

Mezzanine Lending: Overcoming Lender Risks to Protect ROI

Negotiating Intercreditor Agreements and Assessing Foreclosure and Bankruptcy Strategies

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Today's faculty features:

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Mezzanine Lending Protecting ROI:

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Introduction

- Overview of customary mortgage-mezzanine intercreditor agreements (ICA).
- Customary core ICA provisions.
- Emerging trends in ICAs.
- Best Practices in Foreclosure.
- Insolvency Issues.

ICA Overview

- ICA sets forth the contractual relationship between the mortgage lender and the mezzanine lender in lien (liquidation) and payment priority.
- The CMBS form ICA may be found at the CRE Finance Council's website:
[http://www.crefc.org/Industry Standards/Standard Loan Documents/Standard Loan Documents/](http://www.crefc.org/Industry_Standards/Standard_Loan_Documents/Standard_Loan_Documents/)
- The general form of ICA is used both for mortgage loans that will be securitized and/or held on the balance sheet (after significant negotiation).

ICA Overview (continued)

- Customary ICAs feature several core provisions which tend to see most negotiation and/or are often at issue during the terms of the loan(s).
 - Subordination. The priority of payment to the mezzanine lender(s) (“mezz lender”) is generally subordinated to the mortgage lender(s).
 - Transfer. Limitations on mezz lender and/or mortgage lender transfer of interests in their related debt to third parties.
 - Mezzanine UCC Foreclosure (“Mezz Foreclosure”). Contractual limitations on the mezz lender’s rights, remedies, and relating timing and notices of its UCC foreclosure sale.

ICA Overview (continued)

- Modifications. Permitted modifications of their related loans and consent requirement between lenders.
- Cure Rights. Mezz lender(s) have the option to cure mortgage payment defaults at such time as the mortgage loan borrower is in default (or a default is imminent) under the mortgage loan.
- Default Purchase Option. Mezz lender(s) are generally permitted to purchase the mortgage loan at “par” upon occurrence of a default or a contractually defined “imminent default.”
- Borrower Bankruptcy. Rights of lenders during periods when the mortgage borrower and mezzanine borrower have filed and/or are contemplating filing bankruptcy.

Core Provisions

- Generally, trend toward greater liability for and less flexibility of mezz lenders in their:
 - Separate collateral;
 - Rights; and
 - Remedies.

Core Provisions (continued)

Subordination.

- Mortgage lenders were/are generally superior in recoveries.
- Mezz lenders should try to ensure that payments continue to be made to them if the default is non-material and/or DSCR triggers have not been fully engaged under the senior loan.
- Mezz lenders should ensure that prior to being fully held in abeyance on payment that a “continuing senior loan event” has occurred and is continuing.

Core Provisions (continued)

Subordination (continued).

- Mezz lenders should ensure that prior to expiration of their cure that a senior lender is completely prohibited from exercising its rights and remedies.
- Area of change is timing and priority of recoveries from related guarantor(s).
- Mezz lenders have agreed to delay seeking enforcement.

Core Provisions (continued)

Mezzanine Foreclosure.

- Mezz Lender(s) now required to proffer additional guarantors upon mezz foreclosure, but previously additional guarantor required if original guarantor released as a result of mezz lender foreclosure.
- Need to keep cash management in place or put in place.
- Qualified Transferee needs to take the collateral.
- Premises must be managed by a qualified manager.
- Acceptable additional guarantor gets heavily negotiated.
 - Tests as to what qualifications that the new guarantor must have
- Senior lenders are requiring mezz liability attach when it “directs” or otherwise “causes” the borrower to take an action.

Core Provisions (continued)

Mezzanine Foreclosure (continued.)

- Crux of negotiation is when mezz lender “controls” borrower.
 - Many senior lenders have put the trigger for guarantor based upon a control event such as when a mezzanine lender takes control of the mezzanine borrower via registering the pledged securities under any pledge agreement in its name.
 - Mezzanine lenders should be careful to ensure that this “control event” definition is limited in scope and would not apply to simple administration of the collateral
- Impact of the “Stuy Town” decision (Bank of America, N.A. v. PSW NYC LLC, No. 651293/10, 2010 WL 4243437 (N.Y. Sup. Ct. September 16, 2010)).

Core Provisions (continued)

Transfers.

- Generally, transfers of interests in either the mezzanine or mortgage loan(s) are permitted without lender consent:
 - If transfers do not aggregate to more than 49%.
 - If transfers aggregate greater than 49%, must be to a “qualified transferee” (i.e. a contractually permitted entity that usually has certain net worth thresholds and/or acumen with real estate investments).
 - May be able to negotiate the definition of qualified transferee.
 - Eligibility Requirements may be capable of being modified in “portfolio” context (the “600/250” test).
 - May be able to “hard code” mezzanine lender and its affiliates into the definition thereof.

Core Provisions (continued)

Transfers (continued).

- Transfers to Borrower(s).
 - Mortgage lender(s) want ability to transfer to the related mortgage borrower(s) in a workout strategy without mezz lender's consent.
 - Mezz lenders generally want to prohibit or restrict transfer without its consent.
 - Seen by each party as limitations on rights and remedies.
 - Outcome of negotiation may be impacted by whether mortgage loan is to be securitized or to be held in portfolio.
 - Mortgage lenders may be able to transfer to borrowers in limited instances (i.e., stripped rights, mezz lender consent).

Core Provisions (continued)

Modifications.

- Mortgage lenders required to seek mezz lender consent for most “material modifications” excluding a workout scenario.
- In workouts, a mortgage lender not required to seek mezz lender consent unless:
 - Involves increasing or decreasing the length of the prepayment window
 - Releasing the original obligor from the loan and/or
 - Increasing principal amount.

Core Provisions (continued)

Modifications (continued).

- In recent deals, mezz lenders have consent rights to extension of mortgage loan.
- Mezzanine lender may get right of “first refusal” purchase in a deed-in-lieu situation with respect to the real property.
- Ensure that prior to expiration of cure rights, that the mortgage lender is prohibited from all material modifications without consent of the mezz lender.

Core Provisions (continued)

Cure Rights.

- Mezz lenders have a right to cure monetary and/or non-monetary events of default by the related mortgage borrower(s).
- Monetary default cures generally include lender expenses (i.e. advances, interest on those advances, etc.).
- Cure periods vary. Generally, no later than five (5) business days following default or notice thereof.
- Cures are sometimes subject to an aggregate limit.
- If diligently pursuing rights and remedies, mezzanine lender may have unlimited cures although recent trends have seen a cap of 6-9 cures whether diligently pursuing rights and remedies or not

Core Provisions (continued)

Default Purchase Option.

- Mezz lenders permitted a “par” purchase option when the loan defaults and/or specially serviced.
 - Depending on definition of “specially serviced”, the mezz lender may be able to purchase the loan prior to an actual default.
- For securitized loan, mezz lender’s purchase price should include interest through to the end of the related interest accrual period.

Core Provisions (continued)

Default Purchase Option (continued).

- For securitized loans, a mezz lender's purchase price may exclude default interest, yield maintenance, late payment charges.
 - This will be contractual negotiation point for portfolio mortgage loans.
- Negotiation over special servicing fees.

Core Provisions (continued)

Borrower Insolvency.

- Mezz lenders are prohibited from causing the mortgage loan borrower bankruptcy.
 - After foreclosure bankruptcy filing covered by additional guarantor.
- Recent markets developments have clarified that the mezz lender should be subordinated in all respects in case of borrower bankruptcy.
 - Especially problematic with respect to payments from guarantors (preference).
 - Equitable powers of the bankruptcy court also may come into play (fraudulent conveyance).

Emerging trends and issues in ICAs

- “Stuy Town Effect”: Agreements are increasing pressure on mezz lenders to take affirmative action or in effect forfeit their ability to foreclose.
- Mezz lenders are being required to refrain from actions that would prejudice and/or delay mortgage lenders’ rights and remedies.
- Mezz lenders acquiring greater consent rights over mortgage lender modifications.
- Mezz lenders are getting rights of first refusal to exercise purchase options in a deed-in-lieu context.
- Mezz lenders required to place additional/replacement/substitute guarantors in connection with foreclosure and/or taking control of the borrower.
- Mezz lenders are under pressure to accept liability for borrower attach prior to foreclosure.

Mezz Foreclosure: Best Practices

Mezz Foreclosure

Strict Foreclosure.

- Taking of collateral to satisfy debt (UCC 9-620).
- Lender notifies debtor that it will accept collateral in full satisfaction of the debt. If no objections are raised in twenty (20) days including by anyone with security interests, lender becomes owner of collateral and debt is secured in full. Cannot pursue deficiency claim thereafter.
 - Can use partial strict foreclosure to maintain deficiency claim but requires borrower cooperation.

Mezz Foreclosure (continued)

Private Sale.

- Sale without advertising requirements of a public sale (UCC 9-610)
 - Not useful in commercial real estate mezzanine lending as the lender cannot purchase as the sale involves equity interests that are not “customarily sold on a recognized market or the subject of widely distributed standard price quotations” (UCC 9-610(b)).

Mezz Foreclosure (continued)

Public Sale.

- Public sale of the collateral by secured party where secured party can purchase at an auction (UCC 9-610).
- Must feature advance notice. Notice contents should (UCC 9-613):
 1. Describe the debtor and the secured party;
 - UCC 9-611: notice needs to include debtor, secondary obligors, those holding security interests in the mezzanine collateral.
 - ❖ UCC 9-611 provides that a lien search done 20-30 days prior to sale will satisfy the above requirement.
 2. Describe the collateral that is the subject of the intended disposition;
 3. State the method of intended disposition;

Mezz Foreclosure (continued)

Public Sale (continued).

4. State that the debtor is entitled to an accounting of the unpaid indebtedness and states the charge, if any, for an accounting; and
 5. State the time and place of a public disposition or the time after which any other disposition is to be made.
- UCC 9-614 provides form for fulfilling.
 - UCC-9-612(b) says that a reasonable time for notice is 10 days
- Must be commercially reasonable in all respects.
 - Method, manner, time, place, and other terms.
 - Should place advertisement in major periodical (i.e. New York Times, Wall Street Journal) as UCC 9-610 says that advertisement is important

Mezz Foreclosure (continued)

Some tips:

- Stay on top of timing.
- Know your collateral.
- Review your cash management arrangements.
 - Make sure the Intercreditor Agreement provides that the mezz lender gets a copy of all notices under the senior loan cash management agreement.
- Keep a written paper trail of correspondence with the borrower.

Insolvency Considerations

Insolvency Issues (continued)

- *In re General Growth Properties Inc., et al.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y.).
 - “Bankruptcy remote” is not the same as “bankruptcy proof.”
 - Can file even if not insolvent.
 - Consideration of the interests of the real estate investment trust (REIT) structure as a whole (rather than individual SPEs which may be a member of the REIT group) is appropriate when determining whether the bankruptcy filing was made in furtherance of a legitimate purpose.
 - Control of independent directors.
 - Vigilantly watch and enforce covenants.

Insolvency Issues (continued)

- *In re JER/Jameson Mezz Borrower II.*
 - In tiered mezzanine debt may be difficult to find basis for substantive consolidation.
 - Bankruptcy cannot be used by lenders as an advantage in relationship to other lenders (i.e. a litigation tactic).
 - Possibility of reorganization needs to be factored.