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Real Estate Mezzanine and A/B Loans: Structuring and Enforcing Intercreditor and Co-Lender Agreements

Reconciling the Demands and Objectives of Senior and Junior Lenders

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Today's faculty features:

Brooks S. Clark, Shareholder, **Polsinelli**, New York

Steven Coury, Partner, **White and Williams**, New York

Geoffrey R. Maibohm, Counsel, **Dechert**, Charlotte, N.C.

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MARKET TRENDS

Market Trends

➤ **Increased Origination of Junior Debt**

- As mortgage lenders seek lower LTVs, mezzanine lenders, seeking higher returns, have filled the void for all classes of loans.
- As CMBS loans mature, the mezzanine loan component of the resulting refinancings is likely to expand.
- Tranched mezz financing is also back, which reduces risk to the mortgage mezz lenders and increases returns (and risk) to the junior mezz lenders.

➤ **Non Traditional Lenders**

- Stemming from the 2008 economic crisis, along with the impact of governmental regulations, the availability of financing for construction and development tightened, with opportunity arising for nontraditional mezz lenders to step in.
- Attracted by the high yields of mezz lending, various real estate developers formed funds for making mezzanine loans.

Market Trends (cont.)

- **Erosion of Consensus Between Mortgage Lenders and Mezz Lenders and Widening of the “Bid-Ask Spread”**
 - The general consensus regarding core intercreditor agreement terms that would be mutually acceptable to mortgage lenders and mezzanine lenders has eroded and the “bid-ask spread” has widened, due to several factors:
 - Mortgage lenders encountered a variety of challenges when dealing with mezz lenders during the downturn in the economy and the real estate markets in the 2007 to 2013 period.
 - Actions of certain “rogue” opportunistic distressed debt buyers and the lack of development and real estate management expertise of hedge-fund types foreclosing mezzanine lenders were perceived as harmful to the mortgage lenders’ interest in preserving their capital and in meeting their legitimate expectations in terms of exercising their default remedies. In response, mortgage lenders have sought additional assurances regarding the identity and creditworthiness of mezzanine lenders and foreclosure purchasers.

Market Trends (cont.)

- The high profile “Stuyvesant” case is a leading example of what can go wrong for a mortgage lender in dealing with a mezzanine lender. Hoping to learn from their past mistakes and to reduce their exposure to risk or loss stemming from the presence of mezzanine loans in their mortgage loan transactions, a number of mortgage lenders set out to change their approach to the negotiation of intercreditor agreements on certain key points.
- This trend has been more pronounced when mortgage lenders are originating to hold the mortgage loan for their own portfolios (so-called “portfolio lenders”).
- Capital markets lenders providing financing through a combination of a mortgage loan and a mezzanine loan are likely to provide intercreditor agreement terms more favorable to the mezzanine lender than would be obtainable from a portfolio mortgage lender, in order for the capital markets lender to increase the likelihood of a successful sale of the mezzanine loan to a third party (or to benefit the capital markets lender if it intends to retain the mezzanine loan for its own account).

Mezzanine Financing and Key Provisions of Mezzanine Intercreditor Agreements

Mezzanine Financing

- Borrower is a direct or, for junior mezz, indirect owner of the equity of the property owner.
- Secured by a pledge of equity collateral, not a mortgage or deed of trust.
- Mezz lender's remedy is to foreclose on the equity collateral, not the property.
- This structure subordinates payment and enforcement to the mortgage loan.

Governance of the Mortgage/Mezzanine Loans

- An “Intercreditor Agreement” governs the relationship between the mortgage lender and the mezzanine lender.
- The Intercreditor Agreement sets forth various rights, remedies and obligations with respect to the real estate collateral, the borrowers and the guarantors, for example:
 - The permitted collateral for a mezzanine loan.
 - When a mezzanine lender may accept payments from the mezzanine borrower.
 - Modification of mortgage and mezzanine loan documents.
 - The remedies that may be exercised upon a default of either loan.
 - The right of the mezzanine lender to purchase the mortgage loan.
 - The right of the mezzanine lender to receive notice of mortgage loan borrower defaults and an opportunity to cure.

Governance of the Mortgage/Mezzanine Loans (cont.)

➤ **Structural Subordination**

- Mezzanine borrower is the owner of 100% of equity interests of the mortgage borrower/property owner; mortgage borrower is the owner of the property
- Bankruptcy remote SPEs as the mortgage borrower and mezzanine borrower
- Equity pledges as collateral

➤ **Equity Pledge Features**

- Different collateral compared to mortgage loan
 - No mortgage lien priority
 - Upon foreclosure mezzanine lender takes subject to all liabilities and obligations of the property owner absent contractual subordination or termination rights
- Voting rights
- UCC Article 8 vs. Article 9 perfection
 - Article 9: file UCC-1.
 - Opt in to Article 8: certificated securities with irrevocable proxy

Governance of the Mortgage/Mezzanine Loans (cont.)

- Recourse carveouts that are unique to mezzanine loans, as distinguished from mortgage loans
 - Full recourse on bankruptcy or reorganization to cover mezzanine borrower and any intervening entities, as well as mortgage borrower and guarantor
 - Expansion of full recourse on due-on-sale or due-on-encumbrance provisions to include deeds-in-lieu and consensual foreclosure or sale agreements of the mortgage loan
 - Increased exposure of carveouts guarantors to recourse damage claims for violation of SPE provisions due to structural subordination
 - Mortgage loan modifications not approved by mezzanine lender
 - Purchase of mortgage loan by mortgage borrower related party
 - Real property transfer taxes upon foreclosure
 - Compensating for lack of mortgage priority and risk of mechanics' liens, unapproved contracts and agreements, claims/liabilities, borrower indemnity obligations, judgments and tenant breach claims

Governance of the Mortgage/Mezzanine Loans (cont.)

- Special provisions relating to mortgage loan documents
 - Expressly permit the pledge and foreclosure of the equity interests in mortgage borrower; foreclosure of equity collateral would not be a recourse event to guarantors
 - Inclusion of Article 8 “opt-in” and other provisions in favor of mezzanine lender in property owner’s operating agreement
 - Grant of cure rights and powers of attorney in favor of mezzanine lender upon any default under the mortgage loan
 - Cross default to mortgage loan event of default
 - Prohibition against modification of mortgage loan documents
 - Insurance/condemnation proceeds and mortgage loan reserves
 - Restrict the right of a mezzanine lender to exercise remedies against a common guarantor if the mortgage loan is pursuing a claim against the common guarantor or has notified the common guarantor of an outstanding claim

Intercreditor Provisions

- Representations and Warranties
 - Who is making the representations?
 - Does a transferee need to remake all representations and warranties?
 - Representation that transferee is a “Qualified Transferee”

- Transfers of Junior Loans or Mortgage Loans
 - Few restrictions on mortgage Loan transfers.
 - Attempt to close loophole permitting unrestricted transfers in Mezzanine Lender.
 - “Qualified Transferee” requirements, and increased thresholds during periods of additional advances.

Foreclosure of Separate Collateral

- Definition of “Realization Event”
- Replacement Guarantor
- Deemed Replacement Guarantor Requirement
 - Borrower and/or mortgage lender demands for provision of replacement guarantor upon acquisition of the equity collateral (through UCC foreclosure or assignment in lieu thereof) by mezzanine lender or a third party purchaser, and mezzanine lender reluctance to provide same or to narrow carveout liabilities
- Obligation to cure mortgage borrower monetary defaults as a condition to foreclosure.
- Conditions precedent and conditions subsequent to mezzanine foreclosure
 - Obligation of the successful bidder to appoint a qualified replacement property manager within after the foreclosure sale — some mortgage lenders may demand that mortgage lender have the exclusive right to appoint a property manager under the mortgage loan documents, rendering it impossible for the foreclosure purchaser to meet the foreclosure requirement to appoint a replacement property manager

Foreclosure of Separate Collateral (cont.)

- Mezz loan pledge agreements typically provide the mezzanine lender with the right upon a borrower default to exercise all voting rights with respect to the mortgage borrower, without the need to foreclose.
- In addition, in mezzanine loans secured under UCC Article 8, the mezzanine lender holds as collateral the equity certificate, so that the mezzanine lender can immediately take voting control over the mortgage borrower.
 - However, there is risk of lender liability once mezzanine lender has taken control of the mortgage borrower.
 - Upon assuming control, a mezzanine lender can vote to cause the mortgage borrower to voluntarily file for bankruptcy.
 - Mortgage lenders now attempt to include the exercise of voting control rights by the mezz lender along with UCC foreclosure in requiring mezz lender to provide a replacement carve-outs guarantor, materially reducing the value of mezz lender obtaining a pledge of voting rights as a remedy.

Foreclosure of Separate Collateral (cont.)

- A further impediment to a junior lender in implementing this strategy is found in the case In re JER/Jameson Mezzanine Borrower II, LLC, 461 B.R. 293 (2011). In Jameson, the junior mezzanine lender, Gramercy Loan Services, assumed control of the senior mezzanine borrower, replaced the non-independent directors of the junior borrowers with its nominee and filed a voluntary chapter 11 petition. Gramercy then intended to use the automatic stay to prevent the UCC auction scheduled by the senior mezzanine lender.
 - The Court dismissed the case, holding that the debtor had filed for bankruptcy in bad faith on the eve of the UCC foreclosure sale, solely to hinder the foreclosure sale and for no legitimate bankruptcy purpose.
 - The ability of a junior lender to cause the voluntary bankruptcy of its borrower so as to impede the mortgage lender's ability to foreclose, or to use the threat of such actions as a negotiating tactic, would be severely curtailed by the Jameson ruling.

Foreclosure of Separate Collateral -- “Qualified Transferee”

- To foreclose on its equity collateral a mezzanine lender must qualify as a “Qualified Transferee”, which requirements include:
 - Pre-approved qualified transferees
 - Eligibility requirements
 - Use of subsidiaries
 - Permitted fund managers
 - Rating agency approval of otherwise non-qualifying purchasers
 - Credit requirements applicable to future funding obligations
- In many recent Intercreditors, the mezzanine lender or its successor would no longer automatically qualify as a Qualified Transferee, and must meet the same financial criteria that a third party would need to satisfy, and cannot be a “Disqualified Person”
- This is in effect attempting to import to a mezzanine loan foreclosure the kind of approval rights that a mortgage lender would have in a loan assumption transaction.

Modifications, Amendments, Etc.

- Rights of Cure
 - Time frame and number of cures
 - Monetary Defaults vs. Non-Monetary Defaults

Mezzanine Lender Purchase Rights

- Purchase Option Event Triggers
 - After the occurrence of certain “triggering events”, including acceleration of the maturity date, scheduled interest or principal payments being delinquent for 90 days, maturity default, borrower’s bankruptcy or becoming a specially serviced mortgage loan, mezzanine borrower has the right to buy out the mortgage loan.

- The use of purchase options has been severely limited due to:
 - Capital restrictions of mezz lenders.
 - Deteriorating collateral values resulting in the mezzanine loan being “out of the money” and having little value.
 - Closing as little as 10 days after exercising the option, which would be of little value to a mezz lender

- Purchase Price: Par plus accrued interest plus expenses. Prepayment fees, exit fees, late charges, default interest are negotiated.

- Mezz lender should seek to not lose its right to purchase until either (i) the mortgage loan foreclosure is completed or (ii) after mortgage lender is in a position to accept a deed-in-lieu of foreclosure, adequate notice is given to mezz lender and a reasonable time is provided for mezz lender to purchase the mortgage loan.

Mezzanine Lender Purchase Rights

- Mortgage Loan Deed-in-Lieu Restrictions
 - Customarily, the granting of a deed-in-lieu to the mortgage lender would be full recourse to guarantor, while a mortgage foreclosure would not be full recourse.
 - However, mortgage lenders may demand that if the mortgage lender negotiates a deed-in-lieu with the mortgage borrower, and the mezzanine lender declines to purchase the mortgage loan, the granting of a deed-in-lieu will not result in full recourse liability under the mezzanine loan's guaranty.
 - This forces the mezzanine lender to either buy the mortgage loan or be at risk of a complete loss of its investment.
 - The mezzanine lender would far prefer that the mortgage lender conduct a mortgage foreclosure, as the mezzanine lender would recover a portion of its investment if the winning bidder pays a purchase price in excess of the mortgage loan.

Additional Provisions

- Relief for foreclosing Mezzanine Lenders on financial covenants, interest rate cap strike price, required reserves, extension conditions, and other provisions.
- Agreement to provide copies of notices and financial statements.
- Joint determination/consultation regarding trigger periods.
- Mezzanine Endorsement to Owner's Title Policies
- Ground Lease Defaults.
- Resizing of the Mortgage Loan; Mortgage Lender's ability to crease additional mezzanine loans prior to securitization.
- Mortgage Lender's ability to uncross properties and require separate mezzanine loans.

Additional Provisions

- Affiliated Junior Lenders.
- Mortgage Loan Standstill Provisions in rapid foreclosure states.
- Disqualified Persons

Key Provisions of Co-lender Agreements, Including Control Rights of B Note Holders

Co-Lending: A/B Structured Loans and Participations

- In an A/B structured loan, the mortgage loan is split into tranches evidenced by one or more mortgage notes (“A-Notes”) and one or more junior notes (“B-Notes”).
- Each B-Note is secured by the mortgage which secures the A-Note.
- The A-Note may be securitized and divided among certificate holders of the securitization trust.
- An alternative structure is creating participation interests in a single note.
- The participants have no privity with the borrower and all of their rights flow through the mortgage lender.
- Either of these structures can also be used with a mezzanine loan.

Payment Priorities

- Senior/subordinate yield differential based on payment priorities
- Dual waterfall structures
 - Alteration of payment priorities following a “Sequential Pay Event”
- Default waterfall triggering events, cure rights of B Note holder and limitations on cure rights

Co-Lender Provisions

- Rights of Controlling Noteholder & Major Decision Rights
- Appraisal Reduction Event
- Defaulted Loan Purchase Price
- Interim Servicing Agreement
- Qualified Transferees
- Loan Servicing and Servicing Agreement
- Timing of Payments to Subordinate Noteholders
- Subordinate Noteholder Cure Rights
- Subordinate Noteholder Purchase Rights
- Transfer Rights

Participation Agreements as a Variation of Co-Lender Agreements

Participation Agreements Overview

- Variation on a co-lender agreement where one or more parties have beneficial ownership rights with respect to the underlying mortgage loan but do not have contractual privity with the related borrower
- Benefit of participation agreement is that the borrower is not a signatory (so assuming free transferability in the underlying mortgage loan documents) agreement is opaque to underlying obligor(s)
- Participation Agreement mirror co-lender agreements in many ways but have several differences

Differences in Participation Agreements and Co-Lender Agreements

- No contractual privity between the participants and the underlying borrowers
- Contractual privity remains between the “lender/mortgagee” and the underlying borrowers
- Differentiation between having a beneficial ownership interest and being lender of record
 - Lender may want to divest itself of legal title if it maintains no economic interest in the underlying mortgage loan documents
- Participations are generally not used as collateral in securitization transactions registered under the Securities Act of 1933, as amended, because of look-through to the underlying borrower

Differences in Participation Agreements and Co-Lender Agreements (cont).

- Participations then are generally used (when used) in securitization transactions not registered under the Securities Act of 1933, as amended, because of look-through to the underlying obligor (i.e. “Rule 144(A),” “Section 4(2) Private Placements,” etc.)
- Because Participants do not have contractual privity with the underlying borrowers their rights are derivative and subject to the right of the “lender/mortgagee” under the related mortgage loan documents

Participation Agreement Key Provisions

- Payment Waterfalls
 - Pari Passu Participation Agreements (used extensively in CRE CLO securitizations)
 - All payments are made pro rata and pari passu
 - Senior-Subordinate Participation Agreements
 - All payments prior to a “trigger event” (usually a monetary event of default or a material non-monetary event of default under the related underlying mortgage loan documents) are made with each participant getting its share on interest and its pro rata (or other fixed percentage)
 - Payments following a triggering event are made to the senior participation(s) in full interest and principal prior to being made to a more subordinate participation interest

Participation Agreement Key Provisions (cont.)

- Such payments re-characterize amounts that would otherwise be paid to the subordinate participations and pay them to the senior participation until its interest and principal have been retired (referred to as “turbo”)
 - Interest rate creep may result from the turbo of the senior positions when the mortgage loan is returned to performing status
- Cure Rights (generally only applicable in senior-subordinate participation agreements)
- Subordinate participants are generally given rights to cure underlying defaults under the related mortgage loan documents (subject to a cure cap)

Participation Agreement Key Provisions (cont.)

➤ Control Rights

■ Pari Passu Participation Agreements

- Participants must allocate the enforcement rights of the “lender/mortgagee” between each other
- Issue with respect to multiple participations in a mortgage loan where the related participations are placed into one or more securitization vehicles as to which vehicle controls (if at all)

Participation Agreement Key Provisions (cont.)

- Senior-Subordinate Participation Agreements
 - Subject to a material diminution in value of the subordinate participation (usually a loss of value (including via “appraisal reductions”) of seventy-five percent (75%) or more, the holder of the most subordinate participation will have the right to consent consult and otherwise direct the servicing of the related mortgage loan
 - Includes the ability to remove and appoint with or without cause the related special servicer of the underlying mortgage loan
- Default Purchase Option (generally only applicable in senior-subordinate participation agreements)
 - Subordinate participation holders are generally given option to purchase the participations senior to them at a price equal to “par”

The Role of the Servicer Under Co-Lender Agreements and Tensions with the B-Note Holders

Loan Servicing and Co-Lender/Participation Agreements

- Unified loan servicing and administration
- Roles of master servicer, special servicer, B Note holder, controlling certificate holder, operating advisors, in securitized transactions
- “Accepted Servicing Practices” as servicing standard for A/B loans
- “Accepted Servicing Practices” shall mean a contractual (non fiduciary) duty to each Holder to exercise the same degree of care that administrative agents customarily apply in administering loans similar to the Loan, or that the Agent would apply if it were administering the entire Loan solely for its own account, whichever is higher; in each case with a view to the maximization of timely recovery of principal and interest on the Loan on a present value basis, and without regard to conflicting interests.
 - Never litigated as to exactly what that means
- Seller/servicer in non-securitized transactions — dealing with conflicts of interest
- Pooling and servicing agreements and co-lender/participation agreements
 - Tensions/conflicts between servicing agreement and co-lender/participation agreements

Loan Servicing and Co-Lender/Participation Agreements(cont.)

- Approval rights of B Note holders and/or controlling certificate holders, as operating advisor, subject to servicer “trump” (except for imminent default determination)
 - Any extension of the maturity date, reduction of the interest rate, monthly payment or prepayment premium, modification of timing or forgiveness of interest or principal
 - Any discounted payoff
 - Foreclosure or deed-in-lieu of foreclosure
 - Sale of a mortgaged property, REO property or mortgage loan
 - Making an advance of principal
 - Any release of borrower, any guarantor or other obligor
 - Substitution or release of collateral or any modification or waiver of a “due-on-sale” or “due-on-encumbrance” clause Actions to comply with environmental laws
 - Adoption or approval of a bankruptcy plan of borrower
 - Execution of major leases or replacement of the property manager

Loan Servicing and Co-Lender/Participation Agreements(cont.)

- Consultation rights afforded to B Noteholders that are not binding on the servicer
 - After an event of default, the controlling holder/ operating advisor recommending alternative actions, including foreclosure of the mortgaged property, the sale of REO property or the mortgage loan
 - Material alterations on the mortgaged property, if lender's approval is required under the loan documents
 - Other material changes in any loan documents
 - Waiver of any prepayment notice provisions
 - Approval of any budgets or business plans for the mortgaged property, if lender's approval is required by the loan documents
 - Any proposal to take other significant action with respect to the mortgage loan and the mortgaged property

Loan Servicing and Co-Lender/Participation Agreements

- Limitations on servicer advancing, including contractual and practical considerations and impact on asset management decisions
- Servicing transfer events — imminent defaults, other defaults, B Note holder blocking rights through cure or consent rights
- B Note holder or controlling holder removal and replacement of special servicer — reasons for removal, mechanics and potential for cost savings
- Tensions over appraisal reduction determinations

Loan Servicing and Co-Lender/Participation Agreements(cont.)

- Tensions over what servicer/securitization party performs what duty under the related co-lender agreement
- Tensions between special servicer in securitizations resulting from B Note holder having control rights over the related mortgage loan while the securitization “directing certificateholder” does not over the particular asset
- Servicers are subjected to “tranche warfare”

Borrower Concerns and Considerations

Borrower Concerns and Considerations

- The Borrower is not a party to, and does not receive a copy of, the Intercreditor or Co-Lender Agreement.
- Rights that the Borrower may have negotiated may be affected by additional lenders having consent and consultation rights.
- Reasonableness standards that the Borrower may have negotiated into the loan documents could be lost if other lenders have consent or consultation rights under the Intercreditor or Co-Lender Agreement.
- Delays of having multiple lenders review and consent.
- Quick foreclosure of a Mezzanine Loan.
- Liability triggered under the recourse carveout guaranty.
 - Risk of full recourse liability to existing guarantor for non-complying mezzanine loan foreclosure
 - Risk to existing borrower of recourse liability for bad acts directed by mezzanine lender through use of pre-foreclosure voting rights
 - Risk to existing borrower of recourse liability for bad acts by mezzanine lender or successful bidder post-foreclosure

Lender Strategies for Dealing with a Defaulted Loan

Taking Control of Senior Borrower Prior To Foreclosing

- Mezz loan pledge agreements typically provide the mezzanine lender with the right upon a borrower default to exercise all voting rights with respect to the senior borrower, without the need to foreclose.
- In addition, in mezzanine loans secured under UCC Article 8, the mezzanine lender holds as collateral the equity certificate, so that the mezzanine lender can immediately take voting control over the senior borrower.
- This is a valuable remedy for mezz lender as it typically will not trigger liability to cure senior loan defaults or an obligation under the Intercreditor to provide a replacement guarantor. This may be more problematic where mezzanine lender has provided senior lender with a springing guaranty.

Taking Control of Senior Borrower Prior To Foreclosing (cont.)

- However, there is risk of lender liability once mezzanine lender has taken control of the senior borrower.
- Upon assuming control, a mezzanine lender can vote to cause the senior borrower to voluntarily file for bankruptcy.
- Taking control of the borrower and filing for bankruptcy will likely violate the covenants under the Intercreditor and trigger recourse under a replacement carve-out guaranty provided in connection with a foreclosure.
- Senior lenders now attempt to include the exercise of voting control rights by the mezz lender along with UCC foreclosure in requiring mezz lender to provide a replacement carve-outs guarantor, materially reducing the value of mezz lender obtaining a pledge of voting rights as a remedy.

UCC Foreclosure

- Requirements of commercial reasonability and waivers thereof
- Impact of Qualified Transferee restrictions
- Senior lender efforts to bar rogue foreclosure sale purchasers potentially imperils the ability of mezzanine lenders to conduct a commercially reasonable UCC sale
- Obligation to cure senior borrower monetary defaults
- Borrower and/or senior lender demands for provision of replacement guarantor, upon acquisition of the equity collateral (through UCC foreclosure or assignment in lieu thereof) by mezzanine lender or a third party purchaser, and mezzanine lender reluctance to provide same or to narrow carveout liabilities
 - Risk of full recourse liability to existing guarantor for non-complying mezzanine loan foreclosure
 - Risk to existing borrower of recourse liability for bad acts directed by mezzanine lender through use of pre-foreclosure voting rights
 - Risk mitigated for Borrower where mezzanine lender and Senior Lender enter to a springing guaranty at the time the initial closing of both loans

UCC Foreclosure (cont.)

- Conditions precedent and conditions subsequent to mezz foreclosure
- Obligation of the successful bidder to appoint a qualified replacement property manager and/or developer, if the property is under construction, within 30 days after the foreclosure sale — some senior lenders may demand that senior lender have the exclusive right to appoint a property manager or developer under the senior loan documents, rendering it extremely difficult for the foreclosure purchaser to meet the foreclosure requirement to appoint a replacement property manager and/or developer
- Better practice is to push very hard for the right by successful bidder to appoint the property manager and/or developer with consent not to be unreasonably and given within 10 days of request. Definitions of Qualified Manager and/or Developer should be clearly delineated in the Intercreditor Agreement.

Mortgage Foreclosure vs. Deed-in-Lieu

- Customarily, the granting of a deed-in-lieu to the senior lender would be full recourse to guarantor, while a mortgage foreclosure would not be full recourse.
- However, senior lenders may demand that if the senior lender negotiates a deed-in-lieu with the senior borrower, and the mezz lender declines to purchase the senior loan, the granting of a deed-in-lieu will not result in full recourse liability under the mezz loan's guaranty.
- This forces the mezz lender to either buy the senior loan or be at risk of a complete loss of its investment.
- The mezz lender would far prefer that the senior lender conduct a mortgage foreclosure, as the mezz lender would recover a portion of its investment if the winning bidder pays a purchase price in excess of the senior loan.

Replacement Guarantor Considerations

- In addition to a Qualified Transferee, Senior lenders generally require, as a condition of a mezzanine lender foreclosing its equity collateral and assuming control of the senior borrower, that the mezzanine lender provide a replacement carve-outs guarantor under the senior loan, whereby the guarantor will be liable for the entire loan upon a voluntary bankruptcy filing —this effectively eliminates voluntary bankruptcy as a strategy for creditworthy carve-outs guarantors (but not necessarily limited resource guarantors).
- In prior years, replacement of the carve-outs guarantor might only be required if the foreclosure resulted in the removal of the existing carve-outs guarantor.

Replacement Guarantor Considerations (cont.)

- In addition, senior and mezz lenders will often require that the replacement guarantor be liable under any completion guaranty under their loans.
- Many completion guaranties contain a measure of damages, whereby the senior lender need not actually complete the construction. Such damages will typically be liquidated in an amount equal to the estimated cost of lien-free completion of the work.
 - In calculating damages under either the senior or mezz completion guaranty, all construction reserves under either loan should be deducted therefrom.
 - To avoid double exposure of mortgage and mezz borrowers and guarantors, such liquidated damages should be paid under only one of the loans, and any such payment, if paid to mezz lender, should be turned over to the senior lender.

Springing Guarantor Considerations

- Senior lenders are starting to require, as a condition of a mezzanine lender making the mezzanine loan, that the mezzanine lender provide a springing carve-outs guarantor under the senior loan, whereby the guarantor will be liable for the entire loan upon a voluntary bankruptcy filing —this effectively eliminates voluntary bankruptcy as a strategy for creditworthy carve-outs guarantors (but not necessarily limited resource guarantors) or any foreclosure that violates the due on sale provision. The springing guaranty is then replaced with a replacement carve-outs guaranty from the successful bidder at the foreclosure sale.

Lessons from Workouts and Bankruptcies on Structure, Enforceability and Remedies

Bankruptcy Issues

- If a defaulted borrower has failed to workout its loan with its lender, as a last resort, borrower could file for Chapter 11 bankruptcy reorganization.
- Widespread use of recourse carve-outs guaranties from the borrower's sponsor has largely deterred voluntary bankruptcy filings, as the guarantor would become liable for the entire loan.
- This is not 100% effective as a deterrent:
 - The guarantor may be “judgment proof” such that the deficiency claim may be greater than guarantor's available assets.
 - The lenders could be adversely affected by the bankruptcy.
 - If the value of the real estate is substantially less than the amounts owed under the mortgage loan, there is a risk of a “cram down”.
 - Even if the market value of the real estate exceeds the amounts owed under the mortgage loan, there is a risk of a “cram up” where the mortgage loan can be materially modified, for example, extending the maturity date and lowering the interest to current market rates.

Bankruptcy Waivers

- Junior lenders typically are required to waive most of their statutory rights as secured creditors in a bankruptcy proceeding and to designate senior lender to take such actions on their behalf.
- This loss of control can lead to the junior lender having its interests crammed down or wiped out in liquidation.
- Typical bankruptcy waivers include waiving rights to:
 - Vote on a plan of reorganization - the junior lender can attempt to modify this assignment so that the senior lender can only vote on behalf of junior lender if such plan of reorganization would result in senior lender being “impaired” under the Bankruptcy Code.
 - Vote bankruptcy claims of the junior lender and to prosecute any claims.
 - To make any election, give any consent, commence any action or file any motion or take any other action in a bankruptcy proceeding.
 - To challenge any claim or any valuation of the mortgaged property submitted by senior lender.

Enforceability of Bankruptcy Waivers

- While under Section 510(a) of the Bankruptcy Code, Intercreditor Agreements are treated as “subordination agreements” making them generally enforceable, application of Section 510(a) to the enforceability of bankruptcy waivers is not settled:
 - One court found that the senior creditor was not entitled to vote the claims of the junior creditor as provided in a subordination agreement - but enforced its economic provisions. (In re 203 North LaSalle Street Partnership, 246 B.R. 325 (Bankr. N.D. Ill. 2000))
 - Another court reached a contrary conclusion, finding that Section 510(a) can be used to enforce the provisions of a subordination agreement granting the senior lien holder the right to vote the junior lien holder’s claim. (In re Aerosol Packaging, LLC, 362 B.R. 43 (Bankr. N.D. Ga. 2006))

The Stuyvesant Case - Impediment to Mezz Foreclosure

- In what is typically referred to as the “Stuyvesant” or “Stuy Town” case (Bank of Am., N.A. v. PSW NYC LLC, 29 Misc. 3rd 1216(A), 918 N.Y.S.2d 396 (Table), 2010 WL 4243437 (Sup. Ct. N.Y. Cnty. 2010)), the Court enjoined a mezzanine lender’s upcoming UCC foreclosure sale, requiring that in order for the mezzanine lender (the holder of senior mezzanine loans purchased at a substantial discount), to foreclose on its separate equity collateral, all defaults needed to be cured under the senior loan — in this case, payment in full of the entire \$3 billion senior mortgage loan.
- The Court disagreed with the assertion of the mezzanine lender that Section 6(d) of the Intercreditor was designed to prevent the senior lender from accelerating the senior loan due to a transfer of the Equity Collateral, holding that it was “not grounded in the terms of the Intercreditor Agreement”.

The Stuyvesant Case Impediment to Mezz Foreclosure (cont.)

- Section 6(d) provides:

“(d) To the extent that any Qualified Transferee acquires the Equity Collateral pledged to a Junior Lender pursuant to the Junior Loan Documents in accordance with the provisions and conditions of this Agreement ..., such Qualified Transferee shall acquire the same subject to (i) the Senior Loan and the terms, conditions and provisions of the Senior Loan Documents and (ii) the applicable Senior Junior Loans and the terms, conditions and provisions of the applicable Senior Junior Loan Documents, in each case for the balance of the term thereof, which shall not be accelerated by Senior Lender or the related Senior Junior Lender solely due to such acquisition and shall remain in full force and effect; provided, however, that ... (B) all defaults under (1) the Senior Loan and (2) the applicable Senior Junior Loans, in each case which remain uncured or unwaived as of the date of such acquisition have been cured by such Qualified Transferee or in the case of defaults that can only be cured by the Junior Lender following its acquisition of the Equity Collateral, the same shall be cured by the Junior Lender prior to the expiration of the applicable Extended Non-Monetary Cure Period.”

- The Court’s ruling is contrary to the common reading of this provision among practitioners, which is that cure of any senior loan default was not a precondition to a mezzanine foreclosure, but a protection against acceleration of the senior loan upon a UCC foreclosure. The defaults under the senior loan would remain an ongoing obligation of the Qualified Transferee to cure post-foreclosure.

The Stuyvesant Case Impediment to Mezz Foreclosure (cont.)

- In the event that the senior loan has matured or been accelerated after a default, a court following the ruling in Stuyvesant would effectively block the ability of the mezzanine lender to foreclose on the equity collateral, take control of the senior borrower and file for bankruptcy relief under Chapter 11, so that any foreclosure of the senior loan would be enjoined by the automatic stay.
- Mezzanine lenders would be forced to move to foreclose much earlier, prior to an acceleration or default under the senior loan, and/or negotiate with the servicer from a weaker position.
- The Stuyvesant case was never appealed, as the senior lender instead negotiated to purchase of the mezzanine debt at the price paid by the holder, therefore the applicability to Intercreditors generally remains unsettled. In recent, Mezzanine lenders added language to the cure provisions of Intercreditors to address the Stuyvesant Case by providing that curing all defaults is expressly not a pre-condition to a Realization Event.
- However, in recent Intercreditors, a number of senior lenders are seeking to condition mezz loan foreclosure on cure by the mezz lender of all senior loan defaults that can be cured without taking possession of the property, including payment of the senior loan at maturity or upon acceleration.

The “W” Strategy – How the Most Junior Mezz Lender Made itself Whole

- In what is typically referred to as The “W” Strategy, LEM Mezzanine, a mezzanine lender managed by Lubert-Adler Partners, a well-known, real estate private equity firm, headquartered in Philadelphia bid \$ 2 million for the “W” Union Square, a 270 key hotel located at Union Square in New York City.
- In October 2009, the once high-flying real estate investment company, Istithmar World Capital, defaulted on payments under the mezzanine loans secured by the membership interests in the owner of the W Hotel. The loans secured by the W Hotel were composed of \$117 million in mezzanine loans and \$115 million securitized mortgage loan. The \$117 million in junior loans were held as follows:
 - \$60 million held by DekaBank Group
 - \$37 million held by Sandelman Partners
 - \$20 million held by LEM Mezzanine
- Istithmar had purchased 90% of the W Hotel in 2006 for \$282 million and later brought the remaining 10% from UBS three years later for \$4 million.
- In the midst of workout negotiations, LEM Mezzanine, initiated UCC Foreclosure proceedings. At the UCC auction Istithmar without the funds it had 3 years earlier lost to LEM Mezzanine which was able to credit bid up to \$20 million. LEM Mezzanine was able to acquire hotel at a basis (including its \$20 million loan) \$222 million vs. Istithmar’s \$286 million.

The “W” Strategy – How the Most Junior Mezz Lender Made itself Whole (cont.)

- Subsequently, in March 2010, LEM Mezzanine’s subsidiary, Hotels Union Square Mezz 1, LLC declared bankruptcy in Delaware (In re: Hotels Union Square Mezz 1 LLC, U.S. Bankruptcy Court, District of Delaware, No. 10-10971 (Bankr. Del. 2010)) to stop the UCC foreclosure by DekBank and Sandelman Partners on the two senior mezzanine loans.
- Maryland-based Host Hotels & Resorts (“Host”) purchased the hotel in September 2010 for \$185.3 million in connection with approval of Chapter 11 Plan of Liquidation, whereby DekaBank was paid in full, Sandelman Partners converted its \$37 million loan into equity in the new joint venture with Host and LEM Mezzanine was paid off.
- Overlooked by some observers was the NYC Real Property Transfer Tax (“Transfer Tax”). The UCC foreclosure resulted in the imposition of Transfer Tax on the \$204 million in consideration on the foreclosure; which was no small sum, over \$6 million.
- Under Section 1146(c) of Chapter XI of the Bankruptcy Code, transfers of real property and improvements in connection with an approved Chapter 11 Plan of liquidation are exempt from Transfer Tax.
- Finally, this strategy will not work in the context of a mezzanine loan that is participated. Mezz lender must hold a whole loan or control the mezzanine loan being foreclosed upon.

280 Park Avenue – Business Case Study – What should the Holder of Mezzanine Loan F Do?

- 280 Park Avenue (“280 Park”) in New York City is 1.2 million square foot, Class A office building located in midtown, New York City.
- 280 Park was last sold in 2007 for \$1,279,800,000 to Broadway Partners by Istithmar. Istithmar had paid Boston Properties \$1.34 billion in 2006.
- The capital stack was a \$440 Million of Senior Mortgage Debt (“Senior Loan”) and approximately \$670 Million in Mezzanine Debt composed of 6 separate loans in the following amounts and priority:
 - A \$315 Million (controlled by Helaba)
 - B.\$60 Million
 - C \$130 Million
 - D \$71.5 Million
 - E \$20 Million
 - F \$73.5 Million (Vornado)
- Senior Loan has a Debt Service Payment Reserve of \$115 million. The Senior Loan carries an interest rate of 6.85%. Yearly debt service is \$30,140,000. Interest Reserve is projected to last 45 months. The Senior Mortgage Debt closed over 45 months ago.

280 Park Avenue – Business Case Study – What should the Holder of Mezzanine Loan F Do? (cont.)

- Debt Service Payment Reserve should be exhausted. Underwritten Cash Flow for the building is \$53 million. Debt Service on the Senior Loan is \$30,140,000, which leaves approximately \$20 million to pay the mezz. Not enough to pay the debt service on all the Mezzanine Loans.
- Mezzanine Loan A was participated out to five lenders on a *pari passu* basis as follows:
 - Helaba Landesbank Hessen-Thüringen (Helaba) who holds \$125 million and is administrative agent and controls Mezzanine Loan A.
 - The remaining \$190 million was participated to Westdeutsche Immobilien Bank AG (Westimmo), ING Real Estate, Landesbank Saar (Saar LB) and Deutsche Genossenschafts-Hypothekenbank AG (DG HYP).
 - The identity of holders of Mezzanine Lenders holding Mezzanine Loans B, C, D and E are not important to this Case Study.
 - What does the holder of Mezzanine Loan F do to protect its investment?

Thank You

Steven E. Coury
White and Williams LLP
courys@whiteandwilliams.com



Brooks S. Clark
Polsinelli
bclark@polsinelli.com



Geoffrey Maibohm
Dechert
geoffrey.maibohm@dechert.com

