BORROWER CONSIDERATIONS IN MULTIPLE LENDER TRANSACTIONS

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During the past several decades, real estate financings have developed from fairly simple borrower/single-lender relationships to structured multiple-lender and capital-markets driven arrangements. Lower pricing and increased loan proceeds have made these types of transactions very attractive to borrowers. However, borrowers may not fully appreciate the intangible costs that arise out of the changes to the relationship between a borrower and its lender. Unfortunately, some borrowers experience the consequences of these changes at critical times.

The effects of these changes are varied. In a syndicated loan transaction, lenders join together to offer loans that are larger than what would be offered by a single lender. One result is that consent of multiple lenders may be necessary for key decisions, including in the context of restructurings. Another result is that the composition of a lender syndicate may change, sometimes without the consent of a borrower. In a mezzanine financing transaction, a mortgage lender, although holding a senior position, cedes or shares many aspects of control of a borrower and the underlying mortgaged property to a mezzanine lender. In those same transactions, the interest of a mezzanine lender may be transferable without the consent of a borrower. In addition, the typical documentation provides a mezzanine lender with remedies that, depending on the jurisdiction, may be far more powerful than the remedies provided to a mortgage lender. Some of these issues appear in different forms in other types of transactions. For example, the potential for unexpected guarantor liability may lurk beneath the surface of a preferred equity transaction.

This article will explore changes to the traditional borrower/single-lender relationship that arise in syndicated loan and mezzanine loan transactions, with an emphasis on a borrower's perspective. This article will also highlight some borrower and sponsor concerns about their relationship with their mortgage lender that may arise in a preferred equity transaction.

SYNDICATED LOANS

The dollar amount of a credit facility requested by a borrower may exceed the amount that a particular lender is comfortable providing. This could be due to self-imposed limits or regulatory credit exposure limits imposed with respect to a single project, market, or sponsor. It is not uncommon for a lender with this type of limitation to be in a situation where it wants to bid for a transaction against other lenders who have the wherewithal to provide the large financing on their own. In those situations, that lender could consider partnering with other lenders to provide the large financing. Another possibility, depending on the smaller lender's relationship with a borrower, is that the smaller lender could commit to providing the larger amount, subject to bringing in other lenders at closing to provide the amount of the loan that exceeds the smaller lender's limit. In that situation, a borrower, and possibly also a broker or advisor, may facilitate the formation of the syndicate by encouraging bidders to work together or introducing other relationship lenders.

A lender may also increase its profitability in a transaction by bringing other lenders into a transaction both at and after the closing. The lender would be the agent and could retain a portion of the loan fees and perhaps even a portion of interest payments that otherwise would be allocable to the portion of the loan that is sold. It has become increasingly common for a selling lender to provide a purchasing lender with a priority interest, i.e., a selling lender will subordinate its right to receive payments to a purchasing lender. In exchange for this risk, the new lender would receive a lower interest rate than is paid by a borrower on the underlying loan, and the selling lender would retain the excess as a higher yield to compensate the selling lender for accepting the subordinate position.

A syndicated loan also could provide a lender with the necessary administrative capacity that it does not have in-house. For example, a lender may be approached with an opportunity to provide a construction loan, but may not have the necessary administrative staff and experience. By joining with another lender that has these skills and will act as

the agent, the lender that was first approached can provide the facility.

The form of loan documentation for a syndicated loan is the same as the documentation for a single lender, with three key exceptions:

1. Some of the terms of a syndicated loan may be negotiated so as to be acceptable to potential syndicate members. For example, a borrower with an existing relationship with a lender may have developed document forms in prior transactions in which the lender is the sole lender. If a prospective transaction is going to be syndicated to other lenders, some of the terms may need to be modified to be acceptable to a broader range of lenders. Although the more material terms of this nature should be addressed at the term sheet phase, other terms, such as provisions that would be required by lenders based in foreign jurisdictions or that may require reporting beyond what would be required by the single lender, may first be seen in the draft loan documentation.
2. The loan documentation will include the concept of the lead lender acting as agent for the lenders. This relationship generally will be addressed in the loan agreement by including the agent as a party to the loan agreement. The loan documentation will use a granular approach to the rights and obligations of the agent and lenders by, in numerous places, specifically referring to the agent, rather than the lenders, as the party that interacts with a borrower. The loan documents also will include specific references to the lenders in mechanical contexts such as advancing loan proceeds, as well as in the context of determinations that require lender consent.
3. The broader relationship between agent and lenders will be dealt with in one or two separate sections of the loan agreement or, in limited circumstances, through a separate co-lender or intercreditor agreement. These provisions are not dissimilar to provisions found in joint venture agreements and other forms of partnership agreements, although they tend to be much shorter in length.

Each lender will designate and appoint the agent as its exclusive agent with the appropriate grants of authority and power. Since the relationship between the agent and the lenders generally is intended to be a basic contractual relationship, it is common for the agreement to specify that the agent does not have a fiduciary or trustee relationship with the lenders. Consequently, the agreement often will provide that the agent is only required to exercise the same standard of care as that customarily exercised by the agent in the administration of similar loans held for its own account or some variation of this standard. In this regard, it is common to provide that the agent will not be responsible for the consequences of its conduct outside of willful misconduct or gross negligence. Similarly, since the bulk of the agent's responsibilities are administrative, the agent will not have liability to other lenders for losses arising from the problems with the underlying transaction. In that regard, it is typical to include a provision to the effect that the lenders will accept sole responsibility for underwriting the transaction. Further, syndicated loan agreements will provide that the agency provisions of the agreement are solely for the benefit of agent and lenders, and neither the borrower nor any other loan party has rights as a third-party beneficiary.

An agent will be granted the sole and exclusive authority to deal and communicate with a borrower, any guarantor, and other borrower-side loan parties with respect to the loan on behalf of the lenders, and the right of any lender to take any direct action as a lender will be waived or limited.

While the agent is commonly granted the sole right to communicate with a borrower, guarantors, and any borrower-side loan parties, in some circumstances, particularly in larger loans, some direct communication rights between the lenders and a borrower possibly may be negotiated, especially when part or all of the facility funds construction advances. A typical formulation is that prior to an event of default, each lender has the right upon reasonable request of a lender to the agent: (i) to meet with the borrower, the guarantor and, in the case of a construction loan, the construction consultant with

the agent present; and (ii) to participate in meetings or phone calls with the agent, the borrower, the guarantor and/or construction consultant. If an event of default has occurred and is continuing, the agent may also be obligated to use good faith efforts to include the lenders in all material meetings and scheduled conference calls with the agent, the borrower, the guarantor and/or the construction consultant. Interestingly, a borrower may not be aware of these provisions if they are included in a co-lender agreement that is not provided to the borrower; in that case, these provisions may contradict some of the provisions of the loan documentation that limit a borrower's direct contact with lenders.

Nonetheless, when entering into a syndicated loan, a borrower should expect that it may need to interact and communicate with a larger lender group, although in many circumstances it may prefer only to deal with the agent, regardless of the number of other lenders. When this is important for a borrower, it should be negotiated.

An agent will be empowered to hire professionals and other third parties to assist it and will not be responsible for any errors made by these parties as long as the agent selected them with reasonable care.

A distinction will be made between an agent's role as agent and as lender so as to preserve the agent's rights related to its position as a lender. The loan agreement or co-lending agreement will expressly provide that the person serving as administrative agent has the same rights and powers as any other lender and may exercise the same as though it were not administrative agent. It is typical to specify some of the categories of things the agent and its affiliates can do in their capacity as lender, such as accepting deposits, lending money, and acting as a financial advisor. Such a provision will state that when an agent is acting in its capacity as a lender, it has no duty to account for any such actions, in such capacity, to the other lenders.

Disbursement, payment, and loan procedures will be established. These procedures will cover the disbursement of loan proceeds and payments received on account of the loan. Provision also will be made for payment by a borrower or agent expenses and lender contributions of expenses and protective advances in default situations.

Restrictions will be imposed on an agent's power to agree to specified amendments or waivers without lender consent. These may vary by transaction, but generally will include the following key points:

- Extension of interest, principal payment, and maturity dates;
- Reduction of principal or the interest rate;
- Any write-off or increase in the principal amount;
- Release of any material portion of the collateral;
- Release of a borrower or guarantor from any material obligations with respect to the loan;
- Consent to a material transfer that is not otherwise permitted by the loan documents; and
- Modification of lender consent rights or the definition of required lenders or majority lenders.

An agent may be restricted in providing some consents, waivers, or approvals that are particularly important in the context of the transaction. These additional restrictions may apply to items such as waivers of debt yield, debt service or other financial covenants, or key lease approvals. In construction loans, it is not unusual to see lender consent requirements related to significant changes in the project that could have an adverse effect on value or the construction budget. These consents or approvals may require unanimous majority or supermajority consents.

It is helpful for a borrower to consider and understand situations in which some level of lender consent may be required. A borrower also should consider the process of obtaining consent and, in particular, the amount of time that would be necessary. Many lender consent rights are inviolate and cannot be negotiated. While some matters may require unanimous consent, other consent rights may be limited to supermajority or majority lender approval (often under the label of "Required Lenders" or "Requisite Lenders"). Even more problematic

for a borrower is the existence of a co-lending agreement to which the borrower is not a party and which has not been provided to the borrower. Consequently, the borrower may be unaware of the specifics of lender consent rights over an agent's decision-making authority. It is commonplace for a co-lending agreement to provide that the provisions of the co-lending agreement that govern the extent of an agent's decision-making rights also govern any conflicting provisions set forth in the loan documents. Usually, a co-lending agreement will provide that the decision-making terms and conditions of the co-lending agreement will control. Also, a co-lending agreement also may provide that the agent must act in accordance with the instructions of the majority (or requisite lenders or all lenders, as applicable) in accordance with the co-lending agreement, particularly in a default situation.

If a borrower is concerned about how certain decisions will be made by a lender group, it should try to seek clarification as to limitations on the agent's authority; ideally this assurance will come in the form of a covenant or representation and warranty. From a borrower's point of view, unanimous consent lender approval rights should be limited, as opposed to majority or supermajority consent. Also helpful from a borrower's point of view is the negotiation of deemed consent provisions indicating that consent is deemed granted should the agent fail to respond within a specific time period. Unanimous lender consent is typically required for major actions such as workouts and enforcement actions. The inability to garner unanimous consent for major decisions, in the context of an event of default, may obligate the agent to accelerate the loan and enforce its remedies to recover the property.

An agent will have the right to resign as agent, and there will be procedures for the appointment of a successor agent. So long as no potential default or event of default exists, a borrower often will have a consultation or approval right with respect to the appointment of a successor agent.

Since the agent often is a borrower's relationship bank, a borrower may attempt to negotiate for the agreement of the agent not to resign. That effort often is unsuccessful, but a common compromise is that the agent won't resign: (i) absent a default; (ii) if the agent institution decides to withdraw from generally agenting loans; or (iii) the agent institution's interest as lender falls below a certain level. The latter condition often leads to a request by a borrower that the agent institution agree to a "minimum hold" level. The benefit to a borrower of having a minimum hold is not only precluding an agent resignation but also preserving the voting interest of a borrower's bank. That effort also often is unsuccessful, but a common compromise is that the minimum hold falls away after a default or, if the institution decides that as a general matter, it no longer wants to hold interests in that type of loan.

The lenders will have the right to remove an agent in certain circumstances, generally limited to gross negligence, willful misconduct, or a breach by the agent of its obligations as agent. As with a resignation by an agent, a borrower often is granted the right to approve successor agents in the event of an agent removal if there is no loan default.

The agreement will specify consequences for a breach by a lender of its obligations under the co-lender provisions. There are a variety of formulations, but the general formulation is that if a lender defaults in its obligations, its voting and other rights are suspended and its right to receive payments is subordinated to the other lenders until the default is cured. This provision also may address the right of the other lenders to advance funds on the defaulting lender's behalf and the right of the non-defaulting lenders to purchase the defaulting lender's interest, sometimes at a discount.

In the negotiation of loans with future advances (such as a construction loan), borrowers often raise issues related to the failure of a lender to fund its pro-rata share of a loan advance. Funding obligations typically are characterized as being the "several" obligations of the respective lender. When this is the case, a borrower will only have a cause of action against the non-funding lender. The loan agreement may also provide that the other lenders

are excused from their obligation to fund when a non-funding lender has failed to fund its pro-rata share. When this is the case, a borrower should seek the right to fund the non-funding lender's shortfall with a contemporaneous obligation for the other lenders to fund their pro-rata share. Although the issue of the non-funding lender tends to be a difficult one to resolve, a borrower and its counsel should keep in mind that a lender's failure to fund may be a breach of its contractual obligations to a borrower and a borrower may have traditional remedies for such a breach. A borrower also should consider negotiating the right to replace a defaulting lender with a substitute lender.

It is common for the co-lender provisions in a loan document to allow an agent and the lenders to modify the co-lender provisions without the consent of a borrower. A borrower's counsel should review the entire co-lending provision since there may be a limited number of provisions in this section that warrant borrower consent.

The loan documentation will address the rights of a lender to sell all or a portion of its interest in a loan. The interest can be sold as a direct assignment of all or a portion of a lender's interest, in which case the assignee becomes a lender. A lesser-used alternative is the sale of a participation interest in all or a portion of a lender's interest; in that case, a participant holds only a contractual interest to receive payments that are received by the selling lender from its corresponding interest in the loan. It is important to recognize that a participant is not a lender and is not in privity with a borrower, agent, or other lenders. Because a selling lender remains a lender for the interest that is the subject of a participation, a selling lender remains responsible to a borrower, agent, and other lenders as though the participation was not sold. Note that the sale of a participation, as distinguished from an assignment, may result in less favorable capital treatment for a selling lender.

Draft loan documents often include a provision that has its origin in capital market transactions allowing a lender to split the loan in various tranches and varying collateral profiles. Aside from the basic business issue of whether a borrower would accept that type of provision, it may overlap with the syndication provisions addressing the right of the lenders to sell interests in the loan and should be reviewed with an eye toward that interplay. While savvy borrowers may want to negotiate the extent of the lender's right to sell interests in the loan, lenders are usually cautious about limiting their secondary market rights and accommodating borrower requests if such requests could have the potential for making the lenders' interest in the loan less transferable.

The assignment of an interest is generally subject to a number of conditions. The assignment requires the consent of the agent and, so long as no default exists at the time of the assignment, the consent of a borrower. There are various formulations with respect to borrower's consent, including consent not to be unreasonably withheld. Consent is not required in the case of an assignment to affiliates or a defined class of institutional lenders or for a participation.

Many borrowers (in particular, larger and more sophisticated borrowers) attempt to negotiate the lender assignment rights at the term sheet phase but it is surprising how many do not. Even if a negotiation of this provision is unsuccessful, it should, at minimum, give rise to a discussion about a lender's syndication intent and strategy.

Whether a borrower bears the cost of syndication is often a point of negotiation. It is not unusual for a borrower to agree to pay all or a portion of a lender's syndication costs related to the initial syndication and perhaps a targeted post-closing syndication to targeted hold levels. These costs may include travel, document platform costs, and legal expenses. Another negotiation strategy for a borrower is to seek a cap on its liability to pay the syndication costs.

The minimum principal amount is the easiest way to limit the number of lenders in a particular transaction and tends to be a straightforward negotiation. This provision is an intra-lender provision. A borrower should be aware that new lenders often require their own notes, leading to the need for a borrower to execute substitute notes.

MEZZANINE LOANS

The additional leverage gained through any secondary financing, whether mezzanine, second mortgage, or unsecured financing, creates additional risk for a borrower and its sponsor. Mezzanine financing presents some specific additional risks that arise out of a mezzanine loan structure.

A mezzanine loan structure requires the mezzanine borrower to be a single purpose entity whose sole purpose is to own the mortgage borrower. The mezzanine loan proceeds are advanced to the mezzanine borrower and are contributed by the mezzanine borrower to the mortgage borrower. The collateral for a mezzanine loan is a mezzanine borrower's pledge of its ownership interest in the property-owning mortgage borrower. A mezzanine lender generally is not affiliated with a mortgage lender and will not have a direct collateral interest in the property.

Since a mortgage loan borrower is a single purpose entity that owns no assets other than the property, foreclosure of a mortgage would result in the mortgage borrower losing its only asset. Since a mezzanine loan borrower is a single purpose entity that owns no assets other than the equity interests in a mortgage borrower, a loss of the property by a mortgage borrower would render the mezzanine collateral valueless. In order to provide a mezzanine lender with the ability, should it choose, to delay a mortgage foreclosure, a mortgage lender and mezzanine lender enter into an intercreditor agreement. An intercreditor agreement will provide a mezzanine lender with rights that include the right to cure a mortgage loan default for a specified period, to allow the transfer of a property to a mezzanine lender or a qualified transferee through a foreclosure of the pledged equity interests in a mortgage borrower, and to purchase a defaulted mortgage loan. The market forces that led to the evolution of mezzanine financing have resulted in mortgage lenders accepting (and in some cases embracing) mezzanine financing. However, the concessions granted by a mortgage lender to a mezzanine lender in an intercreditor agreement are offset with conditions and other limitations that are designed to protect the mortgage lender and its collateral.

The collateral pledged to secure the mezzanine loan is personal property rather than real property. The pledge is usually governed by Article 8 or Article 9 of the Uniform Commercial Code (UCC) in effect in the applicable jurisdiction. A mezzanine lender generally will require a UCC insurance policy, issued through companies within the title insurance industry that insure the attachment, perfection, and priority of the lien on the pledged equity interests and that such interests be certificated under UCC Article 8. A mezzanine lender also generally will require endorsements to the owner's title insurance policy that name the mezzanine lender as an additional insured, and protect the mezzanine lender from defenses to coverage arising from actions of the mortgage borrower as an insured party and dissolution or similar events affecting the mortgage borrower.

The mezzanine lender's primary remedy is a non-judicial foreclosure under the UCC. Consequently, a mezzanine loan default can trigger a quick foreclosure. Because the UCC limits the ability of a mezzanine borrower to challenge a foreclosure, a sponsor has few options other than to repay a mezzanine loan or lose its interest in the entity that owns the property. There are many transactions in which the option to prepay a mezzanine loan or the source of prepayment may be limited by the intercreditor agreement entered into between a mortgage lender and a mezzanine lender. This limitation may require that a mezzanine loan cannot be prepaid without a concurrent prepayment of a mortgage loan, potentially requiring a sponsor also to repay the much larger mortgage loan. Ironically, because this documentation often is done between a mortgage lender and a mezzanine lender out of the eyesight of a mortgage borrower, mezzanine borrowers and their sponsors may not be aware of this limitation until a mezzanine loan is already in default. Although this type of restriction is far from universal, it is an example of a significant risk in a mezzanine loan structure.

The primary source of funds to make mezzanine loan payments is the distribution that a mezzanine borrower, as owner of the pledged equity interest in a mortgage borrower, receives from a mortgage borrower. Specifically, it is the cash flow remaining after the payment of all operating and other property-level expenses, and other sums and payments paid on account of a mortgage loan that is available to be distributed to a mezzanine borrower to make payments with respect to a mezzanine loan. If the distributed funds are insufficient to pay sums due to a mezzanine lender, absent cash reserves provided to a mezzanine lender or additional cash contributions made to a mezzanine borrower by its owner/sponsor, a payment default will occur under a mezzanine loan.

A mortgage loan typically will not be cross-defaulted with a mezzanine loan. As a result, absent the occurrence of a default under a mortgage loan, a mezzanine lender would be free to exercise its remedies against the equity interests in a mortgage borrower. However, the intercreditor agreement between a mortgage lender and a mezzanine lender will set forth categories of potential equity owners that would be permitted to become owners of the equity interests in a mortgage borrower through the foreclosure without obtaining lender consent. If the transfer at the foreclosure sale complies with those requirements, the initial indirect owner of the property will be replaced by the successful bidder at the foreclosure sale and a mortgage loan will remain in place.

The form and terms of a mezzanine loan agreement, guaranties, and non-security documents parallel those of a mortgage loan documents (other than principal amounts, interest rates, and other terms of the specific mezzanine financing). In particular, there are certain contract points, such as release of reserves and accounts and disposition of casualty proceeds or condemnation awards, where the subordinate nature of a mezzanine loan and a mezzanine lender's rights to its own collateral need to be addressed.

Mezzanine loans generally are closed concurrently with mortgage loans. It is common to begin negotiating the senior loan documents before a mezzanine lender's counsel begins drafting mezzanine loan documents. At some point in the process, mezzanine loan documents will be created based on the senior loan documents, although it is not unusual for a mezzanine borrower not to see those documents until shortly before closing. Although there is a benefit to first reviewing near final mezzanine loan documents redlined against mortgage loan documents, the need to do an orderly review and negotiation may warrant requesting the draft mezzanine loan documents sooner.

Mortgage loan documents, and in particular the guaranties, should provide that guarantors should not have liability for any obligations that arise after the completion of a mezzanine loan foreclosure.

A mezzanine lender will have many of the same consent rights as a mortgage lender but may have restrictions and consent requirements that go beyond those of a mortgage lender. This presents the property owner with the need to get a second set of consents from a mezzanine lender with a security position and perhaps an outlook and objective different than that of a mortgage lender.

Since a mezzanine loan's source of payment is the cash flow distributed by a mortgage borrower, limits on distributions in mortgage loan documents can be problematic. For example, a mortgage loan that includes a cash trap if cash flow falls below a specified debt yield or debt service coverage ratio would block a distribution even though a mortgage loan is not in default. Mortgage lenders in transactions with mezzanine loans recognize this issue and generally are agreeable to allowing mezzanine debt service at non-default rates to be released from a cash trap. The release of mezzanine debt service from a cash trap is best negotiated at the term sheet phase for a mortgage loan.

Construction financings employing mezzanine financing present a host of specialized issues. Mortgage lenders generally will require that mezzanine loan proceeds be fully disbursed before mortgage loan proceeds are disbursed. A key element of this discussion is how a mezzanine lender's interest and other fees will be paid if a mezzanine loan is fully

disbursed. Mezzanine lenders often will want to hold back loan proceeds for interest payments or establish a reserve rather than rely on mortgage loan disbursements. Another issue is whether the same construction consultant is used in a mezzanine loan and a mortgage loan draw process and the responsibility of the consultant to each of the lenders. Yet another issue is the right of a mezzanine lender to review draw packages for mortgage loan proceeds and what level of input is provided to a mezzanine lender.

These issues are best addressed at the term sheet phase both from a borrower's perspective of minimizing procedures, consents and costs, and for obtaining the agreement of a mortgage and mezzanine lender to these key issues at this early stage.

Mezzanine lenders may also want to share a mortgage lender's appraisal, third-party reports such as environmental and property condition reports, and perhaps insurance review. These reliance issues are best addressed at the term sheet phase.

Mezzanine lenders will want the ability to freely transfer their interest in a mezzanine loan. Although some mezzanine borrowers may be relatively indifferent to the identity of their mezzanine lenders, others will be more focused on this issue. For example, a bank or other financial institution may approach issues differently than a mezzanine lender that is affiliated with an organization that also operates properties. That mezzanine borrower may be particularly concerned about a "loan-to-own" lender that, in a workout situation, would view a mezzanine financing with its comparatively low principal amount and it short-fuse foreclosure as a potential opportunity for a low-cost purchase.

This type of concern highlights the need to carefully consider mezzanine loan document provisions addressing a mezzanine lender's pre-default transfer rights. Consider negotiating for the same restrictions on transfer that are discussed above with respect to syndicated loans, but recognize that these restrictions should not be expected to apply in a default situation.

The UCC establishes basic non-judicial procedures to foreclose the pledged collateral. The security interest in mezzanine loan collateral is created and perfected pursuant to Article 9 of the UCC and, at the election of a mezzanine lender, Article 8 with respect to the pledged interests. Article 9 provides for foreclosure of the pledged collateral without resort to the courts. Article 9 requires a commercially reasonable disposition with advertising to the public and notice to specified parties in interest. Although it is common to hear that, from a timing perspective, only 10 days' notice is necessary, that is an aggressive position, particularly in the context of a large commercial real estate financing. The accepted requirement has a practical orientation: through advertisement or public notice, the public should be provided with a meaningful opportunity for public bidding to ensure that the auction will garner the highest commercially reasonable price.[1] Consequently, the conservative course, particularly with larger mezzanine loans, is to provide information and notice periods and to ensure that through advertising and other means, the sale is well publicized in a manner consistent with reasonable non-foreclosure marketing.

The enforcement of the remedies is done through a non-judicial UCC foreclosure. The foreclosure, done in good faith, should be completed in as little as 30 to 60 days. In the case of property located in a jurisdiction that allows foreclosure of a mortgage in a correspondingly short time frame, a borrower may be more acclimated to the rapid foreclosure of a mezzanine loan, having already accepted that risk with respect to a mortgage loan. In contrast, in jurisdictions in which mortgage foreclosures take longer, and particularly through judicial foreclosures that present opportunities for defenses, motion practice and appeals, this can be a key change.

Although a mezzanine borrower can attempt to contest a mezzanine loan foreclosure through a court proceeding, it is difficult to maintain such an action in the case of a good faith foreclosure. To the extent that a bankruptcy would stay the foreclosure, the springing recourse provisions of the non-recourse carve-out guaranty are a strong deterrent to a bankruptcy filing.

A mortgage lender and a mezzanine lender enter into an intercreditor agreement governing their relationship. Although this agreement has a direct impact on many aspects of a mortgage loan and a mezzanine loan, mortgage and mezzanine borrowers are not party to this agreement and are not provided with a copy of the agreement as part of the documentation and closing process.

Intercreditor agreements generally address the following issues that are of particular concern to a mortgage borrower or a mezzanine borrower:

- Transfers of minority positions in a mezzanine loan may be permitted without the consent of a mortgage lender, subject to limitations on transfers to "bad actors" and compliance with anti-money laundering laws and the Patriot Act. Other transfers, including the entire mezzanine loan, may be permitted without mortgage lender consent if the transferee is a "Qualified Transferee." Qualified Transferees are defined in different ways, although the key parameters will be institutional character and satisfaction of financial criteria directly or through an affiliate.
- A purchase of the pledged equity interests at a foreclosure of a mezzanine loan by a mezzanine lender or a Qualified Transferee will not require the consent of a mortgage lender. Additional conditions may be that the Qualified Transferee has the ability on its own or through a third-party engagement to manage the property, and that the purchaser cure any existing mortgage loan defaults that are curable.
- In the event of a mortgage loan default, a mezzanine lender likely can require a mortgage lender to stand still for a designated period by curing a mortgage loan default. This standstill period can be used by a mezzanine lender to address a mezzanine loan default, including through a foreclosure of the pledged equity.
- A mezzanine lender has the option to purchase the senior loan at par for a particular period following a senior loan default. The purchase option price may exclude some items such as default interest and late charges.
- A mortgage lender and a mezzanine lender will limit their abilities to modify their respective loans without the other lender's consent. These modifications will range from changes in key financial terms to some transaction-specific items.
- The intercreditor agreement may subordinate a mezzanine lender's rights against a guarantor and, in some cases, the ability of a mezzanine lender to accept a payment from its guarantor at a time when a mortgage loan is outstanding.
- A mezzanine lender will have permission to pledge a mezzanine loan to secure its own financing. These provisions will afford some of a mezzanine lender's rights under the intercreditor agreement to its lender.
- Other common provisions include confirmation of subordination, providing copies of notices, coordination of additional advances in the case of loans having future advances, addressing the respective rights of the parties in a bankruptcy, and limiting a mezzanine lender's rights under the intercreditor agreement in the event that an affiliate of a borrower or a borrower has an interest in a mezzanine loan.

Although a mortgage borrower and a mezzanine borrower should not expect to be provided with a copy of a mezzanine loan intercreditor agreement, intercreditor agreements share many generic characteristics and examples are generally available. Notwithstanding the lack of uniformity of mezzanine intercreditor agreements, a mezzanine borrower and its counsel should familiarize themselves with key provisions of an intercreditor agreement.

PREFERRED EQUITY

Some borrowers may choose to meet their additional capital needs by seeking funds from preferred equity investors instead of more traditional mezzanine lenders or through a mezzanine loan structure. While structures for preferred equity vary, they are usually considered either "debt-like" preferred equity or "equity-like" preferred equity depending upon the orientation and requirements

of the investor. The "debt-like" preferred equity will more closely resemble the traditional mezzanine loan structure, including significant consent rights of the preferred equity holder and rights to exercise control over the joint venture entity, but without the pledge of entity interests or other collateral. The "debt-like" preferred equity structure will provide for mandatory returns and redemption dates that correspond in many respects to interest and principal payments on a mezzanine loan.

"Equity-like" preferred equity more closely resembles what we historically think of as preferred equity and often does not include the mandatory returns with specified dates, but often provides for a sponsor party to receive a promote interest, i.e., an increased return based on the level of return provided to the investors. In both cases, however, the preferred equity will be unsecured and structurally subordinate to repayment of the debt of the joint venture party or the mortgage debt secured by the underlying real property (but bearing a higher yield for the preferred equity holder). The preferred equity contribution of an investor is usually documented in the organizational agreement of the joint venture entity, typically the direct or indirect owner of the property-owning entity and borrower under the mortgage loan.

The preferred equity structure's primary default remedy is the right of a preferred equity holder to take over control of the venture, a measure comparable to completion of a foreclosure in a mortgage or mezzanine transaction. From the standpoint of a borrower, it is important to keep in mind that a preferred equity holder typically will require a recognition agreement to be entered into by the mortgage lender in order to protect and recognize the rights that the preferred equity holder has negotiated under the joint venture agreement and in particular, the takeover right that is a preferred equity holder's primary default remedy. Most mortgage lenders will resist this request on the grounds that the preferred equity holder is equity and not debt, and will argue that a preferred equity holder's rights are "baked" into the joint venture agreement. The mortgage lenders also will take the position that to the extent necessary, the loan documents should be negotiated by the borrower and the preferred equity provider to allow the changes in control and transfers that could occur with a preferred equity takeout and therefore do not need to be supplemented by an agreement from the mortgage lender. As with the intercreditor agreement between a mortgage lender and a mezzanine lender, the negotiation of a recognition agreement will not involve a borrower/sponsor party as an active participant.

CONCLUSION

Counsel for the sponsor party should carefully consider the rights to control the joint venture entity that are negotiated by a "debt-like" preferred equity holder, since the sponsor party might have liability under a non-recourse carveout guaranty under a mortgage loan, but with no control over the property or income stream. Often, a mortgage lender will require in a recognition agreement or the mortgage loan documents that a preferred equity holder provide a replacement guaranty in the event such holder exercises remedies to take control of the joint venture entity. In that event, the joint venture documentation should provide that a condition to a change of control event is that a preferred equity holder provide a mortgage lender with any required replacement guaranty. A borrower also should consider including in any guaranty provided to a mortgage lender that would be superseded by a replacement guaranty, a provision limiting liability following the preferred equity holder taking control.

Notes

1 Note that the 10 days' notice requirement appears in an Official Comment to section 9-610 rather than the statute itself, which speaks to the need for a commercially reasonable disposition.

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