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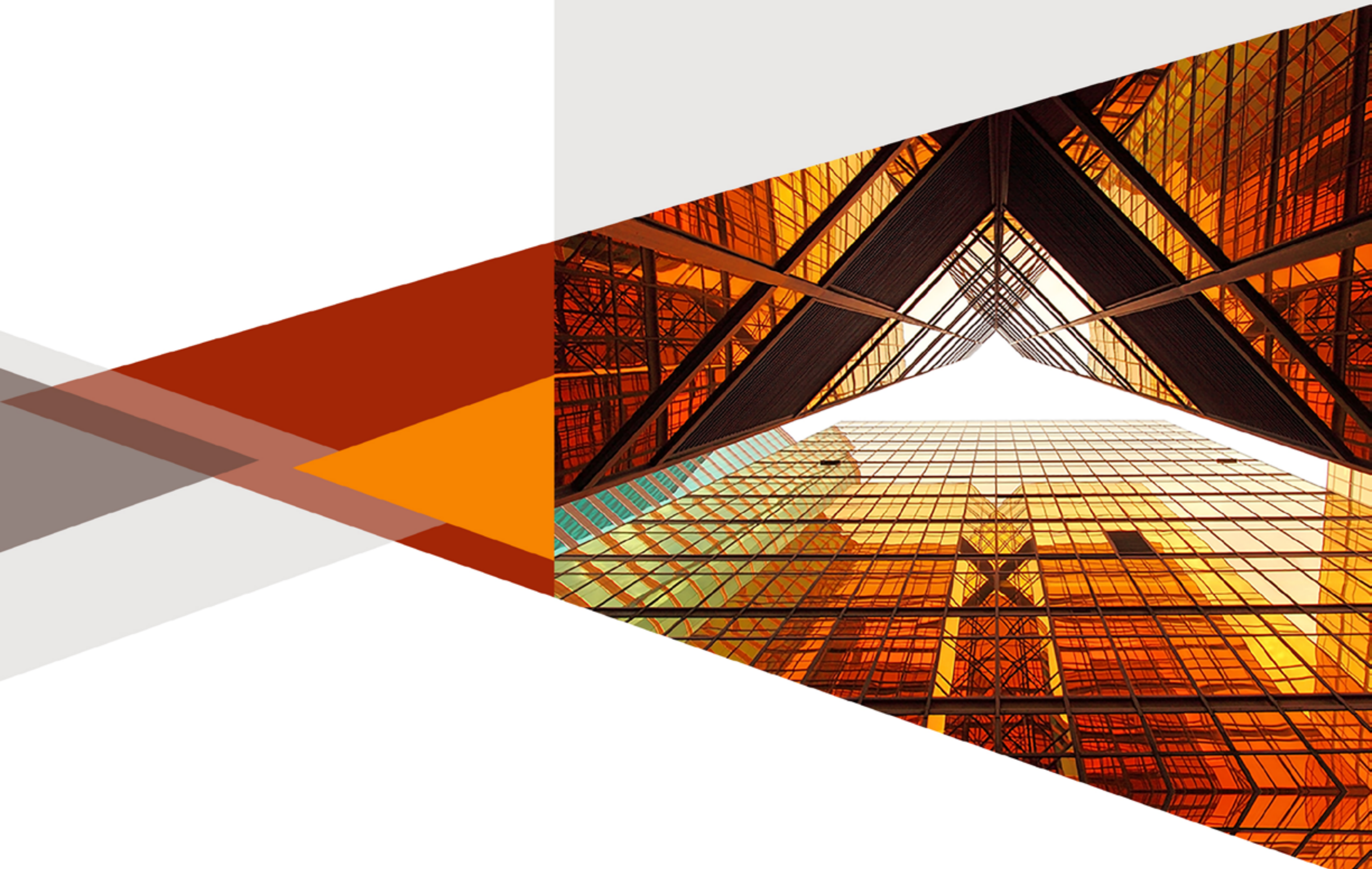
November 2017



Subordinate Finance in Real Estate Transactions

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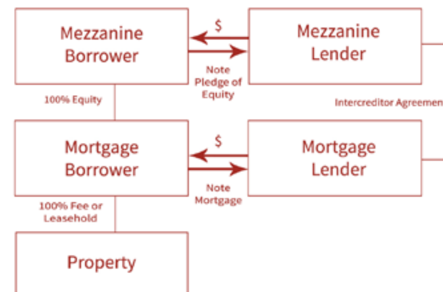
1 Introduction

Commercial real estate borrowers often need financing in amounts exceeding what traditional first mortgage lenders will provide. Second mortgage loans historically were the most typical method of increasing available loan dollars. However, as many first mortgage lenders became less willing to allow second liens on their primary collateral, especially following the development of commercial mortgage backed securities ("CMBS") and the strong stance taken by the rating agencies against second mortgage debt, finance providers creatively responded by expanding existing, and inventing essentially new, forms of subordinate financing that did not require a lien on the real estate. In order to provide a helpful introduction to a complex area for workout professionals, this article will focus first on the various types of subordinate financing available to borrowers and their equity owners, then cover intercreditor agreements governing mezzanine loans as well as "recognition" agreements in connection with the related area of "preferred equity" financing, and finally, the chapter will address the post-default enforcement of mezzanine loans and preferred equity. Some of the discussion and analysis will address special issues that arise with CMBS loans as a result of the impact of certain rating agency standards and other aspects of CMBS on real estate subordinate finance.

2 Mezzanine Financing

In its simplest terms, a true mezzanine loan is a loan to the mortgage borrower's parent company secured by its equity interest in the mortgage borrower (See Fig. 1). Although the mezzanine lender will have no lien on the real property as collateral for the mortgage loan, it is the value of the real property above the amount of the mortgage loan that gives value to the mezzanine collateral. Over the last 20 years, mezzanine financing has essentially been the most popular form of subordinate financing structure, although occasionally having to share pride of place with B Notes (See 36.5 below). Secured by equity collateral and sandwiched between the senior mortgage lien and the borrower's equity cushion, the mezzanine lender must evaluate the transaction from both debt and equity perspectives, since if its loan goes bad, it will wind up with an equity investment and a mortgage to support.

Fig. 1 Mezzanine Structure



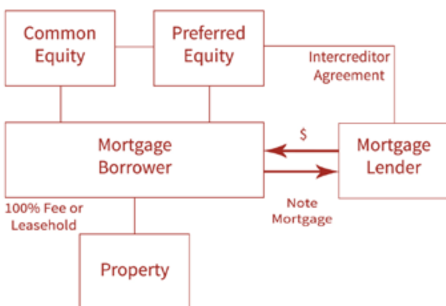
While the mezzanine loan and the mortgage loan are separate loans to separate borrowers, each lender's rights and remedies affect the other lender, so their relative rights usually are governed by an intercreditor agreement. Typically, prior to a mortgage loan default, loan payments then due and payable are made first to the mortgage lender and then to the mezzanine lender. Following a mortgage loan default, the mezzanine lender is paid only after the mortgage lender is paid in full. (See below for a more detailed discussion of mezzanine intercreditor agreement provisions.)

Upon a foreclosure of the mezzanine loan, the mezzanine lender usually becomes the owner of the mortgage borrower and, consequently, the indirect owner of the mortgaged property. However, if the mortgage lender forecloses, the mezzanine lender's equity pledge becomes worthless because the real ultimate value of the mezzanine borrower's equity interest, the mortgaged real property, will pass to the purchaser of the underlying real estate collateral at the foreclosure sale.

3 Preferred Equity Financing

A generally more expensive form of subordinate financing is preferred equity. Despite its "equity" moniker, it is in almost all cases another form of subordinate debt[1] in which the preferred equity holder receives an ownership interest in the mortgage borrower in exchange for the infusion of "capital" (See Fig. 2). In recent years, preferred equity has come to rival mezzanine loans in terms of popularity and is in the process of rapid evolution toward more and more of a debt product.

Fig. 2 Preferred Equity Structure



A preferred equity holder is not a typical lender and the terms of preferred equity financing are set forth in the organizational documents of the mortgage borrower rather than in a set of loan documents (although the provisions in the organizational documents increasingly mimic mezzanine and other debt documents with respect to such items as required monthly payments, hard maturity dates (referred to usually as "mandatory redemption" dates), events of default, acceleration provisions, removal of the sponsor from management and even ownership, "bad boy" guaranties, increasingly elaborate "forced sale" provisions designed to achieve the equivalent of a mezzanine foreclosure, and even pledges of sponsor equity where it can be engineered).

[1] Consistent with the parties' usual desire and intention, preferred equity is usually treated as debt for both financial accounting and income tax purposes and is likely subject to recharacterization as debt in bankruptcy.

The phraseology associated with this form of subordinate financing also is evolving. It has always been quite different from the typical form of investor preference that has been common for decades in limited partnership/LLC syndications - where the investor is to receive a preferred return on its investment before the sponsor/manager receives a return. On the other hand, since its emergence, the term "preferred equity" has meant a more debt-like structure where monthly or other periodic payments equivalent to interest are required and the consequence of default has been some combination of property management removal, entity management removal, and dilution, subordination, or elimination of the sponsor's ownership. Now, as the "technology" of this form of financing is further evolving, the phrases "soft" and "hard" preferred equity are commonly used, referring to a continuum from more equity-like ("soft") to more debt-like ("hard") features.

Unlike a secured lender, whether mortgage or mezzanine, a preferred equity holder in most cases has no specified collateral in which it perfects a security interest. More like a joint venture or limited partner or LLC investor, it has a right to a preferred distribution at an agreed-upon rate of return. But if the borrower fails to make the preferred distributions out of excess cash flow (after payment of operating expenses and mortgage loan debt service), then the preferred equity holder's remedy, rather than suing the borrower to obtain and enforce a judgment, is to exercise specific control rights against the common equity holders of the mortgage borrower, including substitution or removal of one or both of the property manager or the manager of the mortgage borrower itself. Once the preferred equity holder exercises its rights, all or part of the economic return on the common equity holders' interests in the mortgage borrower is effectively transferred to the preferred equity holder and the common equity holders either lose their equity interests in the mortgage borrower entirely or, at a minimum, suffer one or both of dilution or subordination.

Instead of an intercreditor agreement with senior lenders, the preferred equity holder receives a so-called "recognition" agreement. Like the preferred equity documents themselves, these agreements are becoming more elaborate and more like (and are even starting to be called) intercreditor agreements as they evolve more debt-like complexity. (See below for a more detailed discussion of preferred equity/intercreditor agreement provisions.)

4 Loan Participation Structures

Loan participations have long provided a way to share risk and allocate priorities among lenders. In a typical participation, a lead mortgage lender enters into a contractual arrangement with other lending parties through a participation agreement that entitles participants to ownership of a portion of the loan depending on their allocated share (See Fig. 3-1). In a basic participation structure, the mortgage borrower works only with the lead mortgage lender, who acts for itself and all participants, so the mortgage borrower may or may not deal with or even know the identity of the participants. Using a participation structure may allow the mortgage borrower to obtain a large loan that is otherwise beyond the lending capacity of the lead mortgage lender or a higher loan-to-value percentage advance on a loan because the mortgage lender is able to spread the risk among other lenders. Participations may be structured on a *pari passu* or senior-subordinate basis.

A *pari passu* loan is one in which the participants share the upside and downside of the loan equally. Except for certain fees and other payments sometimes paid exclusively to the lead lender to reward it for originating and administering the loan, all payments are paid first to the lender but then distributed pro rata to the participants in accordance with their participation percentages.

The *pari passu* participation itself has evolved into a structure, usually called a "syndicated" loan, where there is a lead lender that administers the loan, but there are separate promissory notes for each lender so that each lender is a direct creditor of the borrower rather than a co-owner of the loan. Terms of advancing, expense sharing, loan administration, lender consent requirements, defaulting lender provisions, and so on are either built directly into the loan documents with the borrower or are contained in a separate co-lender agreement among the participants.

The CMBS version of the syndicated loan is commonly called a Pari Passu loan, which is evidenced by multiple, separate promissory notes of equal priority secured by the same real property collateral (See Fig. 3-2). The notes are equal in priority for payments of principal and interest and suffer losses pro rata. The agreement among the lenders is called a co-lender agreement. Such notes may end up in the same securitization, or different ones, or some in and some out of securitizations; if they are not all in the same securitization, the servicers of the first note securitized (called the "A-1 Note") service the entire loan although holders of A-2 et seq. loans have limited control and consultation rights.

Fig. 3-1 Loan Participation Structure

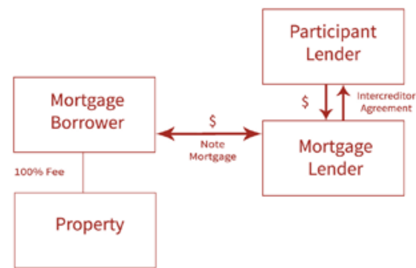
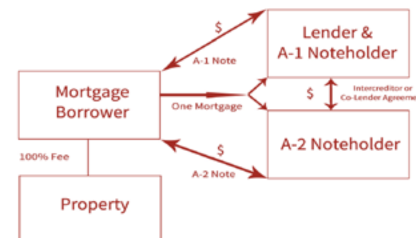


Fig. 3-2 Pari Passu Structure

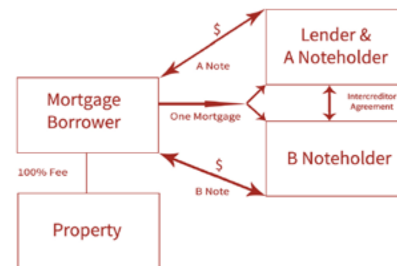


5 A/B Note Financing[2]

We discussed participation structures above, even though some of them are not a form of subordinated debt, to set the stage for a discussion of the A/B note structure, which is essentially a subordinated loan participation structure that allows multiple mortgage lenders to classify and spread the risk among the note holders but with separate notes rather than as owners of a single note.[3] There are variations in the way A and B note loans are structured, but the most common version is a loan evidenced by two promissory notes, generally referred to as the A Note and the B Note (See Fig. 4). Both notes are secured by the same mortgage and other loan documents, with the rights and obligations of the respective note holders governed by an intercreditor agreement that typically is called a co-lender agreement or a similar name, and although containing many similar provisions, it is significantly different in certain respects from the intercreditor agreement used in connection with mezzanine lending.

The A/B loan structure is a subordinated loan participation but with separate promissory notes. The A Note represents the lower risk portion of the debt. The B Note represents the higher leverage, higher risk portion of the debt, and furnishes credit support for the A Note.

Fig. 4 A/B Note Structure



The A Note is senior to the B Note in rights of payment and receives principal and interest payments first. Conversely, the B Note holder suffers all losses, until the B Note is wiped out, and only thereafter does the A Note holder realize any loss. A/B loans usually allow principal and interest payments on a *pari passu* basis until a default occurs, whereupon the A Note holder is entitled to all cash flow until paid in full. Because of the credit support structure, and the increased risk of first loss, the B Note often carries a higher interest rate.

Given that the aggregate amount of the component notes will be secured by the same first mortgage lien, it might seem at first blush that the maximum size of the loan would be the same, based on loan-to-value ("LTV") analysis and debt service coverage ratio ("DSCR") standards, whether the loan is represented, for example, by one $50 million note or by a $35 million A Note and a $15 million B Note. In either case, the probability of a default under the loan will be the same. But the senior/subordinate aspect of the A/B Note structure may allow the senior lender to securitize the A Note on a disproportionately profitable basis. If the A/B Note structure gives the B Note fewer rights on a default than a holder of a similarly sized, undifferentiated *pari passu* interest in the whole loan, rating agencies are, not surprisingly, likely to treat the A Note markedly better than they would an undifferentiated *pari passu* interest in the whole loan. Ideally, the A lender could also find a B Note investor that, not being bound to as conservative of an underwriting approach as the A Note holder, believes that the chance of default on the

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[2] The A/B Note structure discussed in this chapter is different than an A/B "Hope Note" structure where a lender in a workout agrees to accept a B Note that may (or may not) be paid from future cash flow or a capital event that yields proceeds beyond the amount necessary to pay the restructured A Note, often either after, or on a pro rata percentage with, "new equity" contributed by the borrower's owners in connection with the workout.

[3] The desire for separate notes can derive from various motivations, including the desire to ensure that the participation will be classified as "debt" for regulatory and accounting purposes, a desire for a direct credit relationship with the borrower, or simply a perception that a separate note gives the participant more control than a mere participation interest.

B Note is not as great as the A Note holder or rating agency analysis would suggest, making the entire A-B package materially more valuable than it would be standing alone.

But the creeping expansion of the control rights accorded to B Notes has caused at least one rating agency to express concern over the continued efficacy of the A/B Note structure to provide subordination benefits to the A Note. In early A/B Note transactions, the B Note was a very passive investment, able to collect its pro rata share of payments when no default existed and to protect its interest by buying out the A Note in the case of a default, but having no real input on the administration or servicing of the mortgage loan. Rating agencies particularly liked to see A Notes in CMBS pools with the B Note left outside the pool, because the loans in the pool were typically serviced by a third party servicer pursuant to an agreement with a servicing standard that required the servicer to act in furtherance of the best interests of the investors in the pool. With the B Note outside the pool, the servicer would be free to make decisions to maximize the return to the CMBS investors with no concern for the effects of its decisions on subordinate lenders. Over time, however, many B Note holders have obtained greater protections with respect to the servicing of the loans, such as the right to consult with the servicer regarding decisions, the right to have the best interests of the B Note included in the servicing standard, or certain rights to appoint the special servicer, provided that the B Note has not lost most of its value. When the rights afforded to B Notes are so expanded, the rating agencies will no longer view the B Note as essentially another source of possible repayment, but instead, as a competing interest that might compel a high-risk and time consuming workout strategy that may be the B Note's only hope of repayment at the cost of exposing an over-secured A Note to the risk of litigation and deterioration of the collateral.

Before the financial crisis of 2008-2012, B notes vied with mezzanine loans in popularity and may have been even more popular in CMBS transactions. But post-crisis the B notes have lost some of their luster, although that is more likely a result of other factors than a response to any evidence that B notes suffered greater losses during the crisis than mezzanine loans. In fact, given the havoc wrought on mezzanine loans in those years, one might successfully wager that a thorough study would show that mezzanine debt suffered disproportionate losses compared to B Notes, which at least had a lien on the real estate and substantially more consent rights regarding senior lender actions than mezzanine lenders.

One reason for their declining popularity is likely that, as previously discussed, rating agencies tend to assign greater value to the mortgage note in a mezzanine structure than to the A Note in an A/B structure. A likely stronger reason for the decline in use of the A/B structure is that the mezzanine structure has become far more popular with junior lenders, who perceive that they have far more control of their destiny as mezzanine lenders. In the CMBS context the B note is truly the tail on the dog, required to wag or droop along with the A-Note and the heightened discretion of the senior lender post-default. The only mechanism for the B Note holder to exercise control is to exercise its right to purchase the A Note, which can be a very risky and expensive proposition, while the mezzanine lender can exercise its cure rights and foreclose and take over ownership of the borrower. The trade-off for this possibly illusory belief in more control over its destiny is the loss of a direct security interest in the real estate, making the mezzanine lender vulnerable to intervening secured and unsecured creditors of the mortgage borrower. The rating agencies' tendency toward lower valuation of A Notes in the A-B structure than in the mezzanine situation, as discussed above, may evidence that the junior mortgage position has more value by virtue of its combination of property lien and consent rights than the mezzanine lender's mere security interest in the equity. The next significant downturn in the real estate market may reveal whether the mezzanine lenders' "wager" was justified.

Another reason B notes may have fallen somewhat out of favor is that the co-lender agreement subjects them to loss of consent, consultation, cure, and other rights if they become

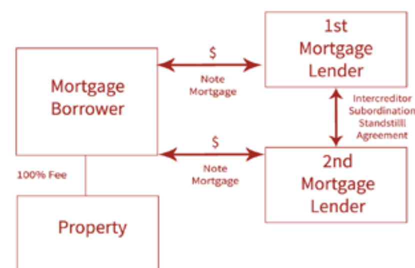
“out of the money” or “appraised out,” which will occur if the property declines in value so that the deemed principal amount of the B note, based on the re-determined value of the property, is less than 25% of its original amount.

In the A/B structure, since two notes are secured by the same mortgage, the holder of the A Note is vulnerable to a determination, in the event of a bankruptcy of the borrower, that the A Note is undersecured (i.e. the value of the collateral is less than the amount of the debt) because the A Note and B Note indebtedness may be deemed to be a single indebtedness in that circumstance. (*In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 22 Bankr. Ct. Dec. (CRR) 651, 26 Collier Bankr. Cas. 2d (MB) 955 (Bankr. S.D. N.Y. 1991)) If, on the other hand, the B Note were secured by a different instrument, i.e. a subordinate mortgage, the holder of the A Note would be less vulnerable to a claim that it is undersecured because only the A Note indebtedness would be counted in determining the amount of the claim secured by the A mortgage. If undersecured, the holder of the A Note’s post-petition interest and attorneys’ fees (which can be substantial) are not entitled to be included in its secured claim, whereas they may be included if the holder of the A Note is fully secured. It should be emphasized that this would not happen to the A Note holder if the B Note was secured by a second mortgage rather than a subordinated slice of the first mortgage.

6 Second Mortgage Financing

A second mortgage loan is secured by a subordinate interest in the real property collateral itself (see Fig. 5). Unlike the A/B structure, there are two notes and two mortgages rather than one mortgage secured by two notes. If the borrower encounters difficulty, the mortgaged property’s cash flow may not support payments to the holder of the second mortgage loan, in which case the second mortgage lender could enforce its rights and prevent further losses through a property foreclosure. If the mortgage borrower defaults on the first mortgage loan, a resulting foreclosure of the first mortgage could extinguish the mortgage lien of the second mortgage lender. In such event, the second mortgage lender might elect to purchase the property at the sale (or by negotiation of a deed in lieu of foreclosure) to preserve the value of its investment.

Fig. 5 Second Mortgage Structure



A first mortgage lender allowing its mortgage borrower to grant a second mortgage is likely to require a subordination and standstill agreement to prevent the second mortgage lender from interfering with the operation of the property or the enforcement of first mortgage lender rights. The terms of such agreements vary, but some go so far as to prevent the second mortgage lender from exercising its remedies, requiring it to “take out” the first mortgage by paying it in full or a lesser agreed amount. Such an agreement essentially makes the subordinate mortgage loan a “soft second,” which is viewed more favorably by first mortgage lenders.

Second mortgages were the most typical form of subordinate financing structures until the 1990s. However, primarily due to the hostility of the rating agencies, they have fallen out of favor with senior lenders and typically are not permitted due to the rating agencies’ perception that that a second mortgage lender has a stronger position vs. the first mortgage lender in connection with borrower bankruptcy and mortgage loan enforcement as compared to other subordinate financing structures, especially mezzanine, where the mezzanine lender does not need to be named as a defendant in a foreclosure suit and is less likely to assert a

claim in the mortgage borrower's bankruptcy. Again, a more careful study of actual experience rather than theoretical speculation might someday allow second mortgage lending to enjoy a new life.

7 The Rake Bond

We should at least briefly mention one other form that subordinate financing takes in CMBS--the "Rake Bond." Occasionally, a lending party wants a CUSIP'd security rather than a note in a loan transaction destined for a securitization execution. They will sometimes arrange that their debt be in the form of a special trust certificate or bond issued in the securitization that "rakes" out the subordinate portion of a single loan. The holder of that certificate or bond does not, like the non-rake bondholders, suffer gains or losses based on how the entire pool operates but only with respect to the subordinate portion of the raked loan.

8 Borrower's Perspective

From the borrower's perspective, mezzanine financing is generally cheaper than preferred equity financing and is perceived to have less risk of loss of control over the property or dilution or even elimination of its ownership interest than preferred equity financing. Safeguarding their equity allows the common equity greater flexibility and control over their business and preserves for the owners the upside potential of their investment.

Mezzanine financing can serve a variety of financial purposes for the borrower. It can be used in an acquisition where the borrower requires more financing than the mortgage lender is willing to provide. It can be used in a recapitalization, allowing borrower's equity owners to take cash out of the enterprise but continue to own it. Recapitalization is often an attractive alternative to selling the property and incurring tax liability and also foregoing future appreciation in the value of the property. Mezzanine financing can furnish funds for necessary capital expenditures, strategic planning, wealth management, or retirement planning if, for example, a partner wants to cash out but the remaining partners want to remain in ownership of the property.

One of the highest priorities for mezzanine and mortgage borrowers is to ensure that the respective loan documents are as consistent as possible, with particular attention to certain important provisions: default, cure periods, prepayments, permitted transfers, lease approval, property management, financial reporting, insurance, casualty, condemnation, and organizational restrictions. Lenders desire this result as well, so much so that the drafting of the mezzanine loan agreement will often await the negotiation of the mortgage loan agreement and follow its model in many respects.

Where an existing mortgage loan is in place, mortgage lender approval generally is required by the loan documents before a borrower can obtain subordinate financing. Whether or not a borrower is anticipating the use of subordinate financing at the time it obtains a mortgage loan, the borrower should consider negotiating a right to incur subordinate financing and certain related provisions when it obtains the mortgage loan because seeking approval after the mortgage loan is in place can be difficult to impossible. Even if subordinate financing is put in place at origination, the borrower needs to consider the possibility of needing to increase or refinance the junior debt. Key provisions include ownership transfers, aggregate financial covenants, the types of permitted subordinate financing (making sure to cover pure mezzanine, preferred equity, and any other conceivable structures), the time periods during which new financing will be allowed, and the mortgage lender's other conditions for approval. If the borrower seeks subordinate financing during the term of a mortgage loan and it was not contemplated in the mortgage loan documents, the mortgage lender will likely re-underwrite the mortgage loan prior to giving consent. Therefore, the borrower must take this re-underwriting process into consideration when weighing its options, especially if the borrower or collateral value has weakened in any way since the mortgage loan was originated.

Since one or more of the borrower's principals are apt to have delivered a nonrecourse carveout guaranty imposing liability on those guarantors for various acts and omissions, not just of their own doing but the borrower's, it is critical that the guarantors think through the protections they need if they lose control (whether to a mezzanine lender or a preferred equity provider) and the new control party commits those very acts or omissions, such as an unauthorized transfer or other liability trip-wire. The guarantors must strive for the maximum possible protection in that situation, looking to the senior lender for a carve-out from the carve-out, if you will, exculpating them from responsibility for the acts of new control parties; and if they are not fully successful in that negotiation, to then negotiate with the junior lender a combination of structural features (for example, approval by the ousted guarantors of actions that could impose liability) and indemnification to protect them from some potentially very severe consequences beyond their control.

9 Subordinate Lender Underwriting

Subordinate lenders have a somewhat different underwriting focus than senior mortgage lenders. Cash flow from the real property is their most important underwriting consideration because healthy cash flow reduces the risk that the mortgage borrower will default on the mortgage loan or fail to distribute sufficient profits to make required payments on the subordinate financing. Cash flow can be evaluated using a number of different benchmarks, including the property's historical operating performance, tenant roster, rent roll, comparable market rents, tenant's sales and profit per square foot, and the mortgage borrower's anticipated capital expenditures. Where cash flow is not entirely dependable, debt service and other reserves are likely to be required.

The borrower's sponsor is an even more important underwriting factor to subordinate lenders than to mortgage lenders, although it is vital to both. Strong capitalization, high liquidity, and established management experience are all critical to reduce the risk to the subordinate lender. The greater the capitalization and liquidity, the more the sponsor has at risk, so, arguably, the sponsor has more to lose and will work harder to prevent a default.

10 Mortgage Lender Underwriting

If the borrower receives subordinate debt simultaneously with the origination of the mortgage loan, the mortgage loan underwriting will consider its effect on the mortgage loan, i.e., whether the LTV and DSCR can support additional debt and to what extent the subordinate debt increases the re-finance and rollover risk. A high LTV increases the risk of a default and of a subordinate lender taking control of the property. This could have a substantial negative impact because the mortgage lender is usually relying to a large degree on the strength and experience of the mortgage borrower's sponsor. In the case of preferred equity, a high LTV could result in a situation where the unpaid preferred return becomes so large that the common equity holders lose all hope of ever getting a decent return and lose motivation to aggressively operate and manage the property.

11 Loan Sizing Considerations

As noted previously, much of the impetus for developing subordinate financing structures stems from the borrower's desire to increase the amount of borrowed capital invested in the transaction. In true mezzanine financing, the size of the mezzanine loan will not have a significant impact on the size of the mortgage loan because normally a default under the mezzanine loan will not cause a default under the mortgage loan. The same holds true with respect to the size of preferred equity investments. While both senior and subordinate loans usually will be supported only by the value and cash flow of the real property, a mezzanine loan foreclosure or a change of control in favor of a preferred equity holder may not cause any disturbance in the administration of the mortgage loan. This can depend on various factors, including whether (i) all of the revenue from a property is being paid directly into a lockbox controlled by the mortgage lender,

(ii) a bankruptcy-remote structure is in place to minimize the risk of involving the mortgage borrower in bankruptcy proceedings of its affiliates, (iii) the mezzanine lender or preferred equity holder is, or is required to engage, an entity with satisfactory property management experience, and (iv) there are appropriate provisions in the mortgage loan agreement and the intercreditor or recognition agreement requiring the mezzanine lender or preferred equity holder to provide a replacement guarantor for the mortgage loan upon a change of control.

12 CMBS Considerations

Issues Common to all Subordinate Debt. When considering how the existence of subordinate debt might affect a securitization, it is important to note some considerations that apply to all types of subordinate debt. Rating agencies, certificate purchasers (especially the most subordinate B-piece buyers) and other parties to the securitization transaction ("Securitization Parties") assume that any subordinate debt puts additional stress on the mortgaged property because a property owner will have less equity and a correspondingly reduced incentive to build property value or, when trouble arrives, even to preserve it.

It is believed that the existence of subordinate debt increases the likelihood of default, a disruption in operating the real property post-default, and the severity of loss with respect to a defaulted mortgage loan and, therefore, will result in a higher default rating. Securitization Parties will analyze the mortgaged property's overall DSCR, LTV, and securitized pool fundamentals such as loan concentration to affiliated borrowers and geographic and property type diversity to determine the potential impact of subordinate debt on the rating. They will also analyze the various loan and intercreditor documents to determine the subordinate lender's ability to (a) transfer debt, (b) control the mortgaged property, the mortgage borrower, loan servicing and enforcement, and property management, and (c) receive payments and enforce its rights, before or after default, under the mortgage loan. In response to evolving market standards, mezzanine and mortgage lenders may increasingly rely on provisions in their loan agreements requiring borrowers to cooperate in restructuring their loans for flexibility in securitizing the loans. Lenders want the broadest possible restructuring rights, while borrowers want to ensure that any restructuring does not modify material economic or non-recourse provisions, materially increase borrower obligations or decrease borrower rights, or cause them to incur any, or at least excessive, additional costs.

Issues Specific to Mezzanine Financing. Securitization Parties will have several concerns about mezzanine financing:

- **Structure of the Loan.** Securitization Parties normally require mezzanine loans to be secured by a 100% equity pledge so that the mezzanine lender can quickly take control of the mortgage borrower upon a default, and prefer mezzanine loans to be coterminous with mortgage loans so as to limit refinance risk. Mezzanine loans should not be secured by a subordinate lien on the real property, a guaranty by the mortgage borrower, or any other credit enhancement that would reduce the likelihood of repayment of the mortgage loan or violate the single/special purpose entity ("SPE") restrictions of the mortgage loan.

- **Structure and Identity of the Mezzanine Lender.** Because of the mezzanine lender's ability to take control of the mortgage borrower, Securitization Parties examine the mezzanine lender closely, including its structure and experience in the real estate investment community (thus, as discussed below, the requirement that mezzanine debt may be transferred only to a "Qualified Institutional Lender" or "Qualified Transferee"). If there is more than one mezzanine lender, they will expect an agreement among the mezzanine lenders clearly specifying workout and enforcement details and preferably designating one mezzanine lender to negotiate all issues with the mortgage lender.

- **Structure of the Mezzanine Borrower.** The mezzanine borrower will be required to be a bankruptcy remote SPE and to provide a substantive non-consolidation opinion concluding that the assets of the mezzanine borrower would not be consolidated into the bankruptcy estate of any affiliated persons or entities that collectively own, directly or indirectly, more than a 49% of the mezzanine borrower.

- **Cash Management.** A cash management arrangement with appropriate "waterfalls" in place is a standard requirement.

- **Intercreditor Agreement.** Although intercreditor agreements will be covered in detail later in this chapter, it should be noted here that Securitization Parties will require the agreement to address such issues as default and cure, prepayment, loan transfers, and control and approval rights over leases, property management, and other operational issues.

Issues Specific to Preferred Equity. A preferred equity arrangement, especially of the "soft" variety, is likely to have the least negative effect on the rating of a mortgage loan. Some senior lenders who will not tolerate secondary "debt" on their mortgaged property will consider preferred equity to be essentially equity rather than debt for the purpose of interpreting such covenants even if the preferred equity has extensive debt indicia and would be treated as equity under income tax and accounting rules. This has been true recently in construction lending where some bank lenders governed by the HVCRE regulation requirement that their borrower must have a certain level of equity capital in the project have been willing to consider preferred equity as appropriate equity to be included in calculating the borrower's contribution.[4]

Senior lenders want to examine the level of control that the preferred equity holder can exert over the mortgage borrower. It is not uncommon for the preferred equity holder to have removal and replacement rights regarding property management or the entity itself, or even the ability to sell the property in compliance with the mortgage loan documents (in the case of CMBS, either of such rights are likely subject to a "Rating Agency Confirmation" that the action will not cause a downgrade, qualification or withdrawal of the applicable rating of securitized debt), but Securitization Parties may look skeptically at a preferred equity holder's ability to affect the daily operations of the mortgage borrower or exercise other controls over the mortgage borrower.

Additionally, senior lenders will examine the identity of the preferred equity holder and its ability to transfer its interest in the mortgage borrower. As the preferred equity holder demands and gains more potential control over the mortgage borrower and the mortgaged property, the identity of the preferred equity holder becomes paramount. Senior lenders and Securitization Parties will expect the preferred equity holder to meet certain "Qualified Transferee" standards as to financial strength and experience in real estate investment and management. A preferred equity holder with solid credentials and a properly structured investment could even enhance the credit rating of the mortgage loan. As with mezzanine lenders transferring mezzanine debt, the preferred equity holder's ability to transfer its interest in the mortgage borrower would generally be subject to the transferee meeting the same standards or obtaining a Rating Agency Confirmation as to transferee's acceptability, or both.

As noted above, preferred equity has increasingly mimicked mezzanine financing, an evolution that is likely to continue in the same direction, which will mean that inevitably the concerns of the senior lenders will be the same as in the mezzanine financing context.

[4] Under the current regulation, the requirement is 15% or more of the as-completed value of the real estate as determined by a current appraisal (but giving the borrower no credit for the appreciation in the value of the land from its acquisition date to the date the loan is made).

13 The Impact Of Servicing And Control Rights

In each structure, there will be a tension between senior and junior debt as to how much control each will have over the borrower's decisions. Where there is no subordinate debt, the mortgage lender can have all of the control rights. But in each instance where a subordinate lender has the right to participate in a control decision, the mortgage lender's freedom to act to protect its own interests is constrained to some degree. A mortgage lender that approves a capital improvement or a lease proposed by the mortgage borrower, which they both agree would benefit the property, could be frustrated by a subordinate lender that disapproves of the proposed action. The subordinate lender, on the other hand, exposed to the risk of first loss on the property, can make a credible case that it has more reason to be intimately involved in the details of the property's operation than the mortgage lender sitting comfortably atop an equity cushion stuffed extra full with funds provided by the subordinate lender.

The balance struck with respect to these operational consents will vary from loan to loan and from lender to lender. As discussed below, while senior and junior lenders in the CMBS arena have more or less settled into a post-financial crisis and post-Stuy Town (see below for discussion of the Stuy Town case) set of now customary agreement provisions, senior lenders outside of the CMBS context are often more rigid.

14 Intercreditor Agreements Generally

Negotiation of an intercreditor agreement between the mezzanine lender and the mortgage lender can be one of the most difficult and time consuming aspects of documenting a mezzanine loan. The core issues, regardless of loan complexity or the size of the lender group, are generally the same, although obtaining a consensus among the members of a larger lending group is more challenging.[5]

[5] Many of the provisions discussed below are also included in the A/B co-lender Agreement.

To increase consistency and decrease negotiations among lenders, the Commercial Mortgage Securities Association, now known as the CRE Finance Council or CREFC, with input from the rating agencies, mortgage lenders, and mezzanine lenders, developed a form of intercreditor agreement (the "CMBS Form") that was widely used for many years as a benchmark and common starting point for negotiations, whether or not a mortgage loan was securitized. The CMBS Form was considered credit neutral by the rating agencies and deviation from the CMBS Form could impact the rating of a CMBS loan. If a mortgage loan was not securitized, the mortgage lender had greater flexibility in deviating from the CMBS Form because there was no rating agency involvement. Nonetheless, investors became so familiar with the CMBS Form that excessive changes could affect the marketability of even a non-CMBS loan.

During the financial crisis of 2008-2012, increased loan defaults resulted in disputes among lenders as to the interpretation and practical application of intercreditor agreements, including the CMBS Form, revealing a variety of ambiguities, omissions, and problems with implementing the agreements as written. As a result, lenders have moved away from using the CMBS Form as the industry standard. Some lenders have revised the CMBS Form to address its perceived inadequacies, while others have opted to use entirely new forms.

The following sections in this chapter address the most common points of negotiation on intercreditor issues. It should be noted that the relative negotiating leverage of the parties depends on a variety of factors including market conditions, combined LTV, and the mortgage borrower's influence over the parties.

15 Intercreditor Subordination And Standstill

Intercreditor agreements typically provide that the mezzanine loan is subordinate to the mortgage loan, including all

payments and liens, but that the mezzanine lender may accept mezzanine loan payments prior to a mortgage loan default. After a mortgage loan default, however, the mezzanine lender will not be permitted to receive payments from mortgaged property income until the mortgage lender is paid in full or until the mortgage loan default is cured. Any protective advances made by the mortgage lender typically will have the same payment priority as the initial advance under the mortgage loan. If the mezzanine lender and the mortgage lender each obtain a guaranty from the same principal of the mortgage borrower, the mortgage lender commonly requires that the mezzanine lender's right to payment from the guarantor is subordinate to the mortgage lender's payment right. Most intercreditor agreements provide that the mezzanine lender may enforce its security interest against any collateral that is not also collateral for the mortgage loan. More than one commentator has worried about possible complications caused by the standard intercreditor agreement's seemingly unnecessary provisions subordinating the mezzanine debt when the mezzanine lender is already structurally subordinated in that it does not have a claim against the mortgage borrower but only its parent.

16 The Impact Of Intercreditor Agreements On Default And Remedies

The mortgage lender wants to be sure that a foreclosing mezzanine lender is a financially strong entity with experience in operating properties similar to the mortgaged property. In the context of a CMBS loan, the mortgage lender typically will permit the mezzanine lender to foreclose against its collateral if (a) a Rating Agency Confirmation is obtained, or (b) each of the following is satisfied: (i) the transferee of the property upon mezzanine loan foreclosure is acceptable, (ii) the mortgaged property will be managed by an acceptable manager after such foreclosure, (iii) if a change of control results, delivery of a new non-consolidation opinion, and (iv) hard cash management arrangements and appropriate reserves are in place or will be implemented. Items (i) and (ii) most often are satisfied so long as the mezzanine lender is a "Qualified Transferee" and the mortgaged property is managed by a "Qualified Manager."

Of vital importance, intercreditor agreements now also require that a foreclosing mezzanine lender must provide a replacement mortgage loan guarantor acceptable to the mortgage lender that meets specific objective standards set forth in the intercreditor agreement. The CMBS Form required the transferee to provide a replacement guaranty only if the original guarantor was "removed" as a result of the transfer. Most mortgage lenders took the position that "removed" meant removal from the ownership or management of the borrower, which almost always would occur in connection with a mezzanine foreclosure. Mezzanine lenders, on the other hand, often argued that the provision required termination of the guaranty, which in most instances would not occur. At best, the term was ambiguous, and lenders are now clarifying this provision to require the replacement guarantor on any transfer without reference to the concept of guarantor "removal."

17 The *Stuy Town* Case

Many intercreditor agreements have required a foreclosing mezzanine lender, in connection with "realizing upon its equity collateral," including completing a foreclosure of its equity interest in the mezzanine borrower, to cure all existing defaults under the mortgage loan. In the famous, or infamous depending on one's point of view, "*Stuy Town*" case (*Bank of America, N.A. v. PSW NYC LLC*, 29 Misc. 3d 1216(A), 918 N.Y.S.2d 396 (Sup 2010)), a Judge of the New York Supreme Court (a trial court despite the lofty appellation of "Supreme") in Manhattan conferred extraordinary status and power on a mortgage lender wielding this provision by (1) interpreting ambiguous language in the agreement to require the cure of such defaults before and as a condition precedent to the equity collateral foreclosure rather than an obligation to be honored following the foreclosure and (2) refusing to relegate the mortgage lender to a suit for damages against the

mezzanine lender for breach of the provision, but, instead, issuing an injunction preventing the mezzanine lender from foreclosing on the equity interests until it had actually cured all defaults under the mortgage loan. The mortgage loan had been accelerated, thus requiring the mezzanine lender to pay the mortgage lender a huge sum of money, $3.5 billion, an impossible amount to raise in then-existing market conditions even if the project had not declined in value (or, actually, never achieved the value hoped for by the buyers and their lenders). The mezzanine lender was thus thwarted in its strategy (in hindsight a strategy it probably too openly and boldly announced) to take over the mezzanine borrower property owner and file a Chapter 11 to stave off foreclosure and restructure the loan and "cram down" the restructured loan on the mortgage lender. Other courts have issued similar injunctions although many lawyers would argue that an injunction, as opposed to requiring the mortgage lender to resort to a lawsuit for contract breach damages, is an inappropriate draconian remedy that is not justified in this situation.

The issue has not been resolved in the courts as of this writing, in part because senior and mezzanine lenders have reached an understanding of what should occur in the Stuy Town type of situation that is reflected in current post-Stuy Town intercreditor agreements, which typically more narrowly define the limits of the mezzanine lender's cure obligations as a condition to accomplishing a mezzanine loan foreclosure. A sample cure provision, post-Stuy Town, is as follows:

> Notwithstanding anything to the contrary contained herein, in no event shall Mezzanine Lender or any Qualified Transferee be required, as a condition to completing a foreclosure or other realization upon the Equity Collateral, to cure (i) any Event of Default under the Senior Loan Documents arising from Borrower's failure to repay the Senior Loan in full on the Senior Loan maturity date, or (ii) any Event of Default under the Senior Loan Documents which is not susceptible of being cured by Mezzanine Lender or such Qualified Transferee (or which is not susceptible of being cured until after completion of such foreclosure or other realization upon the Equity Collateral); provided, however, that nothing in this Section is intended as (x) a waiver of or by Senior Lender of any such Event of Default or of any rights or remedies Senior Lender may have as a result of such Event of Default or otherwise under the Senior Loan Documents at law or in equity or (y) any agreement on the part of Senior Lender to extend the term of the Senior Loan or otherwise modify any of Senior Loan Documents in any respect except as expressly set forth herein.

How then is the senior lender to prevent the mezzanine lender from doing exactly what the Stuy Town mezzanine lender wanted to do—complete the mezzanine foreclosure, file Chapter 11, and cram down a restructured loan on the senior lender? Whether fully intended or not, the requirement of the replacement guarantor discussed above indirectly solves that problem in most cases. Since the foreclosing mezzanine lender must obtain approval of a replacement guarantor as a condition to its foreclosure, the replacement guarantor would become liable for the entire debt under the "springing full recourse" provisions of the guaranty upon the filing of the Chapter 11.

18 Intercreditor Agreement Bankruptcy Provisions

Although bankruptcy is addressed in more detail below, a few bankruptcy-related intercreditor agreement provisions should be noted here. Most intercreditor agreements, including the co-lender agreement in the A/B structure, limit the mezzanine lender's rights upon a bankruptcy, insolvency, or reorganization of the mortgage borrower. The mortgage lender will likely require the mezzanine lender to agree that (i) the mortgage lender's claims are paid first in the bankruptcy proceeding, (ii) the mezzanine lender will not commence, or conspire with others to commence, a bankruptcy proceeding against the mortgage borrower, and (iii) if the mezzanine

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lender is deemed a creditor of the mortgage borrower in the latter's bankruptcy proceeding: (a) the mortgage lender may vote the mezzanine lender's claims (if any) except under limited circumstances and (b) the mezzanine lender will not challenge any good faith claims of the mortgage lender in the bankruptcy proceeding, dispute any valuation of the mortgaged property submitted in good faith by the mortgage lender, or take any other action adverse to the mortgage lender's ability to enforce its rights. The mortgage lender might permit the mezzanine lender to file a fully subordinated bankruptcy claim, but will not permit the mezzanine lender to vote on any plan in bankruptcy; rather, it will require an assignment of such right from the mezzanine lender, although there is some disagreement among the courts as to the enforceability of such assignments as discussed below. Again, such provisions can seem anomalous when the structurally subordinated mezzanine lender supposedly has no claim against the mortgage borrower, which is the primary reason the rating agencies are hostile to second mortgages and favor mezzanine debt.

The mortgage lender also will likely require that, upon the commencement of a bankruptcy proceeding of the mortgage borrower, the mezzanine lender's cure period under the intercreditor agreement with respect to the cure of non-monetary defaults of the mortgage borrower under the mortgage loan documents will terminate, unless the bankruptcy proceeding is later dismissed, in which case the right may be reinstated.

19 Intercreditor Restrictions On Transfer Of The Mezzanine Loan

In order to address the mortgage lender's concerns about the mezzanine lender's financial capacity following a mezzanine loan foreclosure, most intercreditor agreements restrict the mezzanine lender from selling, transferring, or pledging more than 49% of the mezzanine loan unless to a "Qualified Transferee," and, if applicable, subject to obtaining a Rating Agency Confirmation. Mezzanine lenders also may negotiate pre-approval of certain types of transfers, including the sale of a participation interest, so long as the mezzanine lender retains a controlling interest. Although a mortgage lender's standard definitions for such terms might preclude the mezzanine lender or its property management affiliate from qualifying to hold such positions, mezzanine lenders sometimes are successful in negotiating exceptions to prequalify them, their affiliates, and certain other specifically identified entities with investment and management experience acceptable to the mortgage lender. One issue in this negotiation is the possible deterioration of the mezzanine lender's financial position between the time the loan is made and the occurrence of a transfer.

20 Mezzanine Lender Cure Rights

Mezzanine lenders want extended mortgage loan default notice and cure rights so they can act to protect their security interests, whereas mortgage lenders typically want the ability to foreclose as soon as possible to stem potential declines in mortgaged property value. The middle ground position will require that the mortgage lender provide prior notice to the mezzanine lender of mortgage loan acceleration and foreclosure, and will allow the mezzanine lender to cure mortgage loan monetary defaults within a set number of days after the later of either notice from mortgage lender or expiration of the mortgage borrower's cure period. Typically, the mezzanine lender is only permitted to continue to cure such monetary monthly defaults of the mortgage borrower under the mortgage loan for a specified number of consecutive months (often set at four), unless the mezzanine lender is simultaneously pursuing foreclosure of the mezzanine loan.

In the case of non-monetary defaults, the intercreditor agreement often provides that the mezzanine lender has the same time period as the mortgage borrower, but if the default cannot be cured within such period, the mezzanine lender's cure period can be extended as reasonably necessary for the mezzanine lender to cure, provided that (a) mezzanine lender has made timely payment of any amounts due under the

mortgage loan documents; (b) the extension period does not exceed a specified number of days, unless the default cannot be cured within such period, in which case mezzanine lender shall have such additional time as is reasonably necessary to cure but often with an absolute deadline; (c) such default is not caused by a bankruptcy; and (d) during such extended cure period, there is no material impairment to the value, use, or operation of the mortgaged property.

Mezzanine lenders want to negotiate longer cure periods in all of these provisions to better protect the value of their loans, whereas mortgage lenders want to limit those periods to reduce the potential negative impact on their enforcement rights.

21 Mezzanine Lender Purchase Options

Depending upon the economics of the mortgaged property, the mezzanine lender may attempt to save its investment by purchasing the mortgage loan rather than curing a mortgage loan default. Most intercreditor agreements include a purchase option that may be exercised after the mortgage loan has been accelerated or a foreclosure action has commenced. The mezzanine lender should try to expand the triggers for the purchase option to include events such as a bankruptcy of the mortgage borrower, a deed in lieu of foreclosure, and a failure of the mortgage borrower to pay the mortgage loan on the maturity date.

The most important aspect of the purchase option provision is the method for determining the purchase price. The mortgage lender will want payment of the full amount that would have been paid if the mortgage borrower were prepaying the mortgage loan at that time, including: (a) accrued and unpaid interest; (b) protective and other servicing advances; (c) late charges; (d) default interest; (e) prepayment premium or fee, exit fee, or yield maintenance charge; (f) liquidated damage amounts; (g) liquidation, workout and servicer fees; and (h) enforcement costs, including attorneys' fees, and all other costs and expenses. It is not uncommon for the mezzanine lender to negotiate the removal of some or all of items (c) through (g). For example, with respect to a CMBS loan, the agreement might provide that if the repurchase occurs within 60 days of the date of the notice of the mortgage loan becoming a "specially serviced whole loan," then liquidation, workout or similar servicer fees are specifically excluded. And senior lenders will often agree not to insist on collecting prepayment premiums in connection with such a purchase. In the recent past, due to the financial crisis, the mezzanine lender's purchase option often has proved to be illusory since many mezzanine lenders have not been able to muster the financial wherewithal to purchase the mortgage loan in a crisis environment of plunging valuations and nonexistent market liquidity.

Intercreditor agreements usually specify the documentation to be delivered in connection with a mortgage loan purchase. The mezzanine lender may negotiate to expand the mortgage lender's representations in those documents to include representations that the mortgage lender: (a) has the power and authority to transfer the mortgage loan and has delivered to the mezzanine lender all material mortgage loan documents; (b) has provided to mezzanine lender the outstanding balance of the mortgage loan and all related reserves and escrows; and (c) owns the mortgage loan and has not previously assigned, transferred, participated, or encumbered its rights in the mortgage loan, unless such participation or encumbrance will be released prior to the transfer.

22 Restrictions On Mortgage And Mezzanine Loan Modifications

The mezzanine lender and the mortgage lender each want the ability and flexibility to amend its loan documents without the consent or input of the other lender. However, neither the mezzanine lender nor the mortgage lender wants the other lender to amend its own loan documents without first obtaining the consent of the other. As a compromise, most intercreditor agreements contain a lengthy list of loan modifications that require the consent of the other lender.

In keeping with the general theme of the mortgage lender's overriding right to get paid, however, the mortgage lender enjoys greater discretion when its rights are imperiled. Following a mortgage loan default, the mortgage lender will be permitted to make almost any modification to the mortgage loan it deems necessary without the consent of the mezzanine lender, except for certain significant modifications, such as those increasing the principal amount of the mortgage loan (aside from protective advances), extending any prepayment lockout periods or changing prepayment fees.

Following a mezzanine loan default, the mezzanine lender will have a limited degree of flexibility to modify the mezzanine loan documents without the consent of the mortgage lender in connection with a workout, surrender, extension, or indulgence, except in certain significant areas, such as increasing the principal amount of the mezzanine loan or shortening the maturity of the mezzanine loan. In addition, if the mezzanine loan guaranty is not also collateral for the mortgage loan, the mezzanine lender should be able to amend, supplement, or waive any guaranty. The mezzanine lender also should be able to further modify its cash management provisions to retain excess net cash flow without the mortgage lender's consent, so long as the mezzanine lender makes such cash flow available to the mortgage borrower for property-related expenses.

23 Control And Approval Rights

Although both lenders desire to maintain approval rights over certain issues such as leases, property management and the property's operating budget, the mezzanine lender often has a more heightened concern due to its first loss position in the loan structure. If there are inconsistencies between the mortgage and mezzanine loan documents on these issues, the mezzanine lender will want to address the inconsistencies in the intercreditor agreement because otherwise the mortgage loan provisions will control.

Approving requests of the mortgage borrower are generally dealt with in one of three different ways by the mezzanine lender and the mortgage lender: (a) the mezzanine lender has the sole approval right until a specified trigger event occurs, and then the mortgage lender will have the initial review right, followed by mezzanine lender review; (b) the mortgage lender has the approval right and the mezzanine lender is prohibited from exercising a veto of the mortgage lender's decision once it is made, or (c) the mortgage lender has the approval right, but the mezzanine lender may be able to require that the mortgage lender use reasonable efforts to consult with the mezzanine lender prior to the mortgage lender's determination, provided there is no default under the mortgage loan documents. The allocation of many approval rights between the mortgage lender and mezzanine lender are negotiable provided that the exercise by the mezzanine lender of its approval rights does not negatively impact the value of the mortgaged property or impair the value of the mortgage loan. The following are examples of how certain scenarios can be resolved:

- **Books and Records.** The mortgage lender typically requires the mortgage borrower to deliver certain financial statements and to permit review of its books and records. The mezzanine lender does not have a direct contractual relationship with the mortgage borrower, but wants the same information from that entity. Therefore, the mezzanine lender may require that the mortgage lender provide notice to the mezzanine lender upon its inspection of the books, records, or property of the mortgage borrower, and direct the mortgage borrower to reasonably cooperate with and provide equal access to the mezzanine lender.
- **Annual Budget.** A mezzanine lender generally has the right to review the annual operating budget for the mortgaged property, although its input can range from merely having a right to consult with the mortgage lender to having a right to approve it before it goes to the mortgage lender for review. In any case, however, the

mezzanine lender usually winds up compelled to accept the budget as reasonably approved by the mortgage lender.

- **Leases and Alterations.** Both the mortgage lender and the mezzanine lender want the right to approve leases (including any termination or modification of any leases) and alterations of the mortgaged property. Often the mezzanine lender can require that the mortgage lender consult with the mezzanine lender regarding such leases and alterations, without such consultation being binding on the mortgage lender. In addition, the mortgage lender can require that the mezzanine lender not unreasonably withhold its consent to any proposed lease or alteration reasonably approved by the mortgage lender.

- **Insurance.** Mezzanine lender will be an additional named insured on the insurance policies held by the mortgage borrower, so the mortgage lender will want an agreement that the mezzanine lender will not have the right to receive and apply insurance proceeds until the mortgage loan has been paid in full. In return, the mezzanine lender may seek consultation rights with respect to the settlement, adjustment, contest or challenge of claims, or that no approval of any such disposition will occur without the approval of the mezzanine lender.

- **Notices of Transfers.** Mortgage loan documents typically require that the mortgage borrower request approval of equity and fee transfers or pledges. As a result, the mezzanine lender will want to require that the mortgage lender notify the mezzanine lender if the mortgage lender receives any notice or request for approval of such a transfer or pledge. A mezzanine lender can often require that a mortgage lender with a right to withhold its consent to a requested transfer or encumbrance do so unless the mezzanine lender approves the request.

- **Replacement of Property Manager.** The intercreditor agreement should enable the mezzanine lender to replace the property manager with a qualified property manager (the objective qualifications for which should be set forth in the intercreditor agreement) or a property manager that is reasonably acceptable to the mortgage lender, and often subject to receipt of a Rating Agency Confirmation in the case of a CMBS loan. Often, this right falls to the mortgage lender if there is a mortgage loan default, and the mortgage lender may subsequently exercise its similar rights to override an action that was previously taken by the mezzanine lender.

24 Limitations On Mezzanine Borrower Affiliate Purchase Rights

It is not uncommon for an affiliate of a mezzanine borrower to seek to purchase the mezzanine loan and become the mezzanine lender. Although an intercreditor agreement typically will have substantial Qualified Transferee requirements, those requirements have not always been drafted to exclude mezzanine borrower affiliates (or even the mortgage or mezzanine borrower) from purchasing the loan or an interest therein even though they may otherwise be a Qualified Transferee. By virtue of such a transfer, the affiliate would, unless the intercreditor agreement otherwise provides, be entitled to approval rights over certain actions of the mezzanine lender, for example certain modifications to the senior loan as describe above. In order to avoid this occurrence, most intercreditor agreements provide that, immediately upon the affiliate becoming the owner of the mezzanine loan, the rights of the mezzanine lender under the intercreditor agreement to cure defaults, exercise purchase options, and approve, consult, consent, and receive notices and information, shall become null and void.

25 Refinancing Considerations

From the mezzanine lender’s perspective, the intercreditor agreement should provide that, prior to a mortgage loan default, the mortgage lender will not accept any mortgage loan prepayments. Similarly, mezzanine loan documents

usually prohibit the mezzanine borrower from consenting to any supplemental mortgage financing or mortgage loan refinancing without mezzanine lender consent. The mezzanine lender does not want the existing mortgage financing replaced with a senior mortgage more unfriendly than the existing mortgage and with no intercreditor agreement protections. Moreover, upon a refinancing, the mezzanine lender may be able to negotiate an intercreditor agreement that is more friendly to the mezzanine lender than the initial intercreditor agreement, although it is more likely that the terms of the initial intercreditor agreement would be used by the refinancing mortgage lender in opposition to such changes ("You agreed to such a provision before, so why not again?").

26 Rating Agency Confirmations

In CMBS intercreditor agreements Rating Agency Confirmation will be required for a variety of events, including (i) a transfer of the mezzanine loan, (ii) a foreclosure by the mezzanine lender, (iii) the termination of the property manager, and (iv) the pledge by the mezzanine lender of its interests in the mezzanine loan. Notwithstanding that Rating Agency Confirmation may be required under the terms of the intercreditor agreement, unless the mortgage loan is a large loan or a loan of special interest or concern to the rating agencies, the rating agencies often choose to waive or decline review of the transaction and, therefore, refuse to issue a Rating Agency Confirmation. If this occurs and the intercreditor agreement does not provide an alternative, such waiver or decline can cause certain events or transactions to occur that could be detrimental to the mortgage loan or to the mortgaged property. Thus the senior lender should consider including in the intercreditor agreement alternative criteria, in compliance with REMIC requirements, to be satisfied in connection with the occurrence of any action, event, or transaction where the rating agencies decline review. The mezzanine lender would seek provisions identifying specific criteria applicable to the senior lender's consent and that such consent not be unreasonably withheld, conditioned, or delayed.

27 Tranched Mezzanine Loans

Prior to the financial crisis of 2008-2012, in larger transactions multiple mezzanine loans were often tranched with different priorities and returns. These have disappeared from the current scene though they could reappear. The loans may be originated by different lenders or may be made by one lender with the intent to sell some or all of the loans to other lenders after closing. In these situations intercreditor agreements must be expanded beyond the typical mortgage-mezzanine concepts to address the rights of each mezzanine lender vis-à-vis the others. A standard waterfall pattern is applied to payments, security interest priority and other rights, flowing first to the most senior mezzanine lender and then to each successive junior mezzanine lender.

Other rights are allocated to the mezzanine lenders in the opposite order of seniority through a reverse waterfall. These rights include loan cure, as well as the right to purchase more senior loans or the collateral securing those loans. The most junior mezzanine lender may be given a specific period of time to exercise its rights; upon a failure to act, the next most-junior lender succeeds to those rights, again for a specific period, and so on up the waterfall. Alternatively, the intercreditor agreement may allow only one period within which to act, with priority to exercise the right given to the most junior lender that expresses an interest in taking action. If the right involves the purchase of a more senior loan or the collateral securing the loan, there is an added cost of exercising the right--the purchasing junior lender must pay off or purchase all other loans held by mezzanine lenders senior to the purchaser. This prevents the most-junior lender from putting the intermediate level mezzanine lenders at a significant disadvantage by simultaneously holding both senior and junior loans.

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28 Preferred Equity "Recognition" [i.e. Intercreditor] Agreements

The term was historically quite apt for two reasons—preferred equity holders were not deemed to be "creditors," at least in the usual sense, and the rights under the agreement were essentially limited to a "recognition" of certain of the holder's rights under the Limited Partnership or Operating Agreement, including the right of removal of the property manager or general partner or managing member under various conditions acceptable to the senior lender in a given case, so that exercise of those rights will not result in a "prohibited transfer" default under the senior loan documents. As preferred equity has continued to evolve and incorporate mezzanine-like terms and conditions, making it more and more debt-like ("hard" preferred equity), the "recognition" agreement has become more and more like the mezzanine intercreditor agreement and seems likely to continue to do so.

29 Mezzanine Enforcement: The Importance Of Pre-Default Administration And Servicing

Effective enforcement begins before the default, with thorough, diligent loan administration so that the mezzanine lender is prepared to act with full knowledge of the situation. Too often loan documents are mere paper, the provisions ignored in the months or years between the celebratory moment of origination and the depressing moment of default. The worst aspect of a UCC sale of equity interests is that it is essentially the sale and purchase of a business entity subject to all of the liabilities of the business, very often with little, if any, meaningful opportunity for due diligence by either the seller (secured party) or the buyer at the UCC sale (usually the lender itself, in part because of the very absence of opportunity for effective third-party due diligence). In the enforcement process, knowledge truly is power, and, after default, it is very difficult to obtain information to remedy deficiencies in the lender's knowledge and understanding of the situation. The best answer to this is effective and fully, even fanatically, inquisitive and informed loan administration, which is nearly as important as, and arguably more important than, powerful loan documents in creating the conditions for effective loan enforcement.

30 The First And Often Most Difficult Enforcement Problem - The Intercreditor Agreement

Most intercreditor agreements are extremely mortgage-lender-friendly, and the mezzanine lender will often find itself bound and gagged--not just with respect to the mortgage loan but, to a large extent, with respect to work out and enforcement of the mezzanine loan itself. The mortgage lender and the intercreditor agreement often create issues for the mezzanine lender that are more difficult than the issues created by the mezzanine borrower, and the combination of a powerful and difficult mortgage lender and an obstreperous borrower is particularly difficult. Requirements for rating agency approval of various fundamental items can further complicate and delay a process that requires immediate and effective action for success.

Limitations on Mezzanine Workouts and Enforcement. Intercreditor agreements typically allow the mezzanine lender to pursue all collateral in which the mortgage lender has no interest, without the mortgage lender's consent or interference. Otherwise, limitations can be severe. For example, older intercreditor agreements often prevented the mezzanine lender from proceeding against its own collateral and taking control of the mortgage borrower unless it previously cured all mortgage loan defaults. This already onerous requirement became even more formidable in light of Stuy Town and other cases discussed in this chapter, where the courts ordered the extraordinary remedy of injunctive relief preventing the mezzanine lender from pursuing its remedies, rather than simply holding the mezzanine lender responsible for any damages caused by its breach of the intercreditor agreement.

Limited Bankruptcy Remedies. Frequently, junior creditors can benefit as much or more from a borrower's bankruptcy than the borrower's principals, but it is unlikely that the typical mezzanine lender will reap any bankruptcy-related benefits. In most situations, the mezzanine lender will have no standing as a creditor of the mortgage borrower, since it will have served as a lender to one or more owners of the mortgage borrower, rather than to the mortgage borrower itself. Under those circumstances, in order to have any right to participate in the bankruptcy proceedings of the mortgage borrower, the mezzanine lender must first foreclose on the equity collateral to gain control of the mortgage borrower. Even then the mezzanine lender may be subject to the limitations of the intercreditor agreement and thus be vulnerable to a claim for damages by the mortgage lender for breach of the agreement. And, most important, as discussed above, the junior creditor's replacement guarantor will likely become liable for the entire debt in the event of a bankruptcy filing.

Common Guarantors. If the mezzanine and mortgage loans have a common guarantor, the mezzanine lender likely will be limited in enforcing its guaranty. Intercreditor agreements often provide that while the mortgage loan is outstanding, the mezzanine lender must refrain from collecting on a common guarantor's guaranty without the mortgage lender's consent. The mortgage lender is often unwilling to permit the mezzanine lender to upset the workout "apple cart" by chasing after a guarantor that the mortgage lender may deem critical to the turnaround effort. Typically, the mezzanine lender will, at best, be allowed to prosecute a claim against the guarantor at its expense and turn over all collections to the mortgage lender. Nevertheless, the right to pursue a guarantor can be a very important element of leverage for the mezzanine lender in workout and settlement negotiations.

Replacement Guarantors. As discussed above, intercreditor agreements increasingly require, as a condition to exercising pledge rights against the ownership interests in the mortgage borrower, that a foreclosing mezzanine lender provide a replacement mortgage loan guarantor acceptable to the mortgage lender. The mezzanine lender may be unable or unwilling to do this.

Cure Rights. Intercreditor agreements generally allow the mezzanine lender to cure borrower defaults, but the period is often short and the breach itself is often difficult, too expensive, or even impossible to cure. It is critical that the mezzanine lender be alert and react immediately to a mortgage lender cure notice to the extent possible while seeking additional time from the mortgage lender.

Purchase of Mortgage Loan. If the collateral has substantial value above the amount of the mortgage loan, the mezzanine lender is far better off exercising its right to purchase the mortgage loan than struggling to work within the limitations of an intercreditor agreement, especially in the too frequent case where the mortgage lender is peremptory, inflexible, or uncooperative. But it can be extremely unwise for the mezzanine lender to "throw good money after bad" by purchasing the mortgage loan in a declining market, and, unfortunately, it is seldom true that there is a sufficient equity cushion. Even if such a cushion exists, the mezzanine lender often does not have access to a refinancing source sufficient to allow it to purchase the mortgage loan. But if the value and liquidity are there, such a purchase can be an invaluable opportunity for the mezzanine lender to seize control of its own destiny, and if the mezzanine lender does not seize this opportunity, another party may do so, and at a substantial discount. Unfortunately, experience has dashed the hopes of both the mortgage lenders (that the mezzanine lender would prove to be a practical "take out" source) and the mezzanine lenders (that they could seize control and prevent extinguishment of their interests) because in the financial crisis the great majority of mezzanine lenders did not have the liquidity to exercise purchase options, especially in an environment of downward plunging collateral value.

31 Post-Default, Pre-Foreclosure Lender Remedies

Direct Control of Mortgage Borrower. A well-drafted Pledge Agreement will allow the mezzanine lender to immediately take control of the mortgage borrower after default. This is an extremely valuable right and its exercise should always be considered, but it is fraught with difficulty and danger. It can be very difficult to obtain physical turnover of the property and incidental critical items such as organizational documents and financial, property management, and other such records. Mezzanine borrowers often refuse to allow the mezzanine lender or preferred equity holder to take physical possession. Encountering such resistance, the mezzanine lender must avoid incurring liability for such things as assault, trespass, conversion, libel, and slander and will almost certainly need to resort to the courts for assistance. Once control has been effectively obtained, the mezzanine lender may succeed to duties (including fiduciary duties in some circumstances) and corresponding liability to creditors and other owners (possibly even the defaulting owners themselves) for acts and omissions while in control, concerns similar to the classic ones of "the mortgagee in possession."[6] Despite these problems and dangers, emergency circumstances may require that such risks must be assumed to stave off catastrophic losses. At a minimum, a provision should be considered preventing the borrower from taking any action, and eliminating the authority of its owners to either take any action or cause the borrower to take any action. If the borrower and lender both desire to act on something despite this general prohibition, the lender can consider whether to provide consent or not, one action at a time. Note that at least one rating agency believes that exercise of the foregoing rights should require the delivery of a replacement guaranty and will presumably reduce the rating on the senior loan if the related intercreditor agreement does not contain that requirement.

Receivership. The cautious solution to the problems arising from direct control of the mortgage borrower is to seek appointment of a receiver for the mortgage borrower. This is not the typical property receiver. It is a receiver for the entity itself. There is generally less statutory and case law authority to appoint a receiver for the borrower than there is for appointing a property receiver, so it can be difficult to make a court understand that it does have such authority and should exercise it. Nevertheless, the authority is deeply rooted in traditional equity jurisprudence and should be available. It may be more difficult and expensive, with a less predictable outcome than the property receiver remedy, but if accomplished, it is a much more powerful remedy because the receiver has authority over the entire entity, not just the mortgaged property, and can exercise overarching authority as the replacement for the entity's board of directors or other managers.

A receiver, either equity or property, can be difficult to control or even influence, and a receiver may require payment of expenses objected to by the moving creditor as unnecessary and wasteful (which the court may even order the moving creditor to pay (ouch!) if there is insufficient cash flow from the borrower). However, any such risks or drawbacks may be far superior to allowing the current owners to remain in control.

32 UCC "Disposition" (Foreclosure)

Several factors need to be considered before a mezzanine lender proceeds with a foreclosure sale (the UCC does not use the term "foreclosure" but refers to a "disposition" of the collateral) or another enforcement mechanism. The mezzanine lender needs to analyze all potential foreclosure restrictions and requirements contained in the intercreditor agreement including: (a) replacing the property manager;

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[6] While the authors can't assure the absolute accuracy of this, it is worth reporting even if it is only a rumor as it illustrates the potential value of such provisions: It has been reported that the special servicer of the huge Stuy Town loan is said to have used exactly such a provision to control the asset for years while working its way through a minefield of problems including lawsuits brought by various junior mezzanine lenders in that multi-multi-tranche loan to stabilize and ultimately sell the project for a much higher price than almost anyone would have predicted at the outset of the process.

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(b) providing or obtaining replacement guarantors, additional mortgage loan reserves, nonconsolidation opinions and rating agency no-downgrade confirmation; (c) qualifying a foreclosure purchaser as a Qualified Transferee; (d) providing for payment of a transfer fee under the mortgage loan documents; (e) providing for the payment of any applicable transfer taxes under state law, including real estate transfer, "stamp," or similar taxes that may be payable in certain jurisdictions; and (f) satisfying any other requirements of mortgage lender consent, including any mortgage loan transfer restrictions.

In addition, the members or partners of the mortgage borrower may have the right to consent or withhold consent to a transfer of equity interests in a foreclosure scenario. If the mezzanine lender did not obtain consents from all partners or members at origination, the mezzanine lender may find itself in serious difficulty after default. Absent consent, the transferee in the UCC sale is not deemed an admitted partner/member of the mortgage borrower without the consent of the other members/partners. In such a situation, although the mezzanine lender could receive the economic benefits accruing to the foreclosed equity interests, the foreclosure alone would not give the mezzanine lender control over the mortgage borrower, or consequently, the mortgaged property.

33 UCC Sale

"Commercially Reasonable" Disposition Required. After considering the prerequisites to enforcement of the mezzanine loan by foreclosure, the mezzanine lender must then determine how it will foreclose. Interests in the mortgage borrower will likely be classified as "investment property" under Article 8 of the UCC or as a general intangible under Article 9 of the UCC. In either event, Article 9 remedies of foreclosure by sale and strict foreclosure will apply.

The UCC requires a "commercially reasonable" disposition of collateral. Precisely what constitutes "commercially reasonable" is not defined and there is very little helpful case law dealing with issues arising from foreclosure of security interests in ownership interests in closely held entities. Moreover, the case law can be misleading. For example, a widely-cited Delaware case might suggest that a foreclosing lender is required to retain an investment banker and auctioneer and undertake an elaborate, time-consuming, and expensive process. *Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P.,* 821 A.2d 296, 49 U.C.C. Rep. Serv. 2d 1348 (Del. Ch. 2002), judgment aff'd, 822 A.2d 397 (Del. 2003). But, following the lead of that decision would be foolish in situations involving smaller loan amounts and little to no value in the collateral beyond the amount of the first mortgage loan. Yet now we can expect that borrowers will be taking mezzanine lenders to task in the courts for failing to implement the elaborate (and, if applied in inappropriate contexts, foolishly wasteful) procedures employed in the *Vornado* case. Yet, most ironically, notwithstanding the involvement of Goldman Sachs as investment banker in that case, the only bidder at the sale was the lender! In fact, no matter how elaborate the sale procedures, in almost all cases the mezzanine lender will be the buyer because it is the only bidder at the sale.

Still, it can be very helpful in fending off challenges to the commercial reasonableness of the sale to retain the services of one or both of an auctioneer or broker to perform some combination of services (and ultimately to serve as an expert witness if necessary) including such things as advice about advertising the sale and otherwise notifying prospective buyers, the information to be provided to prospective buyers, the showing of the property (if feasible) and otherwise interfacing with prospective buyers.

UCC 9-603: Contractually Prescribed Standards. Experienced mezzanine lenders sometimes include in their loan documents specific procedures that will, by agreement, constitute a commercially reasonable disposition, taking

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advantage of UCC 9-603, which provides: "The parties may determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party if the standards are not manifestly unreasonable." This very important UCC provision can be a source of great comfort, replacing a court's 20-20 hindsight view of whether a sale was commercially reasonable with a much more lender-friendly standard of whether the procedures set forth in the agreement were not manifestly unreasonable--a huge shift in emphasis and burden of proof. But even if the documents attempt to determine the sale standards, they usually will not answer all questions, as even the most thoughtful drafting cannot anticipate all of the issues. It can be a difficult judgment call to determine whether the contractually imposed procedures must be followed to the letter or can be modified or supplemented.

Moreover, attempts to contractually impose sale procedures and standards can backfire by rendering them overly strict, cumbersome, or otherwise inappropriate, such as ill-advised and overly expensive publication requirements. Procedures and standards also can have insufficient detail or subject matter coverage and risk being characterized as "manifestly unreasonable." Recently, we had to advise a lender client that it could not take advantage of the contractually prescribed sale procedures because they were so minimal that we believed a court would likely characterize them as "manifestly unreasonable." Thus, the presence of such standards and procedures in the contract does not free the lender and its counsel from making a difficult assessment and judgment call at the time of enforcement.[7]

Most of the mezzanine loan documents currently in use provide little to no helpful guidance, so the mezzanine lender must determine what type of notice to give, to whom the notice should be given, whether the sale will be public or private, the location of the sale, the timing of the sale, and whether there are any special concerns unique to the pledged equity interests, the mortgage borrower, and/or the mortgaged property.

Public or Private Sale. The mezzanine lender must first determine whether it will dispose of the collateral by means of a public or private sale. Typically, the choice is simple--if the mezzanine lender desires to bid at the sale and the collateral is not of a type that is customarily sold on a recognized market or the subject of a widely distributed standard price quotation, the sale must be public in nature. In almost all cases the only likely bidder, however much all parties might wish otherwise, is the mezzanine lender, and the UCC sale process is a mere formality but one where the formal aspects need to be fully respected.

A public sale occurs where there is a meaningful opportunity for the public to bid competitively for the asset. The principal differences in detail between a public and private sale are the notice and advertisement procedures and the "auction" nature of the sale itself. The UCC requires that notice of all sales, regardless of whether they are public or private, be sent to certain parties including the debtor and any "secondary obligor" (such as a guarantor), as well as any party from whom the mezzanine lender has received notification of a claim of interest in the collateral and any other secured party or lienholder that, ten days before the notification date, holds a perfected security interest in the collateral. Thus, the mezzanine lender must conduct a properly timed UCC search to locate any other potential lien claimants. Notice of a private sale simply requires that the secured party provide notice that a private sale will be conducted on or after a specified date; no "public" notice is required. If a public sale will be conducted, the foreclosing lender must determine to whom, where, in what form, and through which media outlet to publish notice of the sale.

Notice, Advertisement, Timing, Location of UCC Sale. The UCC provides that the contents of a public sale notice should include, at a minimum, the names of the debtor and

[7] And there can be other quirks, such as Colorado's inexplicable, probably unintentional, and easily overlooked omission of the word "manifestly" in its version of UCC 9-603.

the mezzanine lender, the date, time and location of the sale, the terms of the sale, and a description of the collateral being sold. As to timing, the UCC states that ten-day notice is sufficient for notices to the debtor, secondary obligors, and any other secured parties that have an interest in the collateral to be sold. But it is important to understand that compliance with the minimum statutory sale notice contents and time period does not necessarily satisfy the requirement to conduct a "commercially reasonable" sale. That almost certainly will require a longer time period and more elaborate notice and opportunity for further inquiry and due diligence by interested bidders. Notice should be provided sufficiently in advance of the scheduled sale so that prospective purchasers have time to conduct whatever due diligence the circumstances allow, and if feasible, to examine the collateral (which includes, indirectly but most importantly, the real estate owned by the mortgage borrower).

A further complication associated with a public sale is that the securities laws come more prominently into play. While the mezzanine lender may be able to take advantage of exceptions to securities registration requirements in connection with a truly private UCC sale, a publicly advertised sale is more complicated. The standard practice is to comply with certain "no action" letters previously issued by the SEC primarily by including in the sale notice special language to avoid violation of securities laws.

Decisions about where and how often to publish notice of a public UCC sale can be difficult. The mezzanine lender will want to avoid foolishly excessive publication expenses, but placement and frequency of notices must be sufficient to satisfy the 20-20 judicial hindsight test of commercial reasonableness. The local newspaper of highest general circulation where the real estate is located is an obvious place to publish sale notice. But any significant real estate requires consideration of national publications, for example such publications as The Wall Street Journal, one or more trade journals, and the rapidly proliferating Internet media. While it might seem safe to publish many times, including right up to the scheduled sale date, multiple publications (especially where national media are involved) can be brutally expensive, and publication too close to the scheduled sale date gives no time for useful due diligence or the procurement of financing by a would-be third party bidder.

The mezzanine lender should not rely, without careful analysis, on mere publication. Direct notification of potentially interested parties, including the relevant real estate investment and brokerage communities that would likely be interested in the underlying real estate, is arguably as important or more important than general publications.

Where to conduct the sale can also be a difficult decision. While the location of the underlying property might seem like the obvious choice, the location of those who might be the most likely bidders could be a more appropriate place. Usually the sale is conducted in the office of the mezzanine lender's counsel, and frequently the proceedings are recorded or transcribed by a court reporter (or both). Internet auctions are increasing in various contexts and are likely to become more common as a way to overcome geographic barriers.

Disclosure of Information to Prospective Purchasers. The next very difficult decision for the mezzanine lender engaged in this process is determining what information to provide to parties who claim to be interested in bidding at the sale. The difficulties begin with the fact that the mezzanine lender may not have the best current information about the mezzanine borrower and the real estate (emphasizing again the importance of the servicing and administration of the loan prior to default). Moreover, the mezzanine borrower or its owners may claim that some of that information must be treated confidentially. A confidentiality agreement from each person receiving information is optimal. The mezzanine lender is always walking a fine line between the requirement to conduct a commercially reasonable sale on one side and avoiding a misrepresentation lawsuit from the purchaser at a UCC sale on the other. What if there is, for example, a not-very-recent appraisal that clearly overstates the value

of the property? Should that be provided, and, if so, with what disclaimers? Or, the reverse--what if there is a recent but very gloomy appraisal--could it be argued that providing such negative information is inconsistent with conducting a commercially reasonable sale? And what consideration should the mezzanine lender give to the warning it often has received from the performing appraiser--normally located in the appraisal itself--that information in the appraisal is not to be distributed to third parties and may not be relied upon by anyone other than the mezzanine lender itself?

Other items that should be considered for disclosure include the entity's organizational documents (since the ownership interest, not the real estate itself, is being sold), all relevant financial information, rent rolls, title information, physical inspection reports, and the underlying mortgage loan status and documents. The latter item is especially significant as the buyer at a UCC sale is often buying an entity that is in default on a mortgage loan that has been accelerated and beyond cure. Knowledge of this fact will greatly diminish the pool of truly interested bidders.

The Impact of Qualified Transferee Requirements. Any Qualified Transferee requirements of the mortgage lender or rating agencies may also greatly diminish the number of bidders who can participate. Such requirements cause difficulty. Borrowers will contend that these requirements are mere contractual matters between the mortgage lender and mezzanine lender and that it is not commercially reasonable to so limit the pool of possible qualified buyers. The lender's defense is similar to its justification for any limitation on commercial reasonableness caused by the need to limit the "public" nature of the sale in order to comply with the securities laws. The lender should not be required to breach, and thus subject itself to liability for damages under, a provision of the very intercreditor agreement without the existence of which the borrower could not have obtained the mezzanine loan in the first place. To strengthen the lender's position on this issue a provision should be included in the security agreement, similar to those provisions common in connection with the securities law compliance provisions, whereby the borrower acknowledges and accepts the Qualified Transferee limitation. Such "standards" should be deemed not "manifestly unreasonable" under UCC 9-603.

As discussed above, if the mezzanine lender can no longer meet the requirements of a Qualified Transferee under the intercreditor agreement, the mezzanine lender will be in the difficult provision of having no alternative but to breach the agreement, to accept whatever bid a public sale might produce, or, since it cannot bid at a private sale, to find some other way to realize upon its collateral than a UCC sale.

Assistance from Professionals. If the situation warrants, the mezzanine lender should consider retaining one or more real estate brokers, investment bankers or similar advisors, and an auctioneer. There are situations that might warrant extraordinary measures such as obtaining a fresh appraisal or resorting to judicial remedies to obtain additional information from the mezzanine and mortgage borrowers. But the vast majority of UCC sales involve properties and situations that do not justify such measures.

The Art of Accomplishing a Commercially Reasonable Sale. Conducting a commercially reasonable sale that does not involve an absurdly high cost and unnecessary and loss-producing delay is far more of an art than a science. The mezzanine lender and its counsel must move carefully but expeditiously through the process, applying common sense but being very careful to try to anticipate how a future court with 20-20 hindsight, and a desire to protect the borrower as the weaker party in most need of protection, might view the mezzanine lender's conduct of the sale. If the commercial reasonableness of a sale is later challenged, the mezzanine lender has the burden of demonstrating compliance. But keep in mind that the risk of failure to comply might not be very significant after all. Failure to conduct a commercially reasonable sale can result in limitation of a deficiency claim by the amount that the court determines was lost as a result of the sale being commercially unreasonable. If the

mezzanine lender is not concerned about a deficiency (for example, if it does not need to preserve as large a deficiency as possible to use in foreclosing on other collateral or collecting from a guarantor or does not need to preserve some of the debt to credit bid on other collateral or for setoff purposes), "commercial reasonableness" may not be much of a practical issue.

However, also keep in mind that failure to conduct a commercially reasonable sale can create the basis for a claim of damages against the mezzanine lender by the debtor, a guarantor, or a lender with a junior interest in the collateral. Or a court may, under UCC 9-615(f), re-calculate a surplus or deficiency resulting from a sale to the secured party, a person related to the secured party, or a secondary obligor if "the amount of proceeds that a complying disposition to a person other than the secured party, a person related to the secured party, or a secondary obligor would have brought." While, as a practical matter, it may be highly unlikely that such a claim would ever be brought, if the secured party's conduct is too cavalier, or worse, slips over into bad faith, the results can be quite unfortunate.

34 Conduct Of Sale/Lender's Bid Strategy

The mezzanine lender is almost always the only bidder at a sale, but if there are multiple bidders, the sale will be conducted in the manner of a simple auction according to procedures established at the outset by the counsel or mezzanine lender (or in some cases an auctioneer) conducting the sale. The mezzanine lender should develop with counsel a bidding strategy designed to maximize a third party bid at the foreclosure sale while not unnecessarily crediting the borrower and thus adversely affecting the amount of possible collections from additional collateral, guarantors, or other potential sources of recovery. This is challenging even when the mezzanine lender is the only bidder. While each situation is unique and must be analyzed on its own merits, the best approach is for the lender to do its best to analyze, determine, and bid the true value of the collateral less reasonably anticipated expenses that will be incurred in disposing of or otherwise realizing value from the collateral. Purely arbitrary bid amounts should be avoided if possible, even those on the high side that favor the borrower. The bid should be the product of a careful, well-documented analytical process that can be justified later, because the mezzanine lender must look ahead to a possible fraudulent transfer challenge in a subsequent bankruptcy of the mezzanine borrower in addition to a possible commercial reasonableness challenge including a request for re-calculation of a surplus or deficiency under UCC 9-615(f).

Another challenge in connection with bidding is putting into place a bidding procedure that prevents the borrower, a shill for the borrower, or any other unqualified bidder from attending the sale and bidding dollars it does not have, thus running up the sale price and inflating the lender's credit bid in order to minimize the amount of the deficiency that remains owed after the sale is completed. Lenders and their counsel should, therefore, when appropriate, devise procedures that require potential bidders (possibly even including the lender itself, to ensure the appearance of a level playing field) to provide reasonably satisfactory evidence of their ability to deliver the purchase price that they are offering to pay as part of the bidding process.

Often UCC sales are conducted by the lender itself or its counsel. Although useless expense should not be incurred, it can be worthwhile to engage the services of a professional auctioneer to remove any appearance of impropriety or rigging through control of the auction.

Regardless of the lender's bidding strategy, it is generally advisable for the mezzanine lender to assign its bid rights to a wholly-owned SPE that will take title to the collateral at the sale. This is a common procedure employed by secured lenders, whether their collateral consists of real or personal property. By virtue of such assignment, the equity interests, once foreclosed, will be owned by the newly formed SPE, who will own only those equity interests and those equity interests

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alone. Thus, in the event of some unforeseen liability on the part of the owner of the equity interests, the equity interests will be the sole assets (other than contributed capital) of such owner, so that other assets, absent a successful veil piercing, will not be at risk.

35 Post-Sale Takeover

Of course, taking possession of property and records can be as difficult after a UCC sale as before it. Although UCC purchaser status will be more persuasive to a court than pre-sale lender status in obtaining relief, it can still be difficult and expensive to gain control, as discussed above in connection with post-default, pre-foreclosure remedies. A combination bill of sale/assignment and "transfer statement" under UCC 9-619 should be completed by the secured party and delivered to the transferee even if the secured party and the transferee are the same.

As described above, the worst aspect of a UCC sale is that it is a "stock purchase without due diligence." The mezzanine lender (or its SPE), now the owner of an entity subject to all of the liabilities it has historically incurred, known and unknown, will need to discover what it really owns and what it is worth. And it will now require the mezzanine lender's utmost vigilance and best execution to realize value and dodge the arrows of the entity's creditors that will now be aimed at this new, more deep-pocketed target.

36 Judicially-Approved Sale

If certainty is a more desirable goal than speed and efficiency in conducting the UCC sale, the secured party can seek judicial approval of its proposed method of disposition of the collateral. The court's imprimatur eliminates the nagging uncertainties by conclusively establishing the commercial reasonableness of the sale. Yet this practice is seldom used because it is such a cumbersome, expensive, and time-consuming process, because in the great majority of cases it overcompensates for the rather minimal risk to the mezzanine lender of failing to conduct a commercially reasonable sale, and because it invites an often troublesome borrower to opine on (or in some courts, even participate in) the decision-making process in establishing the procedures of sale. Therefore, only the most special circumstances would lead a sensible mezzanine lender to voluntarily subject itself to the judicial process in this situation.

37 Strict Foreclosure - Possibly the Best Solution

A far more useful and relevant way to bypass the uncertainties, expense, and delay involved in the effort to conduct a commercially reasonable sale is to proceed through "strict foreclosure" under UCC 9-620. This is the UCC equivalent of a deed in lieu of foreclosure, where the mezzanine lender accepts collateral in full or partial satisfaction of the debt. Strict foreclosure can be especially appealing to a mezzanine lender with nonrecourse debt. Although it requires the consent of the mezzanine borrower, guarantors, and any other "secondary obligors," such consent can be passively expressed, merely by failing to object to the lender's unconditional (other than to maintain and preserve collateral not in the possession of the secured party) proposal to accept the collateral in full satisfaction of the debt.

A strict foreclosure in full or partial satisfaction of the debt requires that notice of the mezzanine lender's intent to retain the collateral be given to the debtor, secondary obligors, and any other parties that held a security interest in the collateral inferior to the mezzanine lender's on the tenth day before the debtor consented to the strict foreclosure, with a twenty-day objection period following the giving of such notice. The objection period can be waived post-default, further shortening the time frame within which the mezzanine lender can obtain title to its collateral.

A strict foreclosure for only partial debt forgiveness under UCC 9-620 requires affirmative consent of the debtor in a written agreement ("a record authenticated after default")

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but still can be appealing to mezzanine borrowers and guarantors if collateral now having no more than hostage value is surrendered in exchange for a meaningful reduction in personal liability.

In a strict foreclosure the dilemmas of where, when, and how of notice and publication, the delay and expense, the uncertainty and risk of the usual UCC sale are eliminated. Moreover, when strict foreclosure is accomplished through a written agreement, the mezzanine lender can eliminate certain other risks by including a disclosure of assets and liabilities, warranties and representations, indemnifications, and other items important to the mezzanine lender.

38 Special Bankruptcy Concerns

The Mezzanine Borrower's Bankruptcy Case is not a Single Asset Bankruptcy Case. Congress made the lives of real estate lenders much easier when it removed the monetary limits on so-called "single asset" real estate cases, requiring virtually all debtors owning real estate with minimal management (apartments, office buildings, shopping centers, but not, for example full-service hotels) to begin paying interest at the contract rate or submitting a conceivably confirmable plan within ninety days after the bankruptcy filing. Although a mezzanine borrower is likely to own nothing but an entity that owns an interest in real estate, the actual property interest that constitutes the mezzanine lender's collateral is not single asset real estate but intangible personal property. Therefore, the mezzanine lender will not be entitled to the special protections of the real estate lender, exposing it to a longer Chapter 11 process without receiving payment of any current interest.

Fraudulent Transfer. Regularly conducted, non-collusive real property foreclosure sales usually are exempt from fraudulent transfer attack. Not so with the UCC sale of personal property, at least under the case law at this writing. If the mezzanine lender is later held to have provided less than "reasonably equivalent value" (the bid amount at the sale or amount of debt forgiveness in a strict foreclosure) to an insolvent borrower or pledgor, or a borrower or pledgor that became insolvent as a result of the transfer (the sale or strict foreclosure), the transferee may be required to return the property, or the value of the property, to the bankruptcy estate. Further, the mezzanine lender's security interest can be lost in the process, incapable of being reinstated if the transfer is held to have been not in good faith or with knowledge of the voidability of the transfer (a very easy standard for a bankruptcy debtor or trustee to satisfy).

Recharacterization of Debt. One of the more substantive risks in a bankruptcy of the mezzanine borrower is possible recharacterization of the mezzanine lender's security interest as equity. To avoid recharacterization, the mezzanine lender must have consistently and coherently treated the capital advance as debt rather than equity. And as the ultimate fail-safe the investor/lender should obtain a back-up security interest in case it becomes a creditor after all.

39 Preferred Equity Enforcement Issues

Although UCC mezzanine enforcement is not quite as clear and smooth a path as it is sometimes cracked up to be, it is, at least, a path, one that is pretty clearly marked, and not entirely overgrown with brambles, infested with nasty stinging critters, and bandits lurking in the brush. Preferred equity has many of the enforcement problems of mezzanine debt but magnified. The UCC at least provides a statutory structure to govern the parties and ultimately the courts. The enforcing preferred equity holder begins with the same problem as the enforcing mezzanine lender. The sponsor/manager/common equity is in possession of the property, the property and entity records, and all of the other necessary information to deal with the property and the entity. But the mezzanine lender at least has a piece of paper showing it held a statutorily prescribed sale that transferred to the mezzanine lender the ownership of the entity. In the preferred equity situation, it is a mere contract dispute, and the sponsor may be saying,

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> "Come and get it if you can. And, by the way, I am not in default; if I am in default, it is because of your previous material default; and, in case neither of the foregoing is true, your alleged rights are unenforceable as forfeitures and as effectively a UCC foreclosure without following proper UCC remedies."

All of this must be sorted out in a lengthy and expensive judicial proceeding with all kinds of possibilities for mischief where a judge is viewing the preferred equity not as a lender but as a partner with, on an informal and practical if not a formal legal basis, a possibly higher standard of duty toward its common equity partner than a lender. While the judge might appoint a receiver, it would be a much longer and more expensive receivership subject to all the dangers of any receivership.

If the sponsor/common equity loses the contract case, it might file bankruptcy despite any springing recourse provision in the senior debt documents. A likely result is that the preferred equity would be characterized as unsecured debt in the bankruptcy subject to treatment in a reorganization plan and crammed down on the preferred equity. If not recharacterized but considered as equity or a special and separately classifiable hybrid of debt and equity, the results could be even worse.

One helpful counter to these difficulties is for the preferred equity provider to obtain a lien on the sponsor's common equity to secure its obligations. This would likely require the consent of both the mortgage and mezzanine lenders and should be obtained at origination if possible. Another possible solution is to impose what are necessarily quite complicated provisions as part of or akin to a special form of carveout guaranty with indemnification, or, more effectively, springing recourse, for failure to cooperate once a default has occurred or consequent upon a bankruptcy filing or similar hostile acts. Of course, as with all springing recourse provisions, these are only as good as the sponsor's fear of their consequences. As the great song lyric goes, "Freedom's just another word for nothin' left to lose."

40 Conclusion

After mezzanine financing disappeared from the real estate financing arena for a time following the 2008-2012 financial crisis, it has come roaring back and is again a vital player in the arena. Special features of the current landscape, to mix the metaphor (and the cliché), are the decline of the A/B structure in CMBS deals (though not necessarily elsewhere--for example, in life insurance company lending) and the recent surge in popularity of preferred equity financing. Senior and subordinate lenders are using the experience from the 2008-2012 period (and ongoing developments in applicable case law) to better negotiate intercreditor agreements and enforce their respective rights when their loans take a turn for the worse. But are they, like the proverbial old generals, "fighting the last war"? Time, and the next serious downturn, may tell.

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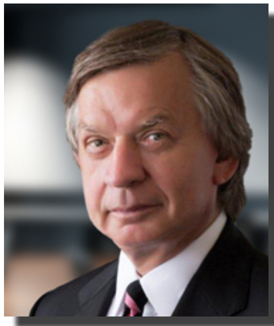

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The authors would like to thank Polsinelli attorneys **Brett Anders**, **Casandra Carpenter**, and **Maribeth McMahon** for their assistance with this publication.

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