usually the subject of intense negotiation. The key flashpoints for a mezzanine lender (in particular, but exportable to an A/B arrangement where the step-in right is provided for in the structure, as discussed above) are usually:

- Events that trigger the right for the mezzanine lender to step in:
  - i) Mezzanine only events of default: tighter covenants or milestones for example.
  - ii) Common events of default where the mezzanine cures the senior Event of Default.
- Any hoops the mezzanine lender has to jump through before they can step in
  - i) Senior ''know your customer'' requirements.
  - ii) No adverse tax effects on the structure.
  - iii) Requirement to cure senior Events of Default either pre or post step in.
- Ability to assign the step in right to third parties:
  - i) Affiliates of the original junior lender.
  - ii) Pre-agreed whitelist expressly authorising the transfer to certain pre-identified potential transferees.
  - iii) Qualifying Institution concept (i.e. financial institutions typically both experienced in the CRE sector as well as holding a certain amount of investment in similar positions on their books).
- Time periods to signify the intention to step in and to execute the step in.

Setting up the mechanics above in a way that is executable in practice is challenging as there are multiple scenarios and outcomes that need to be catered for. The assignability of the right to step in is always a hotly contested point as senior lenders need to accept the possibility that anybody that benefits from this right may end up being a sponsor of the transaction.

7.9 Conclusion

The key to successfully negotiating intercreditor agreements rests in the ability to understand, manage and ultimately accommodate the requirements and concerns of the different classes of participating lenders.

Senior lenders typically require control over the collateral and an ability to control outcomes once certain levels of distress have been crossed. The junior lender's best outcome is thus to be able to control situations effectively before they reach that stage and give themselves the time to be able to effect a turnaround. This is usually achieved by structuring the junior covenant package, cure/buyout rights and, particularly in a senior/mezzanine structure, step in rights to work as a system giving multiple ''bites at the apple'' whilst keeping the senior lenders comfortable.

Knowing what is a practical solution versus a theoretical right is also key. Negotiations often reach a crossroads on the most hypothetical of points, whilst more important practical points often get much less focus. Rights to buy out senior loans are great for a junior lender on paper but need large amounts of capital to effect and therefore are not as practical as they may first seem. The inclusion or exclusion of default interest/prepayment fees and how they are allocated between the lenders, whilst seemingly important, would probably fade into the background at the time that these options are ever contemplated to be exercised. A very effective step in right is, from a junior lender's perspective, much more valuable. As a junior lender one of the greatest bugbears are control valuation type mechanics as they introduce mark-to-market type volatility to situations that require time and a cool head.

In summary, when approaching these negotiations it pays to have a roadmap in mind of the path that a lender would want to use in practice and to structure the negotiations to achieve this. This allows the prioritisation of negotiation points and a successful negotiation and concession strategy in order to secure the key points that any lender may require to be achieved at the outcome of any negotiation process.