Chapter 5

Leverage and the use of Subordinate Debt

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5.1 Introduction

As highlighted throughout this book, a significant development in the capital markets over the last two decades has been the arrival of real estate debt on the global stage as an asset class in its own right. Based on its increasing popularity, the financing and investment of CRE flourished in the market in the period up to 2007, as a result of a highly competitive CRE lending environment, yield compression and the evolution of attractive capital market exits.[1]

During this period, lenders were forced to be more innovative in structuring CRE loans to keep pace with (i) investors' vociferous appetite for CRE assets, (ii) the escalating need for leverage, and (iii) their competitors. As a result CRE quickly became seen not only as a hard asset but also a financial one. Consequently, lenders were forced to provide much higher amounts of leverage than they traditionally did, or may have been comfortable with. However, with the capital markets providing an exit, banks were able to package this additional leverage in a way that appealed to investors across the risk-tolerance spectrum and accommodated a mortgage borrower's desire, to constantly maximise leverage.

Moreover, CRE borrowers' demands for even more flexibility and leverage led to lenders undertaking a constant balancing exercise, between origination volume and their return on their product, without compromising any securitisation or syndication exit, or, in the environment that exists at the time of writing, a club deal exit.[2] This led to a marketplace where subordinate debt structures became commonplace.

In the US, where subordinate debt structures first emerged, originating lenders discovered that dividing or splitting a whole loan into multiple tranches enabled them to create a variety of debt instruments which would appeal to a broad array of investors, while meeting the demands of their mortgage borrowers for greater leverage and flexibility. For example, on a

[1] See further Ch.1.
[2] See further Ch.3.

highly-leveraged property, the related financing was typically structured so as to produce an investment grade portion of the debt that was included in a CMBS, with the remaining portion of the financing split into one or more subordinated tranches, often tailored to meet the requirements of the anticipated purchaser. Thus, for example, a certain investor's risk and return preference might cause such an investor to prefer a slice of the debt that represented 60–70% of the overall leverage of the financing; with other more opportunistic investors with more aggressive risk and return tolerances preferring more deeply subordinated, higher risk, higher-yielding tranches of the financing, at 70% plus. Methods adopted to achieve this balance or alignment of rights was achieved through the introduction of subordinated debt (junior or mezzanine) and the bifurcating of the commercial mortgage whole loan.

This development was not a new development in ''traditional'' (i.e. non-securitised or non-capital markets) global CRE finance transactions, with commercial mortgage loans with related bifurcated subordinate debt appearing frequently in the market. Gradually, such structures found their way into the CMBS market and 2003 witnessed one of the first European uses of an AB loan structure included in a CMBS deal, where the underlying whole loan was split into a separate participation in the underlying loan, with only the senior tranche being securitised and the junior tranches were held outside the CMBS.

Following this, between 2003 and 2007, the CMBS lending market witnessed a proliferation of highly complex modelled subordinate debt structures incorporating a concept of bifurcated or trifurcated real estate loans, comprising of A-1 or A-2, B, C or even D tranches, senior-subordinate tranches and mezzanine or junior debt. As discussed below and in the following Chapter, this practice generated highly flexible structures that built upon the emergence of CMBS as a product of innovation.[3] A product that allowed the subordinate debt to be tailored to comply with the demand in the market, the underlying borrowing group structure and the available lenders (and their legal and regulatory requirements).

Whilst the CRE financing market continues to operate at a vastly reduced level to the boom years of 2000 to 2007, at the time of writing, an improving and growing funding market is emerging. This means that, in an increasingly competitive market, senior lenders are able to pick and choose the deals and the pricing on such deals, with an increasing amount of senior debt becoming available for good secondary assets with secured income, as well as higher-priced defensive subordinated or stressed/distressed loan-on-loan financing. This is true, even of certain senior lenders that write cheques for substantial senior whole loans that internally will tranche or syndicate the loan to a mezzanine provider or fund set up or controlled by

[3] Andrew V. Petersen (ed.) *Commercial Mortgage-Backed Securitisation: Developments in the European Market*, 1st edn (London: Sweet & Maxwell, 2006), Ch.1. and 2nd edn (2012).

such senior lender. Thus, it has become a rare exception for real estate loans not to be structured with some form of multiple separate subordinate debt. Such structures apply to both single and multi-borrower transactions.

In this Chapter, the debt underlying such structures (mezzanine or tranched junior) will be referred to as subordinate debt and generally take one of the following two forms:

- a mezzanine loan interest which is documented pursuant to a separate loan and secured by a separate (or shared) security package ranking behind the security interests securing the senior or whole loan, or in certain cases a separate security pledge over the equity in the borrower (mezzanine debt);
- a B Loan within an AB loan structure, where the single whole loan is tranched into senior and subordinated tranches which are secured by a single security package (AB debt).

This Chapter will examine:

- the emergence of subordinate structures including the key principles and pricing of such structures;
- the common key principles of intercreditor terms surrounding subordinate structures[4];
- the economics and business case for utilising mezzanine debt and/or AB debt;
- the emergence of recent developments surrounding discounted purchase options (DPO).

5.2 The key principles of subordinate structures

It is important to understand the economics behind subordinate debt structures. Therefore the key principles that underpin such structures must be examined, while noting that there can be variations on all of these principles, as no two deals are the same and that each deal will be faced with unique characteristics based on asset type, obligor or borrower group structure (including any legal and regulatory and other restrictions regarding granting of security or historic tax liabilities).

5.2.1 Mezzanine debt

A typical mezzanine secured credit facility (the mezzanine facility) will comprise a term facility that is subordinate to, but coterminous with a senior loan facility. Often the mezzanine facility may increase by any

[4] Note that the key commercial terms and provisions of an intercreditor agreement will be considered in detail in the following Chapter and the key legal terms and provisions will be considered in Ch.7.

payment in kind (PIK) or other amounts accrued. Typical leverage will be an aggregate of the senior facility and mezzanine facility capped at a certain percentage (say 80%) of value of the underlying real estate portfolio. The senior facility will fund a lower percentage of the value, typically in the range of 60–70% LTV.

5.2.2 Mezzanine debt pricing

At the time of writing, there is no ''typical'' pricing of mezzanine debt. Pricing will be dependent on a number of factors, including the size and quality of the deal, the nature of the asset, the number and type of lenders chasing the deal, the economic power of the underlying sponsor and the jurisdiction of the underlying assets. For deals occurring at the time of writing, mezzanine pricing will be in a range from percentages in the high single digits to mid-teens per annum (all-in coupon) of which an element will often be structured to be payable in cash (cash pay interest) and an element may be PIK-ed.

Mezzanine debt may be further structured where the mezzanine lender receives a percentage of excess profits once the sponsor achieves a certain level of internal rate of return (IRR) known as a profit participation. The profit participation will be in addition to any fees and interest payable on the deal. Typically, a mezzanine lender will want to be compensated for its debt being repaid prior to the maturity date. Although, a voluntary prepayment will be permitted at any time after the first year of the term mezzanine facility, prepayment fees will be payable to the mezzanine lender to protect a certain fixed level of return (say 1.35 times equity multiple) on the mezzanine debt. For example, if the mezzanine facility is prepaid and the mezzanine lender has not received a minimum of 1.35 times on the original principal amount of the mezzanine facility, then the mezzanine borrower will compensate the mezzanine lender for the difference between the amount actually received by the mezzanine lender and an amount equal to 1.35 times of the original principal amount. Alternatively, the mezzanine lender may agree an exit fee equal to a specific percentage of an amount repaid or prepaid.

Key terms of a senior loan facility sitting above a mezzanine facility may include: loan to value covenants, with a hard event of default triggered if LTV or ICR values raise above a certain percentage; a cash sweep triggered if LTV values are above a certain percentage, funded by equity or excess cash, and upon such sweep being activated monies being swept to repay the senior loan or placed in reserve to be retained for future cash flow shortages. A cash sweep will often continue until the LTV or ICR values reduce below a certain percentage on two consecutive interest payment dates (IPD).

5.2.3 Borrower PIK election period

Typically, on any IPD where there is a cash trap event caused by triggers in the senior facility which has the effect of stopping cash pay interest to the mezzanine facility (The PIK election does not apply to hard events of default), the borrower may make a PIK election where the total coupon is accrued or rolled and forms part of the mezzanine facility balance until the occurred amount is paid down by the borrower. Typically, the borrower will be limited to a maximum of two PIK elections during the term of the mezzanine loan and will not be able to use its PIK election if this would cause a breach of the mezzanine facility hard default covenants. Following any PIK election quarter where the borrower has no remaining PIK elections, a mezzanine facility event of default will be triggered if the mezzanine facility is not cash paid on any remaining IPD (and the cash escrow released to the mezzanine lender).

5.2.4 Typical mezzanine security package

In a senior/mezzanine funding structure, the senior loan will typically be advanced to the property owning company (the Senior Borrower) while the mezzanine loan will typically be advanced two levels, above the Senior Borrower, to the shareholder of the shareholder of the Senior Borrower (the Mezzanine Borrower). The Senior Borrower's shareholder (the Senior Parent) provides ''insulation'' to the senior lenders that mitigates the risk of the mezzanine lenders bringing claims against the senior lenders' own obligors.

The loan advanced to the Mezzanine Borrower will be on-lent to the Senior Parent and in turn on-lent to the Senior Borrower, in each case by way of an unsecured 'pay as you can' subordinated loan that will be contractually subordinated behind the senior loan and the mezzanine loan.

In a very simplistic case, the rental income stream from the Senior Borrower will then be utilised on a periodic basis:

- first to make payment of all fees, costs, expenses, interest and principal repayments due on the senior loan;
- secondly, provided there is no continuing default on the senior loan, up streamed to the Mezzanine Borrower to make payment of all fees, costs, expenses, interest and principal repayments due on the mezzanine loan.

For so long as the senior loan is in default, typically no payments are allowed to be made in respect of the mezzanine loan and all amounts available for distribution will be applied in repayment of the senior loan (or trapped in a senior controlled account) until it is repaid in full.

Subject to the differences in the overall structures and underlying borrower groups, security for a typical mezzanine facility will consist of the same

typical security package expected for a senior facility, albeit on a subordinated basis, which shall include the following:

Shared with the senior facility (on a subordinated basis) or separate second ranking, each to the extent applicable:

- legal charges over the properties;
- fixed and floating security over all the assets of the borrower(s), including without limitation all bank accounts, material contracts (such as managing agent contracts), insurance (including being co-insured), the hedging arrangements related to the mezzanine facility and all shareholder and other intra-group loan balances;
- deed of subordination between the mezzanine lenders and any shareholder loans or equity confirming neither interest nor repayment of any shareholder's loans or equity permitted until mezzanine facility fully repaid;
- a duty of care letter from the managing agents, if any; and
- any other security as required under the senior facility.

This is typically in the form of common or shared security whereby the senior security agent holds the security on trust for the benefit of the senior and the mezzanine finance parties, but sometimes by way of separate second ranking security. In both scenarios, the mezzanine finance parties will not be able to enforce such security interests until the senior finance parties have been repaid or enforced their security. In addition, the mezzanine finance parties will also take a first ranking charge over the shares in the Mezzanine Borrower and in the Senior Parent and over any intra-group loans made to the Mezzanine Borrower and to the Senior Parent. The common security is held for the benefit of all lenders, whereas the mezzanine security is granted solely for the benefit of the mezzanine finance parties. The mezzanine finance parties are typically free to enforce the first ranking mezzanine security following an event of default on the mezzanine loan for the purposes of taking control of the equity in the Mezzanine Borrower or the Senior Parent, subject to any restrictions in the intercreditor agreement.

In addition, based on potential deal structure and requirements of the mezzanine lender, a first ranking pledge of shares in the mezzanine borrower (or any other appropriate entity depending on the final structure of the transaction) representing control over the entirety of the properties. It is often requested that, in an acknowledgment of the credit support the mezzanine facility is providing and the first loss position it is in, such security is separate and not part of the security package for the senior facility and without any turnover obligation to the senior lenders upon exercise/enforcement or exercise of voting rights attaching to such shares.

Given the subordinated nature of the mezzanine loan, a senior default will always cross default and cause a default of the mezzanine loan. However, a mezzanine default should not result in a default of the senior loan.

5.2.5 Valuation

Often, the mezzanine lender shall, at the mezzanine borrower's expense, have the right once per year to call for a valuation in accordance with the RICS ''red book'' or at any time if it reasonably believes there may be a default or at any time if an event of default is outstanding. Typically, if the mezzanine lender uses this right (in addition to the standard annual valuation provided to the lenders at the borrower(s) expense) that the mezzanine lender will bear the costs of such additional valuation to the extent that this valuation does not result in a cash sweep or an event of default.

5.2.6 Documentation

The mezzanine facility will normally be documented by a facility agreement and related security documentation which are normally based on the Loan Market Association (LMA) documentation[5] used for the senior facility (often using the same form of senior facility after it has been negotiated with the senior borrower/sponsor), this agreement will set out (inter alia) the conditions precedent to drawing, representations and warranties, undertakings, events of default triggers, borrowing costs, pro-rata sharing, set-off, and other provisions usual for such transactions.

The mezzanine facility agreement outlines the relationship between the mezzanine borrower and mezzanine lenders, and an intercreditor agreement[6] outlines the relationship between lenders.

The 2012 Draft Guidelines and the LMA ICAs contemplate a transaction structure where two loans are advanced to finance CRE assets: a senior loan to the property owning entity (the propco) and a mezzanine loan to a mezzanine borrower (who is the sole shareholder of the parent of the propco). The effect of this structure is to structurally subordinate the

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[5] On April 16, 2012, in an attempt to aid transparency and liquidity in the market, the Loan Market Association launched its recommended form of single currency term facility agreement for use in real estate multi-property investment transactions. The new document has assisted standardise the approach taken to real estate specific issues by reducing the time spent negotiating boiler-plate type clauses.

[6] On 10 June 2014 the Loan Market Association published a form structural subordination intercreditor agreement and in August 2016 the LMA produced a contractual subordination intercreditor agreement (the LMA ICAs) providing boiler plate and a structural framework. Whether an intercreditor agreement is based on the LMA ICAs or another form, commercial arrangements between lenders have been subject to on-going discussion and development and so, to supplement the 2012 Draft Guidelines, CREFC has in 2016 produced commentary on these commercial developments (the Intercreditor Agreements—commentary on recent commercial developments.

mezzanine loan to the senior loan. The intercreditor agreement, includes, amongst other provisions, the right of the mezzanine lender to freely enforce its security without triggering a change of control default or mandatory prepayment obligation under the senior facility. The right of the mezzanine lender to cure a senior event of default and the right to purchase the senior facility if accelerated may also be included. In addition to the foregoing, the senior lender will agree not to change any payment date or maturity, increase or vary any fee or interest payable, increase or vary principal or require amortisation or prepayment, or amend events of default without the prior written consent of the mezzanine lender. Often, it is required that the senior lender consult with the mezzanine lender prior to enforcing its security.

The documentation will also contain conditions precedent, undertakings and covenants, representations and warranties, customary for the financings the subject of the deal and in a form and substance satisfactory to the parties and at a minimum mirroring the conditions precedent under the senior facility. Both the commercial and legal terms of an intercreditor will be dealt with in the following two Chapters.

5.2.7 The typical features of AB debt structures

There are certain common features existing within AB debt structures.[7] One such feature is that, although B lenders lack the right to enforce the mortgage loan security they do typically benefit from certain rights following monetary events of default on mortgage loans, in a recognition that they are (as described above for mezzanine debt structures) in the first loss position.

Such rights are not usually available to junior first loss piece holders in a CMBS, known as the ''B piece holders''. The B piece holders in a CMBS hold the most junior note interest in a securitised pool of CMBS loans. They hold the ''last pay'' ''first loss'' note which do not represent individual loans and have no direct relationship with the mortgage borrower, and should not be confused with the B lenders or B loan holders.

B lenders are not obliged to exercise these rights, which vary from deal to deal and ultimately depend on the sophistication and the needs of the

[7] AB Structures were very popular in Europe from 2003 to 2007. See further A.V. Petersen, *Commercial Mortgage-Backed Securitisation: Developments in the European Market*, 1st edn (London: Sweet & Maxwell, 2006), Ch.8. As described herein, their popularity has lessened with the demise of the availability of financiers (and the absence of a fully functioning European CMBS market) that are prepared to arrange or originate a whole loan that will cover the whole of the required debt, although they are still used by certain senior lenders that originate a whole loan and internally tranche such loan into an AB structure and are, at the time of writing, emerging in the marketplace, in an attempt to be economically the same as a senior/mezzanine structure, necessitating the LMA launching their contractual subordination agreement in August 2016 and the CREFC-Europe launching commentary on such intercreditors in 2016.

parties. In theory, B lenders would generally only exercise their rights if the expected recoveries from the mortgage loan would thereby be enhanced. The exercise of cure and repurchase rights (which usually include the B lender's right to purchase the A loan as a means of avoiding enforcement proceedings by the A lender following a mortgage loan payment default by making whole a mortgage loan payment) has implications for the A loan and thereby the rated bonds and in such cases, the structure of the inter-creditor and servicing agreements are extremely important and require detailed analysis and consideration.

5.2.8 The attraction of AB structures

AB structures were very popular during the growth of the European CMBS market in the decade up to 2007. From the perspective of the most junior investor in a CMBS, as payments to the B loan can be subordinated to the A loan in an AB structure, CMBS transactions with AB loans are preferable to CMBS transactions without such a structure. This is because, depending on the transaction structure, as we have seen above, payments to the B lender may be cut off entirely following an underlying mortgage loan monetary event of default until the A loan has been redeemed in full.

Thus, by creating a B loan that is held outside the CMBS, loss severity can be viewed as having been reduced as, following a loan monetary event of default, the A lender benefits from the subordination of payments to the B loan by having the ability to take control over the whole loan and instigate enforcement proceedings before a shortfall has occurred on the A loan, and therefore the rated bonds. This allocates the risks associated with incorporating the additional debt efficiently throughout the market and is preferable to a standard CMBS, in which senior noteholders gain control only after realised losses have eroded the value of the junior CMBS notes. Furthermore, this results in an improvement of the subordination levels of the rated securities versus the subordination levels if the entire loan was included in the CMBS.

However, for multi-loan CMBS transactions, which may pool together various A loans, the additional credit support provided by the subordinated B loans is specific to the individual A loans to which the B loan relates and is therefore not provided to the entire transaction, usually resulting in higher credit enhancement being expected for the lowest-rated level of securitised notes. If losses incurred on any one loan exceed the amount of the B loan, the excess will be allocated to the lowest-rated class of notes.

It is important to note, however, that although a higher percentage of the rated securities are considered investment grade in a pool that is made up of A loans, the investment-grade debt as a percentage of the first-mortgage debt (the first-mortgage debt equalling the combined total of all A and B loans) is not higher. In fact, in most cases the investment-grade debt as a

percentage of the first-mortgage debt would be lower than if the entire loan were deposited into the CMBS. This is due to the weaker form of credit support provided by the B loans that are not cross collateralised, compared to subordinate bonds, which are cross collateralised. For instance, in a pool made up of A loans, if a loan incurs losses, upon the erosion of the B loans, losses would continue upward into the rated securities and not to the other B loans held outside of the CMBS.

At the time of publication of the 2012 Draft Guidelines it was felt that whole loan structures would not typically find market favour. However, at the time of writing it has become apparent that certain lenders and equity sponsors have a preference to utilise whole loan structures when constructing debt finance packages. This is because whole loan structures can have certain advantages over structural subordination models—both on the borrower and on the lender sides.

From a prospective B loan purchaser's perspective there are several benefits to an AB structure. First, the B loan is secured by a preferred form of security, a first mortgage. Also, for many of the institutional B loan purchasers, risk-based capital reserve requirements are less onerous for B loans than that of subordinate bonds. Having to reserve less capital against B loans effectively increases their overall net yield. When contrasted with investing in subordinate bonds, the primary benefit of the B loan is the ability to isolate risk to one asset. Unlike a subordinate bond where losses can be incurred from any one asset in a pool, the loss potential of a B loan is limited to the asset(s) serving as security to the B loan. This makes it easier than in a whole loan CMBS, where the originator, when placing a pooled bottom class of risk, has to try and sell this risk to an investor willing to take the first loss risk on all of the loans in the pool. As a result, risk is effectively dealt with much more discretely and the risk assessment of potential subordinate debt investors is also much more efficient since the due diligence process of evaluating one asset (the B loan) is considerably easier than evaluation of a pool of subordinate bonds. This is especially so in the European market where there is a multitude of loans and variety of asset classes within pools. Another benefit, as discussed above, is the ability to either purchase or cure upon an event of default. While this feature may not always be a viable option, it may be a potential exit strategy. Further, on the lender side there is additional flexibility offered to arrangers in being able to originate a whole loan and determine the sizing and pricing of the tranching at a later stage. Quicker execution may therefore be available if a whole loan structure is used.

5.2.9 Why utilise subordinated structures?

Given the additional complexity of subordinate structures, the natural question to ask is why incorporate this type of instrument into real estate debt transaction? It would be much simpler to just have one lender and one

loan. But from a business standpoint, the use of subordinate debt is important to a number of stakeholders in a real estate transaction.

From the sponsor's point of view, mezzanine debt typically carries a return that is lower than the return required by the common equity and allows the sponsor to invest less cash in a transaction, whether it is for an acquisition, or, refinance. This additional leverage can be accretive to the deal and usually helps to enhance the deal's internal rate of return (IRR).

From the senior lender's point of view, since mezzanine debt is structurally subordinate to the first mortgage, it provides credit enhancement and a significant capital buffer against collateral value deterioration. Moreover, by incorporating subordinate, the senior lender is able to reduce the amount of risk they would otherwise have to hold on their balance sheet.

From the mezzanine lender's perspective, subordinate debt produces a higher yield than senior debt, because there is more risk involved on a relative basis, but is still collateralised.

5.3 Key principles of a senior/mezzanine intercreditor agreement

As discussed above, in a subordinate structure, the legal relationship between the lenders is delineated in an intercreditor agreement (inter-creditor), which both grants and limits certain important rights (which may have an impact on the senior lender), to the subordinate lender. Whilst the next two Chapters will examine the key commercial and legal terms and provisions of an intercreditor agreement in detail, this Chapter will briefly set out certain key structural features.

The list below is not intended to be exhaustive and there can be variations on all of these principles as no two deals are the same and each deal will be faced with unique characteristics based on asset type, obligor or borrower group structure (including any legal and regulatory and other restrictions regarding granting of security or historic tax liabilities). The principles below represent the key terms and principles for an intercreditor governing the relationship between a senior loan (senior loan) made by a senior lender (the senior creditor) and a mezzanine loan (the mezzanine loan) made by a mezzanine lender (the mezzanine creditor). In such a hypothetical case, the principal terms that may be included in the intercreditor are as follows:

5.3.1 Acceleration/enforcement

The senior lenders will have the right, subject to any applicable cure rights the mezzanine lenders may have and subject to certain standstill periods relating to the mezzanine lenders' rights to acquire the equity in the Mez-

zanine Borrower and their rights to acquire the senior debt from the senior lenders, to take any enforcement action in respect of the senior loan including enforcement of its security (whether common security or stand alone first ranking security) once the senior loan is subject to a continuing event of default. In recognition of the subordinated nature of the mezzanine loan, the mezzanine lenders will have no right to enforce their interests in the common security or their standalone second ranking security until the senior loan has been repaid in full or if the senior lenders otherwise consent or, following a fairly lengthy period of time (and often subject to a raft of other conditions) after the senior lenders have failed to take enforcement action following the occurrence of a senior event of default. In the event that the mezzanine lenders do instruct the enforcement of common security this does not afford the mezzanine lenders with the right to control or direct how the security is enforced and the common security agent would still act on the instructions of the senior creditors. Any proceeds of enforcement would be applied first to discharge the senior debt in full and, once discharged, be applied in and towards the discharge of the mezzanine debt. The mezzanine creditor may require the mezzanine loan facility agent/ security trustee to exercise voting rights under the first-ranking share pledge over the mezzanine loan borrower (or if the mezzanine loan borrower is the same as the senior loan borrower, over the borrower's parent company) if an event of default (other than a material default (as defined below)) is outstanding.

The senior creditor shall not require nor instruct the senior loan facility agent/security trustee to take any enforcement action under any security unless it has first consulted with the mezzanine creditor or if the period to exercise any mezzanine lender cure rights have expired.

It is common practice in senior-mezzanine lending structures which include structural subordination, for the mezzanine lenders to have security over the shares in the Mezzanine Borrower. Upon an event of default under the mezzanine loan agreement (which would not in itself constitute an event of default under the senior loan agreement), the mezzanine lenders would be entitled to enforce the share security and acquire all (but not some) of the shares in the Mezzanine Borrower, effectively to step into the equity of the Mezzanine Borrower and, indirectly, the Senior Parent and, in turn, the Senior Borrower.

Exercising these acquisition rights is ordinarily subject to a number of conditions, including curing any remediable senior events of default that are then continuing.

5.3.2 Permitted payments

The intercreditor will contain waterfalls setting out the priority of payments prior to and following the occurrence of a material default. Prior to a material default (as defined below), interest and principal payments

(including any prepayment fees) made by the borrower are to be applied in accordance with the loan agreement.

Upon the occurrence and continuance of a material senior default, cash will be distributed sequentially according to a post-default waterfall resulting in a cessation of cash to the mezzanine creditor and diversion of cashflow to the senior creditor. This will be dealt with in further detail in the following Chapter.

5.3.3 Limit on senior loan

Often any senior loan headroom concept in an intercreditor will be capped at 5–10% to deal with the provision of property protection loans. This means that any increase in the amount of senior loan above any permitted headroom will rank behind the mezzanine loan (excluding any increase in amount of mezzanine loan).

5.3.4 Cure rights

Upon the occurrence of an event of default (other than certain insolvency related events of default) which is remediable, the mezzanine creditor may remedy that default within grace periods between certain fixed periods (say 15 business days in relation to a payment default and 20 business days in relation to other defaults)—each period will be negotiated depending on the circumstances of the deal.

It will often be requested that cure periods for defaults other than payment defaults should be unlimited for so long as the mezzanine creditor is diligently pursuing a cure, again to be negotiated on a case by case basis. Further, the mezzanine creditor may request that it may take such action to remedy as it considers desirable in the circumstances. For remedy of a payment default or financial covenant default, certain actions may be expressly permitted including:

- prepaying the senior loan (excluding default interest and prepayment fees);
- paying the amount of the shortfall;
- placing a deposit on behalf of the senior loan facility agent/security trustee into a cure loan deposit account in an amount equal to the additional amount of net rental income which would have been required to have been received by the obligor to have complied with the relevant financial covenant; or
- obtaining and delivering to the senior loan facility agent/security trustee an unconditional and irrevocable standby letter of credit payable on demand and in an amount equal to the additional amount of net rental income which would have been required to have been received by the obligor to have complied with the relevant financial covenant.

The mezzanine lenders will be limited in the number of times they can exercise their cure rights. Typically, an intercreditor will provide a limit on the number of times that a payment default can be cured, so that the cure right may not be exercised more than a fixed number of times, say twice consecutively in any one 12-month period and no more than four to six times during the term of the facility. It will further be requested that there shall be no limit on the number of times a payment default may be cured where such default is continuing for a 90-day period or more and that there will be no limit on curing other defaults (to the extent the borrower's cure rights are unlimited). An intercreditor may also specify the numbers of cures are limited to one more than the Senior Borrower has under the senior facility agreement. Each time the Senior Borrower exercises a cure right it reduces the number of cures available to the mezzanine lenders and vice versa.

Often it will be provided that any repayment of cure payments made by the mezzanine creditor in respect of cure rights will rank behind the senior loan but ahead of the mezzanine loan. Further, during the exercise of cure rights (and the applicable grace periods for making cures), the senior creditor shall be prohibited from taking enforcement action in respect of any relevant event of default.

For so long as the mezzanine lenders are exercising their cure rights within the permitted timeframe the senior lenders will be prohibited from taking any enforcement action with respect to the event of default which is the subject of the cure rights. However, if another senior event of default occurs which the mezzanine lenders are either not entitled to cure or are not exercising their right to cure, then the senior lenders will be entitled to take enforcement action in respect of that event of default.

5.3.5 Purchase/buy-out rights

In recognition that it is best to have an incentivised mezzanine lender in the deal compared to a dis-incentivised sponsor or borrower, the intercreditor will typically provide that at any time after the occurrence of any event of default under the senior loan or any enforcement action, the mezzanine creditor may elect to acquire the senior loan at par plus accrued interest, any swap breakage costs and funding break costs incurred by the senior creditor as a result of the transfer but excluding prepayment fees and default interest or at a price as otherwise agreed between the lenders.

5.3.6 Amendment rights

In further recognition of the interconnection between the senior loan and the mezzanine loan, an intercreditor will often provide that certain material economic provisions of the senior loan finance documents must not be amended or waived without the prior consent of the mezzanine creditor. These are dealt with in detail in the following two Chapters.

5.3.7 Consultation

An intercreditor may provide that a senior creditor and a senior loan facility agent/security trustee will notify and consult with the mezzanine creditor (without the need for their approval save for enforcement action) before taking any formal step to exercise any remedy against the borrower or taking any enforcement action (which shall require the approval of the mezzanine creditor), save where the senior creditor reasonably determines that immediate enforcement action is necessary in order to prevent the material diminution to the value, use or operation of the security or a material adverse effect to the interests of the senior creditor under the senior loan finance documents—the so-called senior creditor override—a provision that acknowledges the position of the senior loan and its security and the position of the senior creditor in maintaining control of its security and its recovery on the senior loan.

5.3.8 Developments involving DPOs

A major effect that emerged in 2007 as lenders/investors withdrew credit was the ever-decreasing pool of investors buying CMBS. With the origination/distribution model that CMBS shops had relied on effectively closing down, many originators and holders of debt, faced with the prospect of having to sell the logjam or overhang of assets remaining on their books that were destined for a CMBS execution, turned to borrower or sponsor affiliates to buy some of their own debt. The lack of liquidity in the market drove pricing and values down, thus borrowers and sponsors saw sense for them to use available cash to purchase perfectly good debt (in their eyes).

Thus the DPO market was born and with the market evolving very rapidly and investors in short supply and senior bankers (and their new state shareholders) demanding the mortgage-laden balance sheets of the banks be cleared out before the prospect of any true market in CRE lending commencing once again.

A DPO purchase is not without its challenges. In most cases, CMBS documents do not provide for such a transfer without the involvement and agreement of the CMBS parties, being the issuer, noteholders and the B lender. Often CMBS servicing agreements[8] will state that except as contemplated by the issuer deed of charge and the intercreditor agreement, a servicer will not be permitted to dispose of any loan or any B piece. In addition, the usual forms of power of attorney granted under a CMBS deal normally expressly prohibit a servicer from selling the debt to the borrower. Further, typically an intercreditor will not provide for the sale of the debt or B piece and the issuer deed of charge often states that a sale of any of the issuer's loans is not permitted unless the note trustee is enforcing its

[8] See further Ch.11.

security or its sale back to the originator under the original mortgage loan sale agreement. Moreover, as far as an issuer is concerned, it is usually restricted from disposing of its assets unless it has the consent of the note trustee. The note trustee would usually not give its consent unless it gets the consent of the most senior class of noteholders.[9] Moreover, the intercreditor will often contain an absolute restriction on the B lender selling its loan to the borrower or an affiliate of a borrower. Therefore, the B lender would need the consent of the issuer and the facility agent to undertake such a sale.

Notwithstanding these challenges and any prohibitions in the intercreditor, the DPO market still, at the time of writing, remains popular and consent to a transfer of the B loan to a borrower/sponsor affiliate may be sought on the basis that the rights of any B lender (that is also a sponsor or borrower affiliate) should be turned off and should not be exercisable whilst the B lender remains a borrower or sponsor affiliate. This has the effect that, immediately following any such transfer, the B lender will not be able to exercise, have exercised on its behalf (other than by a servicer or a special servicer in accordance with the terms of the servicing agreement) or have accruing to it any cure, enforcement, consultation, approval, appointment and/or control rights (together the ''Rights'') otherwise available to it under the terms of the underlying credit agreement, the intercreditor and/or the servicing agreement.

Typically, following a DPO to a borrower or its affiliate, the Rights should be reinstated (1) for so long as the B lender (A) does not control or manage (in each case directly or indirectly) the management or voting rights in the mortgage borrower or an affiliate of the mortgage borrower; (B) is not controlled or managed (in each case directly or indirectly) by a mortgage borrower or an affiliate of the mortgage borrower; (C) is not party to any arrangements (the ''Arrangements'') with any other entity pursuant to which the mortgage borrower or any of its affiliates would have any indirect control of whatsoever nature in relation to any of the rights; and, for the avoidance of doubt, (D) is not a mortgage borrower or an affiliate of the mortgage borrower, in each case being confirmed to the reasonable satisfaction of the security agent; or (2) with respect to the whole or any part of the transferred B loans, following a subsequent transfer or assignment of such participation by the B lender, as discussed below.

Moreover, the transfer should further provide that each of the servicer and the special servicer will be required to notify the B lender (or any of its designees) with respect to material actions (as determined by the servicer and/or special servicer acting reasonably) to be taken with respect to the whole loan provided that: (A) neither the servicer or, as the case may be, the special servicer will be required to disclose any information to the B lender that, in the discretion of the servicer or the special servicer (acting reasonably), as applicable, will compromise the position of the other lenders in the

[9] See further Ch.13 where the role of the trustee is further discussed.

deal or reveal any strategy of the other lenders that could compromise the position of the other lenders with respect to the whole loan; (B) no such notification will be required where immediate action is required to be taken in accordance with the Servicing Standard[10]; and, for the avoidance of doubt, (C) no such rights shall oblige the servicer and/or special servicer to take into account any advice, direction or representation made by the B lender in connection with such notification.

Furthermore, the B lender should agree that, prior to any subsequent assignment or transfer of whole or any part of any transferred B loan being effective (along with the ability to exercise all or any corresponding rights), (i) the B lender either confirms or procures confirmation to a security agent that the subsequent assignee/B lender is a ''qualifying lender''; and (ii) the conditions set out in each of the underlying credit agreement and the Intercreditor agreement must be otherwise complied with.

5.4 Conclusion

This Chapter has highlighted the purposes, general key features, risks, and benefits provided by typical subordinate structures. Prior to 2007, many regarded the introduction of mezzanine debt and/or AB debt as a positive development, since certain features of the structures behind such debt provided additional benefits that were unavailable to lenders in standard bilateral commercial mortgage loan financings. Such benefits may not necessarily translate into improved credit enhancement levels for loans structured as AB loans. That being said, it is generally recognised that the structural features of subordinate debt ensure that a default of the whole mortgage loan does not necessarily result in a shortfall of funds to, and therefore a default of, the senior loan. In particular, it may be seen that the cure rights of the subordinate lender, the priority of all payments to the senior loan and the enforcement rights of the senior lender reduce the probability of default of the whole loan, leading to the conclusion that subordinate structures provide benefits to rated classes of bonds in single-loan transactions.

Moreover, as is apparent in the restructuring market that has emerged since 2007, whole loan slicing and dicing ultimately creates a variety of interested parties, (whose interests are often at odds) having a variety of consent and approval rights over both ''routine'' mortgage borrower actions such as alterations and lease approvals as well as more complex issues such as material financial modifications. In a whole mortgage loan with multiple pari passu senior tranches, subordinate tranches and possibly mezzanine loans, it is easy to see how a once relatively easy process quickly becomes extremely complicated and convoluted, and will require more time and

[10] For further detailed discussions of the servicing standard and the rights and obligations of the servicer and the special servicer, see Chs 9, 10 and 11.

effort to process, which inevitably leads to increased costs and possibly delays in restructuring the debt.

While certain deemed consent rights are much more commonplace in an effort to streamline this process, as we shall see in the following two Chapters, any insolvency proceedings are bound to be infinitely more complex, with the potential for large-scale conflict among the various stakeholders. Nowhere is this more apparent than in the market conditions witnessed since 2008. In the post GFC market that exists at the time of writing, workouts and stressed properties are more apparent than in the last decade and the role of the intercreditor in such workouts are usually not viewed as a productive outcome to the innovative structuring that has developed over the last few years, as the parties to the intercreditor attempt to agree what rights they thought they had.

In past real estate cycles,[11] a mortgage borrower may have only had to negotiate with one secured creditor, a mortgage bank or at worst a small syndicate of such banks. With the continued popularity of utilising subordinate debt in a transaction, the economic tightrope is walked by many interested parties—hedge funds, distressed debt funds or opportunistic ''vulture'' funds, even borrower or sponsor affiliates together with numerous lawyers representing each of the parties. In the end, only time will tell if the overall impact slicing and dicing, and the effect of intercreditor arrangements, have had a detrimental impact on mortgage borrowers, originating lenders, the restructuring of commercial mortgage and CMBS loans and commercial mortgage loan servicing in general. What is certain is subordinate debt and the intercreditors that are required to document such structures are here to stay.

[11] See Chs 1 and 2.