

**Commercial Real Estate Mezzanine Lending:
Current Structural Features, Loan Document
Concepts and Intercreditor Issues**

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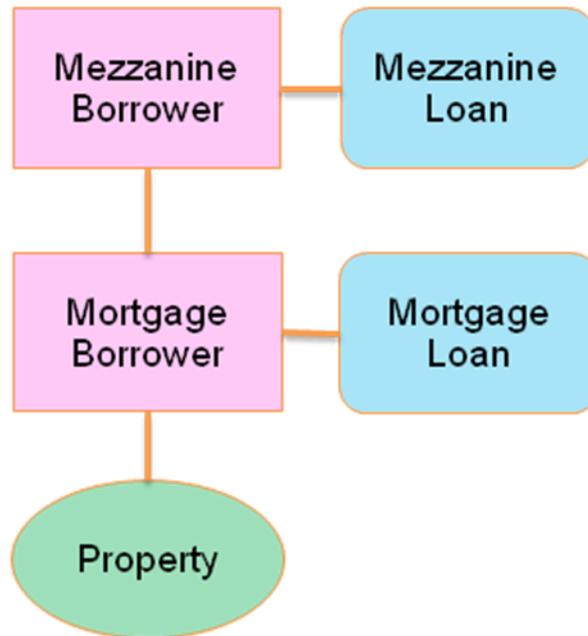
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TABLE OF CONTENTS

	Page
I. WHAT IS A MEZZANINE LOAN?	2
II. CHARACTERISTICS OF A MEZZANINE LOAN.....	3
III. COLLATERAL FOR A MEZZANINE LOAN	4
IV. UNIQUE MEZZANINE LOAN DOCUMENT PROVISIONS	8
V. MEZZANINE LOAN CONSIDERATIONS IN MORTGAGE LOAN DOCUMENTS.....	13
VI. INTERCREDITOR AGREEMENT ISSUES.....	14

I. WHAT IS A MEZZANINE LOAN

A. Generally, a mezzanine loan is a type of subordinate real estate financing that is secured by a pledge of 100% of the equity ownership interests in the owner of real property. The owner of the subject property will typically be a borrower under a first mortgage financing whereby the mortgage lender will be granted a first mortgage lien on the property. As reflected by the diagram below, the borrower under the mezzanine loan will be the 100% owner of the mortgage borrower/property owner:



B. To the extent a mortgage lender is willing to permit subordinate financing, a mezzanine loan is an attractive structure for both the mortgage lender and the mezzanine lender. As opposed to a second mortgage structure, the mortgage lender gets comfort that the mezzanine lender does not have a second lien on the property and the mezzanine lender is not a creditor of the mortgage borrower. The structure is attractive to mezzanine lenders as they can indirectly take title to the property from a foreclosure under the uniform commercial code (“UCC”), rather than an often time-consuming and expensive real property foreclosure.

C. Mezzanine lenders are typically lenders looking for a higher rate of return and who are willing to take on more risk. They can include, among others,

specialty finance companies, REITs, investment banks and life insurance companies.

D. It is becoming common to structure a loan with a mezzanine loan component at closing or to include provisions in the loan documents that allow for mezzanine financing at a future date after closing if certain economic tests and other conditions are met by the borrower.

II. CHARACTERISTICS OF A MEZZANINE LOAN

A. As with other forms of subordinate financing, mezzanine loans tend to have higher interest rates than mortgage loans. The increase in interest rate is due to the higher risk profile of a mezzanine loan as compared to the mortgage financing. One factor contributing to the higher rate of interest is that mezzanine loans are not secured by the real property. Any liens recorded against the related property, whether voluntary or involuntary, will have priority over the mezzanine loan.

B. The mezzanine loan will have a higher loan to value ratio than the mortgage loan. Generally, mortgage lenders will loan up to a certain percentage of the appraised value of the property. Mezzanine loans are used by borrowers to bridge the gap between the amount of proceeds advanced by the mortgage lender and borrower's equity in the property.

C. The mezzanine loan will typically mature on the same date as the related mortgage loan.

D. The mezzanine loan will typically have the same payment date as the related mortgage loan.

E. Mezzanine loans can have a fixed interest rate or a floating interest rate.

F. Mezzanine borrowers will typically be structured as single-purpose, bankruptcy remote entities, in the same manner and subject to the same requirements as the mortgage loan borrowers.

G. The mezzanine loan is serviced separately from the related mortgage loan and will have its own servicer. For convenience, the mezzanine lender may appoint the same servicer as the mortgage lender to process loan payments.

H. The key transaction documents for a mezzanine loan are:

1. Loan Agreement – the central agreement between the mezzanine borrower and the mezzanine lender setting forth the basic terms of the loan.

2. Pledge Agreement – the security agreement pursuant to which the mezzanine borrower pledges its 100% direct equity interest in the mortgage borrower as collateral security for the mezzanine loan.
3. Intercreditor Agreement – the governing agreement between the mortgage lender and the mezzanine lender, setting forth their respective rights and limitations. This agreement is not usually shared with the mortgage borrower or the mezzanine borrower as neither borrower is a party.

III. COLLATERAL FOR A MEZZANINE LOAN

- A. A mezzanine loan is secured primarily by a pledge of 100% of the direct equity interests in the owner of the property, who is the mortgage borrower. Typically, the mortgage borrower will be structured as a limited partnership or limited liability company. The creation, priority, perfection and enforcement of the mezzanine lender's security interest in such equity interests will be governed by the UCC.
- B. The Article 9 of the UCC provides that equity interests in partnerships and limited liability companies are defined as "general intangibles". The only method to perfect a security interest in a "general intangible" is to file a UCC-1 in the state of formation of the mezzanine borrower.
- C. Generally, mezzanine lenders will require that the equity pledged as security for the mezzanine loan be converted from an Article 9 general intangible to a "certificated security" governed by Article 8 of the UCC. By requiring Article 8 certificated securities, mezzanine lenders are able to take physical possession of the collateral and their priority is protected against bona-fide purchasers.
- D. In order to effectuate the conversion into Article 8 certificated securities, language similar to the following should be included in the mortgage borrower's operating agreement or limited partnership agreement, as applicable:

"Member's limited liability company interest in the Company shall be represented by the Shares (defined below) issued to Member by the Company. Member's Shares represent Member's entire limited liability company interest in the Company. Member hereby agrees that its interest in the Company and in the Shares shall for all purposes be personal property. Member has no interest in specific Company property. "**Shares**" means the limited liability company interest in the Company held by Member. The limited liability company interest in the Company shall constitute a "security" within the meaning of, and governed by, (i)

Article 8 of the Uniform Commercial Code (including Section 8-102(a)(15) thereof) as in effect from time to time in the State of New York and (ii) Article 8 of the Uniform Commercial Code of any other applicable jurisdiction that now or hereafter substantially includes the 1994 revisions to Article 8 thereof as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995. Notwithstanding any provision of this Agreement to the contrary, to the extent that any provision of this Agreement is inconsistent with any non-waivable provision of Article 8 of the Uniform Commercial Code as in effect in the State of New York (the "UCC"), such provision of Article 8 of the UCC shall control."

E. Each such certificate is denominated in terms of the percentage of the limited liability company interests in the mortgage borrower evidenced by such certificate and must be signed by a member or an officer on behalf of the mortgage borrower. A transfer of limited liability company interests in the mortgage borrower is effected by the mortgage borrower's registering the transfer upon delivery of an endorsed certificate representing the limited liability company or limited partnership interests being transferred. At closing, the certificate should be signed and endorsed in blank. A sample certificate is included below.

Sample Certificated Interest

"CERTIFICATE FOR

_____ LLC

THIS CERTIFICATE HAS NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT OF 1933 OR UNDER THE SECURITIES OR BLUE SKY LAWS OF ANY STATE. THE HOLDER OF THIS CERTIFICATE, BY ITS ACCEPTANCE HEREOF, REPRESENTS THAT IT IS ACQUIRING THIS SECURITY FOR INVESTMENT AND NOT WITH A VIEW TO ANY SALE OR DISTRIBUTION HEREOF. ANY TRANSFER OF THIS CERTIFICATE OR ANY LIMITED LIABILITY COMPANY INTEREST REPRESENTED HEREBY IS SUBJECT TO THE TERMS AND CONDITIONS OF THE LIMITED LIABILITY COMPANY AGREEMENT (AS DEFINED BELOW).

Certificate Number _____ % of Interests

_____ LLC, a Delaware limited liability company (the "Company"), hereby certifies that _____ (the "Holder") is the registered owner of _____ % of the limited liability company interests in the Company

(the "Interests"). THE RIGHTS, POWERS, PREFERENCES, RESTRICTIONS (INCLUDING TRANSFER RESTRICTIONS) AND LIMITATIONS OF THE INTERESTS ARE SET FORTH IN, AND THIS CERTIFICATE AND THE INTERESTS REPRESENTED HEREBY ARE ISSUED AND SHALL IN ALL RESPECTS BE SUBJECT TO THE TERMS AND PROVISIONS OF, THE LIMITED LIABILITY COMPANY AGREEMENT OF THE COMPANY, DATED AS OF _____, 20__, AS THE SAME MAY BE AMENDED OR RESTATED FROM TIME TO TIME (THE "AGREEMENT"). THE TRANSFER OF THIS CERTIFICATE AND THE INTERESTS REPRESENTED HEREBY IS RESTRICTED AS DESCRIBED IN THE AGREEMENT. By acceptance of this Certificate, and as a condition to being entitled to any rights and/or benefits with respect to the Interests evidenced hereby, the Holder is deemed to have agreed to comply with and be bound by all the terms and conditions of the Agreement. The Company will furnish a copy of the Agreement to the Holder without charge upon written request to the Company at its principal place of business. The Company maintains books for the purpose of registering the transfer of Interests.

Each limited liability company interest in the Company shall constitute a "security" within the meaning of, and governed by, (i) Article 8 of the Uniform Commercial Code (including Section 8-102(a)(15) thereof) as in effect from time to time in the State of Delaware, and (ii) Article 8 of the Uniform Commercial Code of any other applicable jurisdiction that now or hereafter substantially includes the 1994 revisions to Article 8 thereof as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995.

This Certificate shall be governed by and construed in accordance with the laws of the State of Delaware without regard to principles of conflicts of laws.

IN WITNESS WHEREOF, the Company has caused this Certificate to be executed by [_____] as of the date set forth below.

Dated: _____

Name:

Title:

(REVERSE SIDE OF CERTIFICATE
FOR INTERESTS OF _____ LLC)

FOR VALUE RECEIVED, the undersigned hereby sells, assigns and transfers unto _____ (print or typewrite name of Transferee), _____ (insert Social Security or other

taxpayer identification number of Transferee), the following specified percentage of Interests: _____ (identify the percentage of Interests being transferred), and irrevocably constitutes and appoints _____, as attorney-in-fact, to transfer the same on the books and records of the Company, with full power of substitution in the premises.

Dated: _____ Signature: _____
(Transferor)
Address:”

F. Mezzanine lenders should also be cognizant to include a provision in the mortgage borrower’s operating agreement or limited partnership agreement, as applicable, which provides that upon the foreclosure of the mezzanine lender’s pledge of mortgage borrower’s equity, the mezzanine lender will be automatically admitted as a member of the mortgage borrower. Without this provision, the foreclosing mezzanine lender could be exposed to an argument that even though the mezzanine lender owns 100% of the equity in the mortgage borrower, the mezzanine lender would not be able to direct the actions of the mortgage borrower without the consent of the mezzanine borrower. See below for a sample provision which should be included:

“Upon a foreclosure, sale or other transfer of the limited liability company interests of the LLC pursuant to that certain Pledge and Security Agreement (the “**Mezzanine Pledge Agreement**”), between Member and Mezzanine Lender, the holder of such membership interests shall automatically be admitted as the sole Member of the LLC upon such foreclosure, sale or other transfer, with all of the rights and obligations of all of the Members hereunder, at which time [Manager]¹ shall, at the option of such sole Member, be immediately terminated and have no further rights whatsoever with respect to the LLC or the Property. The LLC acknowledges that the pledge of the membership interest in the LLC made by the Member in connection with the Mezzanine Pledge Agreement shall be a pledge not only of profits and losses of the LLC, but also a pledge of all rights and obligations of all of the Members. Upon a foreclosure, sale or other transfer of the membership interests of the LLC pursuant to the Mezzanine Pledge Agreement, the successor Member may transfer its interests in the LLC as it deems necessary or desirable. The pledge of a membership interest in the LLC by the Member is, notwithstanding anything contained herein, permitted hereby and shall not cause the Member to cease to be a member of the LLC.”

¹ In the event the mortgage borrower is “manager managed”, the foreclosing mezzanine lender should have an explicit right to terminate the manager upon a foreclosure.

IV. UNIQUE MEZZANINE LOAN DOCUMENT PROVISIONS

In connection with the origination of a mezzanine loan, the common practice is to draft the mezzanine loan documents based closely on the related mortgage loan documents. Many of the negotiated deal terms, including representations and warranties, covenants, insurance provisions, events of default, and payment terms should be the same in the mortgage and mezzanine loans, so it is efficient and practical to base the mezzanine loan documents on the related mortgage loan documents. In addition to reflecting the specific deal terms related to the mezzanine loan, there are several unique provisions that should be added to the mezzanine loan documents.

A. Representations and Warranties Relating to Mortgage Loan. In addition to the customary representations and warranties regarding the property, the equity collateral and the borrower parties, the mezzanine borrower should make certain representations and warranties relating to the mortgage loan, including the following:

1. “All of the representations and warranties contained in the Mortgage Loan Documents are (i) true and correct in all material respects and (ii) hereby incorporated into this Agreement and deemed made hereunder as and when made thereunder and shall remain incorporated without regard to any waiver, amendment or other modification thereof by the Mortgage Lender or to whether the related Mortgage Loan Document has been repaid or otherwise terminated, unless otherwise consented to in writing by Lender.”

2. “No Mortgage Loan Event of Default or an event of circumstance has occurred which with the giving of notice or the passage of time, or both, would constitute a Mortgage Loan Event of Default exists as of the date hereof.”

B. Specific Covenants.

1. Liquidation Events. It is critical that the mezzanine loan documents contain a covenant that the mezzanine borrower be obligated to pay to Lender all amounts received by the mortgage borrower in connection with a casualty, condemnation, foreclosure of the mortgage loan or refinancing of the mortgage loan, net of certain approved deductions. As a result of the subordinate nature of a mezzanine loan, the mortgage lender will be entitled to receive proceeds from any of the foregoing first and prior to the mezzanine lender. In the event that there are excess proceeds after repayment of the mortgage loan, such amounts should be paid to the mezzanine lender rather than being distributed to the mortgage borrower’s equity owners. Below is a sample provision:

“(a) In the event of (i) any Casualty, (ii) any Condemnation, (iii) a foreclosure or deed-in-lieu of foreclosure of the property (a “**Mortgage Loan Foreclosure Transfer**”) or (iv) any refinancing of the Mortgage Loan (each, a “**Liquidation Event**”), Borrower shall cause Mortgage Borrower to cause the related Net Liquidation Proceeds After Debt Service to be deposited directly into an account designated by Lender (to be treated as a distribution by the Mortgage Borrower). On each date on which Lender actually receives a distribution of Net Liquidation Proceeds After Debt Service, such distribution shall be applied in the same manner as repayments under Section [] hereof, and such prepayment shall include any [Short Interest] and [Breakage Costs]. Notwithstanding anything to the contrary contained herein, each prepayment under this Section shall be applied in inverse order of maturity and shall not extend or postpone the due dates of the monthly installments due under the Note or this Agreement, or change the amounts of such installments.

(b) Borrower shall notify Lender of any Liquidation Event not later than three (3) Business Days following the first date on which Borrower has knowledge of such event. Borrower shall be deemed to have knowledge of a Mortgage Loan Foreclosure Transfer on the date notice of such Mortgage Loan Foreclosure Transfer is given to Mortgage Borrower and a refinancing of the Mortgage Loan on the date on which a commitment for such refinancing has been entered into by Mortgage Borrower. The provisions of this Section shall not be construed to contravene or modify in any manner the restrictions and other provisions regarding refinancing of the Mortgage Loan or Transfers set forth in this Agreement.”

“**Net Liquidation Proceeds After Debt Service**” mean with respect to any Liquidation Event, all amounts paid to or received by or on behalf of Mortgage Borrower in connection with such Liquidation Event, including, without limitation, proceeds of any sale, refinancing or other disposition or liquidation, less (i) in the event of a Liquidation Event consisting of a Casualty or Condemnation, Lender’s, Mortgage Borrower’s and/or Mortgage Lender’s reasonable costs incurred in connection with the recovery thereof, (ii) in the event of a Liquidation Event consisting of a Casualty or Condemnation, the costs incurred by Mortgage Borrower in connection with a Restoration in accordance with the Mortgage Loan Documents, (iii) in the event of a Liquidation Event consisting of a Casualty, Condemnation or Mortgage Loan Foreclosure Transfer, amounts required or permitted to be

deducted therefrom and amounts paid pursuant to the Mortgage Loan Documents to Mortgage Lender, (iv) in the event of a Liquidation Event consisting of a Casualty or Condemnation, those proceeds paid to Mortgage Borrower pursuant to Section [] of the Mortgage Loan Agreement as a surplus that remains out of the Net Proceeds, (v) in the case of a Mortgage Loan Foreclosure Transfer, such reasonable and customary costs and expenses of sale or other disposition (including attorneys' fees and brokerage commissions), (vi) in the case of a Mortgage Loan Foreclosure Transfer, such costs and expenses incurred by Mortgage Lender under the Mortgage Loan Documents as Mortgage Lender shall be entitled to receive reimbursement for under the terms of the Mortgage Loan Documents, (vii) in the case of a refinancing of the Mortgage Loan, such costs and expenses (including attorneys' fees) of such refinancing, and (viii) the amount of any prepayments required pursuant to the Mortgage Loan Documents in connection with any such Liquidation Event.”

2. Mortgage Borrower Covenants. The mezzanine loan documents should require the mezzanine borrower to cause the mortgage borrower to comply with the provisions of the mortgage loan documents. This is possible because the mezzanine borrower is the 100% owner of the mortgage borrower and can cause the mortgage borrower to take actions (i.e. comply with the mortgage loan documents). It is important that the mezzanine lender require compliance with the mortgage loan documents, because an event of default under the mortgage loan could result in a mortgage loan foreclosure which would render the equity collateral securing the mezzanine loan worthless. The mezzanine loan documents should also include covenants prohibiting the amendment of the mortgage loan or purchase of the mortgage loan without the mezzanine lender's consent. Examples of these covenants include the following:

“(a) Borrower shall cause Mortgage Borrower, in a timely manner, subject to any applicable cure periods under the Mortgage Loan Documents, to observe, perform and fulfill each and every covenant, term and provision of each Mortgage Loan Document whether the Mortgage Loan has been repaid or the applicable Mortgage Loan Document has been terminated, unless otherwise consented to in writing by Lender.”

“(b) Borrower shall not cause or permit Mortgage Borrower to (i) enter into any document evidencing or securing the Mortgage Loan that is not a Mortgage Loan Document on the Closing Date, (ii) enter into any amendment, material modification, consolidation,

restatement, supplement, waiver or termination of any Mortgage Loan Document (other than any such termination that is effected pursuant to the terms of the Mortgage Loan Agreement as in effect on the Closing Date) shall be subject to Lender's approval, which approval shall not be unreasonably withheld or conditioned. Notwithstanding anything to the contrary in this Section [___], provided an Event of Default shall not have occurred and be continuing, whenever Lender's approval or consent is required pursuant to the provisions of this Section [___], Lender shall use good faith efforts to respond within ten (10) Business Days after Lender's receipt of Borrower's or Mortgage Borrower's written request for such approval or consent. If Lender fails to respond to such request within ten (10) Business Days, and Borrower or Mortgage Borrower sends a second written request containing a legend in bold letters stating that Lender's failure to respond within an additional five (5) Business Days shall be deemed consent or approval, Lender shall be deemed to have approved or consented to the matter for which Lender's consent or approval was sought if Lender fails to respond to such second written request before the expiration of such five (5) Business Day period."

"(c) None of Borrower, Mortgage Borrower, Guarantor or any Affiliate of any of the foregoing shall acquire or agree to acquire the Mortgage Loan, or any portion thereof or any interest therein, via purchase, transfer, exchange, operation of law or otherwise. If Borrower, Mortgage Borrower, Guarantor or any Affiliate of any of the foregoing shall have failed to comply with the foregoing, then Borrower shall (i) immediately notify Lender of such failure and (ii) cause any and all such Persons acquiring any interest in the Mortgage Loan Documents (A) not to enforce the Mortgage Loan Documents, and (B) upon the request of Lender, to the extent any of such Persons has or have the power or authority to do so, to promptly (1) cancel the promissory note evidencing the Mortgage Loan, (2) reconvey and release the liens securing the Mortgage Loan and any other collateral under the Mortgage Loan Documents, and (3) discontinue and terminate any enforcement proceeding(s) under the Mortgage Loan Documents. Notwithstanding the foregoing, it shall not constitute a breach of the foregoing covenants if Guarantor acquires any subrogation claim in respect of the Mortgage Loan solely by operation of law as a result of a payment under the guaranty executed in connection with the Mortgage Loan, provided that, promptly after acquiring any such subrogation claim, Guarantor agrees in writing that it shall not enforce the same until payment in full of the Debt."

3. Prepayment of Mortgage Loan. Prepayments of the mortgage loan and mezzanine loans are often a source of contention amongst the deal parties. The mortgage lender would prefer that all prepayments go to the mortgage loan first as it is senior in priority to the mezzanine loan, while the borrower would prefer to prepay the mezzanine loan first as it accrues at a higher interest rate. Often a compromise is reached where to the extent there is a prepayment the mortgage loan and mezzanine loan are prepaid simultaneously on a pro-rata basis.

4. Cross Default. The mezzanine loan documents must provide that that the occurrence of an event of default under the mortgage loan documents is an immediate event of default under the mezzanine loan documents. As a foreclosure of the mortgage loan would be devastating to the mezzanine loan (i.e., (i.e., loss of complete value of the mezzanine loan), the cross default allows the mezzanine lender to protect its investment by foreclosing on the equity collateral and exercising its rights to cure the mortgage loan under the related intercreditor agreement. Typically, a mezzanine loan foreclosure can be successfully completed in less time than it takes to complete a mortgage loan foreclosure.

5. Irrevocable Article 8 Proxy. In addition to requiring that the mortgage borrower governing documents contain certain language regarding Article 8 of the UCC as previously discussed above², the mezzanine loan documents should also contain a voting proxy from the mezzanine borrower relating to all of the mezzanine borrower's rights to vote as a member of the mortgage borrower.

“Solely with respect to Article 8 Matters (as hereinafter defined), Pledgor hereby irrevocably grants and appoints Lender, from the date of this Agreement until the termination of this Agreement in accordance with its terms, as Pledgor's true and lawful proxy, for and in Pledgor's name, place and stead to vote the Pledged Securities, whether directly or indirectly, beneficially or of record, now owned or hereafter acquired, with respect to such Article 8 Matters. The proxy granted and appointed in this Section shall include the right to sign Pledgor's name (as a member of Mortgage Borrower) to any consent, certificate or other document relating to an Article 8 Matter that applicable law may permit or require, to cause the Pledged Securities to be voted in accordance with the preceding sentence. Pledgor hereby represents and warrants that there are no other proxies and powers of attorney with respect to an Article 8 Matter that Pledgor has granted or appointed. Pledgor

² This language is commonly referred to as the “Article 8 opt-in” language.

will not give a subsequent proxy or power of attorney or enter into any other voting agreement with respect to the Pledged Securities with respect to any Article 8 Matter and any attempt to do so with respect to an Article 8 Matter shall be void and of no effect. The proxies and powers granted by Pledgor pursuant to this Agreement are coupled with an interest and are given to secure the performance of Pledgor's obligations under the Loan Documents. As used herein, "Article 8 Matter" means any action, decision, determination or election by Mortgage Borrower or its member(s) that its limited liability company interests be, or cease to be, a "security" as defined in and governed by Article 8 of the Code, and all other matters related to any such action, decision, determination or election."

V. MEZZANINE LOAN CONSIDERATIONS IN MORTGAGE LOAN DOCUMENTS

In addition to the specific provisions discussed above which are to be included in the mezzanine loan documents, it is also important when representing a mezzanine lender that the mortgage loan documents are reviewed carefully to confirm that they function properly with a mezzanine loan. The following issues should be considered:

- A. Cross Default. The mortgage loan must not be cross-defaulted with the mezzanine loan. A default under the mezzanine loan should not create a default under the mortgage loan documents. This would allow the mortgage lender to exercise remedies against the property while the mezzanine lender is either foreclosing or attempting to workout the mezzanine loan and while the mortgage loan may otherwise be performing and not suffering any independent default.
- B. Pledge and Foreclosure. The mortgage loan documents must expressly permit the pledge of any direct or indirect interest in the mortgage borrower in connection with the mezzanine loan and the exercise of any rights or remedies that the mezzanine lender may have under the mezzanine loan documents. Mortgage loan document transfer restrictions typically restrict pledges and transfers of the equity interest in the mortgage borrower. Without these exceptions, the making of the mezzanine loan would cause a default under the mortgage loan documents and not allow a mezzanine lender to protect its interest by exercising its remedies under the mezzanine loan documents.
- C. Recourse. The pledge of equity interest in connection with the mezzanine loan and any foreclosure of the mezzanine loan must not be a recourse event under the mortgage loan. Without this exception, the sponsorship of the mortgage and mezzanine borrowers would be motivated to fight a foreclosure of the mezzanine loan, even if the value of the property was less than the total amount of the mortgage loan and mezzanine loan, because the transfer of 100% of the equity

interests in the mortgage borrower would likely result in a full recourse event under the mortgage loan. Also, as stated above in B., mezzanine lenders insist on this drafting point so they can successfully foreclose their mezzanine loan without causing further financial stress and complexity to the property and the borrower.

D. Insurance/Condemnation Proceeds. In the event the mortgage borrower is entitled to any insurance and/or condemnation proceeds after completion of restoration, the mortgage lender should agree to provide those amounts to the mezzanine lender. As discussed with respect to Liquidation Events above, this provision is additional protection to the mezzanine lender to ensure that excess proceeds are paid to the mezzanine lender rather than to the mortgage borrower's equity ownership.

E. Reserves. In the event the mortgage loan is repaid and the mezzanine loan remains outstanding, the mortgage lender should agree to transfer all amounts held in any mortgage loan reserve accounts to the mezzanine lender. This gives the mezzanine lender the right to obtain the benefit of any additional collateral held by the mortgage lender, rather than such amounts going back to the mortgage borrower. Typically, a mezzanine lender will not hold reserve funds as additional collateral for the mezzanine loan because they are being reserved for by the mortgage lender.

VI. INTERCREDITOR AGREEMENT ISSUES

A. In connection with the origination of a mezzanine loan, the related mortgage lender will often require the mezzanine lender to enter into an intercreditor agreement. The intercreditor agreement generally benefits both the mortgage lender and mezzanine lender. The mortgage lender gains comfort that (1) the mezzanine loan is subordinate in structure and payment to the mortgage loan and (2) mezzanine loan transfers are generally restricted. The mezzanine lender often gains the right to: obtain notice of, and the right to cure, mortgage loan defaults, purchase the mortgage loan and foreclose on the mezzanine loan collateral. The mortgage lender and mezzanine lender also exchange various representations and warranties relating to the ownership and status of the mortgage and mezzanine loans respectively.

B. In the real estate capital markets industry, most mezzanine loan intercreditor agreements are based upon the CREFC³ form intercreditor agreement, though the market has adopted a number of modifications since it was originally published. Also, lenders have modified the form agreement in certain ways that are unique to their lending requirements. In short, although these

³ CRE Finance Council (CREFC) is a trade organization in the commercial real estate finance space. More information can be found at <http://www.crefc.org/>.

agreements are typically based on the same form, they can vary dramatically from deal to deal and from lender to lender.

C. Mezzanine Lender Rights:

1. Foreclosure/Exercise of Control Rights. Generally, intercreditor agreements provide that the mezzanine lender can realize on its separate collateral other than equity collateral (e.g., cash reserves or accounts) at any time. To exercise any remedies with respect to the equity collateral certain conditions must be met:

a. The transferee taking title to the equity collateral is a “Qualified Transferee”. This is usually a person that meets certain eligibility requirements (i.e. meeting a specified asset test). The mezzanine lender and its affiliates are often pre-approved in the agreement as Qualified Transferees.

b. Within thirty days after the foreclosure, a “Qualified Manager” is required to manage the underlying property. This is usually a person that meets a specified experience test (i.e. manages a certain number of properties that are similar to the underlying property, has a certain number of years of experience etc.).

c. A party meeting specified net worth and liquidity tests provides to the mortgage lender supplemental recourse carve-out guaranties. It is important to the mortgage lender that a party with assets will stand behind the replacement guaranty as it gives the mortgage lender comfort that the replacement guarantor will be unwilling to take bad acts and put its assets at risk.

In addition to the forgoing, some mortgage lenders require that certain defaults under the mortgage loan be cured prior to the mezzanine lender’s foreclosure on the equity collateral. Mortgage lenders generally fall into three camps on this issue:

a. All mortgage loan defaults must be cured as a condition precedent to mezzanine lender’s foreclosure on the equity collateral (excluding those defaults that cannot be cured without taking title to the equity collateral). This is the most difficult scenario for the mezzanine lender. If the mortgage loan has been accelerated, for a mezzanine lender to successfully cure all defaults under the mortgage loan, the mortgage loan must be paid in full by the mezzanine lender as a condition precedent to a foreclosure.

b. All monetary mortgage loan defaults must be cured as a condition precedent to mezzanine lender's foreclosure on the equity collateral (excluding the payment of full of the loan).

c. No cure of mortgage loan defaults as condition precedent to equity foreclosure. This is the most favorable case for the mezzanine lender and the standard that is generally found in the capital markets. The mortgage lender gains comfort because as a condition precedent to foreclosure the mezzanine lender must provide an additional recourse carve out guaranty and if the mezzanine lender does not cure outstanding defaults after foreclosure, the mortgage lender will have the right to foreclose on the mortgage loan.

In nearly all cases, mortgage lenders will not require the cure of mortgage loan defaults that are not curable by the foreclosing mezzanine lender and do not have a material adverse affect on the use, value or operation of the property. An example would be the failure of the mortgage borrower to deliver to the mortgage lender financial statements of its parent. This default is personal to the borrower and a third party mezzanine lender would be hard pressed to be able to cure this default.

2. Cure Rights. Generally mortgage lenders grant mezzanine lenders monetary and non-monetary cure rights under an intercreditor agreement. Prior to exercising remedies under the mortgage loan documents, the mortgage lender will provide the mezzanine lender with written notice of the underlying default and provide an opportunity to cure such default.

a. Monetary Cures. In the event of a monetary event of default, mortgage lenders will provide mezzanine lenders the right to cure monetary defaults within five (5) to ten (10) business days after mezzanine lender's receipt of notice of such default. Generally, mezzanine lenders only have a limited number of monetary cures. They can range from as few as four (4) cures for the life of the mortgage loan to as many as six (6) consecutive cures. Notwithstanding the cap on cures, mezzanine lenders will generally be able to continue curing monetary defaults so long as they are diligently and continuously exercising remedies against the equity collateral (i.e., foreclosing on the equity collateral under the mezzanine loan documents).

b. Non-Monetary Cures. In the event of a non-monetary event of default, mortgage lender will provide mezzanine lender the right to cure such monetary default within the later of (i) the same period the mortgage borrower has to cure such default, plus

ten (10) business days and (ii) 30 days after mezzanine lender's receipt of notice of such default. Such period is often extended for the period necessary for mezzanine lender to effectuate such cure for so long as the default does not materially impact the use, value or operation of the property or the mezzanine lender is diligently and continuously exercising remedies against the equity collateral. Typically, a mezzanine lender's right to cure defaults will expire upon a bankruptcy of the mortgage borrower.

3. Purchase Option. Under the intercreditor agreement, the mortgage lender typically grants the mezzanine lender the right to purchase the mortgage loan upon the occurrence of certain conditions, usually the acceleration of the mortgage loan or in the event the mortgage lender has commenced exercising remedies. The purchase option will expire upon the earlier of the cessation of the event that triggered the purchase option or the foreclosure of the mortgage loan.

Generally, the mortgage lender must provide the mezzanine lender notice of the occurrence of any of the foregoing triggers. Upon receipt of such notice the mezzanine lender may elect to purchase the mortgage loan by delivering a purchase election notice and closing within ten (10) business days. The mortgage loan option purchase price is generally the sum of the outstanding principal balance of the mortgage loan, plus accrued interest, plus any other costs incurred by the mortgage lender (including any workout fees or liquidation fees due to the mortgage lender's special servicer). Generally, default interest, exit fees, prepayment premiums and other such fees are excluded from the purchase price. These fees are often excluded because the mortgage lender is eager to be paid off when the loan is in default and is willing to accept only the outstanding principal balance of the mortgage loan, plus accrued interest, and any costs it actually incurred.

In connection with negotiating the purchase option right, the mezzanine lender will typically want to build deed-in-lieu protection in to the intercreditor. A deed-in-lieu of the mortgage loan is as devastating to the mezzanine loan as a mortgage foreclosure (i.e., loss of complete value of the mezzanine loan), the only difference is it can happen much faster. As a backstop to any agreement in the intercreditor agreement relating to a deed in lieu, the mezzanine lender will want the mezzanine loan documents to restrict the mezzanine borrower from causing the mortgage borrower to grant a deed-in-lieu to the mortgage lender. In the event the mortgage lender intends to take a deed-in-lieu from the mortgage borrower it should be required to provide the mezzanine lender notice and a chance to purchase the loan at the mortgage loan purchase price. Some

mezzanine lenders are able to gain further protection by having the purchase option right continue for a period even after the mortgage lender has taken title to the property through a deed-in-lieu. In this event, the mezzanine lender also has to pay the costs that the mortgage lender incurred to take title to the property through a deed-in-lieu, such as transfer taxes.

4. Mortgage Loan Modifications. Under a typical intercreditor agreement, mezzanine lenders are often granted consent rights over certain mortgage loan modifications, which include:

- a. increasing the interest rate, principal balance or any other material monetary obligation;
- b. obtaining any contingent interest or equity kicker or imposing new fees;
- c. extending the prepayment lockout period or increasing prepayment fees;
- d. imposing financial covenants or making existing ones more restrictive;
- e. shortening or extending the maturity date;
- f. changing the transfer restrictions of the mezzanine loan;
- g. changing the cash management provisions of the mezzanine loan; or
- h. cross-defaulting the mezzanine loan with any other debt.

Note that a mezzanine lender will lose its consent rights to many of these modifications if the mortgage loan is in default and the mezzanine lender's cure period has expired. If the mezzanine lender is not curing defaults under the mortgage loan, the mortgage lender will see this as a sign that the mezzanine lender is not interested in protecting its investment, therefore the mortgage lender should be free to work out the mortgage loan as it sees fit without having to wait for the mezzanine lender's cure period(s) to expire.

5. Affiliated Borrower Mezzanine Lender. Intercreditor agreements will generally restrict the mezzanine lender's right to transfer the mezzanine loan to the mortgage borrower, the mezzanine borrower or any affiliate thereof. This is an important issue for mortgage lenders as

borrower affiliated mezzanine lenders can use their rights as mezzanine lender as a “second bite at the apple”. For example, if the mortgage borrower defaults in making a mortgage loan payment, the affiliated mezzanine lender would have the right, under the intercreditor agreement, to cure that payment, effectively granting the borrower a notice and cure period for all defaults.

The issue is generally addressed in two ways. First, there could be an outright prohibition on transfers of the mezzanine loan to affiliates of borrower. The other method is to permit such transfers, but, upon such transfer, the affiliated mezzanine lender would no longer be permitted to exercise any rights under the intercreditor agreement (i.e. no right to foreclose, cure, purchase the mortgage loan or have consent rights over mortgage loan modifications).

A sample disability provision from a capital markets intercreditor agreement is as follows:

“Section [___]. Affiliated Mezzanine Lender. Notwithstanding anything in this Agreement to the contrary, in the event that at any time the Mezzanine Loan (or any portion thereof or interest therein) is held by an Affiliated Mezzanine Lender, such Person shall have no rights under Sections 5, 6, 8, 10, 12, 13, 14, 15 or 16 hereof, may not take an Equity Collateral Enforcement Action and may not engage in a Mezzanine Loan Modification without Senior Lender’s prior written consent, which may be withheld in its sole discretion.

“Affiliated Mezzanine Lender” shall mean an owner of all or any portion of the Mezzanine Loan (or any interest therein) who (i) owns, directly or indirectly, more than twenty-five percent (25%) of the direct or indirect ownership interests in Borrower or Mezzanine Borrower or (ii) has the power, directly or indirectly, to direct or cause the direction of the management or policies of Borrower or Mezzanine Borrower, whether through the ability to exercise voting power, by contract or otherwise (but excluding any such ability arising solely through operation of the Mezzanine Loan Documents).”

A corollary issue often negotiated by mortgage and mezzanine lenders is how a “borrower affiliated mezzanine lender” is defined in the intercreditor agreement. For certain mortgage lenders, a person will not be deemed to be a “borrower affiliated mezzanine lender” unless it owns at least 25% of the direct or indirect interest of the mortgage borrower or

controls the mortgage borrower. More conservative mortgage lenders are often more restrictive, and will deem a person to be a “borrower affiliated mezzanine lender” if it owns any interest in the mortgage borrower.