BARTON BENSON JONES

DOCUMENTATION FOR MEZZANINE LOANS, INCLUDING INTER-CREDITOR AGREEMENTS

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He has been engaged in the private practice of law in Texas since 1969, consisting of six (6) years in Corpus Christi, 13 years in Austin and the period since 1988 in San Antonio.

He is currently the senior member of Barton, East & Caldwell, P.L.L.C., a fifteen-lawyer firm in San Antonio, Texas, that was founded in 1993. He is Board Certified in Commercial Real Estate Law by the Texas Board of Legal Specialization and his law practice consists primarily of representing real estate developers and investors in commercial real estate transactions.

Mr. Barton is a fellow of the American College of Real Estate Lawyers. He was a member of the Real Estate Forms Committee of the State Bar of Texas during 1986-2017 and is currently an advisor to the Committee. He served two four-year terms as a member of the Council of the Real Estate, Probate and Trust Law Section of the State Bar of Texas. He served a three-year term as a member of the Commission of the Texas Board of Legal Specialization that administers the annual examinations for board certification of real estate legal assistants. He is a Sustaining Life Member of the Texas Bar Foundation, which named him as one of its five 2016 Outstanding 50 Year Texas Lawyers.

Texas Lawyer chose Mr. Barton as one of five finalists for the first and second "Go To" Texas Real Estate Attorney awards for 2007 and 2012. He was selected as a Texas Super Lawyer in 2003-2016 by Texas Monthly and Law & Politics Magazine, including recognition as one of the Top 50 Lawyers in Central and South Texas in 2006-2007, one of the Top 50 Lawyers in Central and West Texas in 2009-2012 and one of the Top 100 Texas Super Lawyers in 2007. He was designated as one of San Antonio's Best Attorneys in Scene in SA Monthly in 2004-2016.

He was listed in The Best Lawyers in America (Real Estate) (1987-1988 and 1997-2016) Woodward White; and named The Best Lawyers in America Lawyer of the Year in real estate in San Antonio (2014) Woodward White.

He was selected as one of two Outstanding San Antonio Real Estate Lawyers by San Antonio Business Journal (2012).

Mr. Barton received the fourth annual lifetime achievement award from the Real Estate, Probate and Trust Law Section of the State Bar of Texas in 2003 for contributions by a distinguished Texas real estate lawyer.

He received the Ralph A. Mock Award from Texas Lawyers Concerned for Lawyers in 2009 in recognition of his assistance to impaired lawyers in Texas and was the 2012-2013 president of that organization.

He is a member of the Founders Council of the Embrey Real Estate Finance and Development Department of the School of Business of the University of Texas at San Antonio and of the Real Estate Council of San Antonio. He recently served on the Relocation Committees for the San Antonio Children's Museum and Dress for Success – San Antonio.

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I. INTRODUCTION

This presentation addresses some of the issues which may arise among a borrower and two lenders in a situation where the lenders are both providing financing to the borrower for an individual real estate transaction. The issues with which we are concerned here arise where the financing (the "senior financing") provided by one of the creditors (the "senior lender") will be secured by superior encumbrances on the property (the "senior liens") and the financing (the "junior financing") provided by the other creditor (the "junior lender") may constitute either traditional subordinate debt financing which is secured by subordinate encumbrances on the property (the "junior liens") or so-called "mezzanine financing" or "soft debt" which is secured by security interests in the ownership of the borrower or equity capital contributions to the borrower. For simplicity's sake, the term "junior lender" is used to refer to the party providing the junior financing, however the junior financing may be structured or secured, if at all.

Although this presentation typically discusses these issues in the hypothetical context of assembling a new package of senior financing and junior financing in connection with the development of a new property or the acquisition of an existing property by a new owner, these issues can arise in other circumstances. These issues could also arise, for example, in a situation where an owner is attempting to obtain junior financing for the improvement or operation of an existing property and the owner is required to seek the consent of a senior lender in order to obtain or consummate the junior financing. In that situation, the senior lender may seek to impose conditions for granting such consent which will have to be negotiated and resolved between the senior lender and the junior lender in order to achieve the owner's financing objectives. The same issues could arise in a reverse manner, such as the situation where part, but not all, of existing senior financing is being refinanced with new senior financing and the former senior lender is being asked to convert the remaining balance of the former senior financing into junior financing and to become a junior lender with respect to that portion of the financing.

It should be noted that there is a distinction between the concept of the subordination of the liens which secure junior financing to the liens securing senior financing and the concept of the subordination of the junior financing itself to the payment of the senior financing. This distinction will arise at several points in the discussion which follows.

This presentation does not deal with the sometimes similar, but usually quite different, types of issues which can arise between creditors which contemplate providing financing with respect to a real estate project which will actually constitute successive loans of the same order of priority. In other words, we are not discussing here the types of issues which should be negotiated in a buy-sell agreement or a tri-party agreement involving a construction lender providing construction financing for a new real estate project and a permanent lender which has agreed to provide take-out financing replacing the construction loan upon the completion of construction of the project (a situation which is not often encountered in the author's current law practice). Also not addressed here are the issues which may arise among lenders subscribing to shares of a syndicated loan or between a lead lender and the participants in a participated loan.

II. POSSIBLE SCENARIOS

The emergence of these financing and inter-creditor issues in recent years results from the efforts by some institutional senior lenders to reduce their exposure to the risks of specific real estate projects. These senior lenders have sought to reduce their lending commitments from the levels of 70-75% of the value of the mortgaged properties which might have been acceptable at the beginning of the current development cycle to a level of closer to 50% percent of those values. Since most developers are either unable or unwilling to satisfy the resulting additional 20-25% funding requirements themselves, a need has arisen for obtaining financing from other sources to bridge the gap between the reduced senior financing and the 25-30% of conventional equity financing. In many cases, the junior financing for the gap is being provided in the form of debt financing to the borrower secured by security interests in the ownership of the borrower. In other cases, the junior lender insists on securing the junior financing for the gap with junior liens on the real estate itself.

Most senior lenders have had few, if any, concerns where the junior financing is being provided by junior lenders by means of equity-type transactions. Some of the more traditional senior lenders have balked at the "soft debt" transactions involving security interest in the ownership of the borrower, apparently out of a concern for the pressure that even "soft debt" can place on a real estate project and owner. However, concerns by senior lenders have been far more prevalent where junior lenders have wanted the junior financing to be secured by junior liens on the real estate itself.

On the other hand, from the perspective of the junior lender, issues of the type discussed below can arise any time a third-party is providing equity or debt financing for a real estate project which is encumbered by senior liens. Regardless of how the junior financing is structured, the person providing that junior financing is going to be interested in attempting to obtain from the senior lender a number of the protective agreements which are discussed in this presentation. It is for this reason that we have used the term “junior lender” to include institutional equity investors and providers of “soft debt” financing, as well as lenders whose loans are secured by subordinate liens on the subject real estate.

A typical commercial junior lender is often motivated to provide junior financing for a real estate transaction by having a contingent interest arrangement or profit participation interest which it is contemplated will produce a return on the junior lender’s investment in the transaction that will augment the stated interest or other preferred return on its investment and will justify the additional risk which the junior lender is incurring. Some junior lenders, such as governmental agencies or non-profit organizations, are motivated by social objectives in providing junior financing, such as increasing the stock of decent affordable housing for lower-income residents or encouraging the development of manufacturing jobs in a community. In almost all cases, however, junior lenders are motivated by a desire to preserve the principal of the junior financing and to reduce the risk of losing that principal by reason of a foreclosure of the senior liens.

III. SELECTED ISSUES PERTAINING TO MEZZANINE FINANCING

A. General.

The following discussion is not intended to address issues that are common to both mezzanine financing and conventional real estate financing. The issues that are discussed here are perceived by the author to be of special relevance in negotiating a mezzanine loan.

B. Hypothetical Transaction.

Except as noted below, the type of mezzanine loan that is being considered here will usually have the following general features for what we will assume is a newly-constructed, market-rate rental multi-housing project. The project sponsor obtains a conventional first-lien construction loan from a bank or other construction lender for approximately 50% of the cost of the project. The borrower of that loan is a single-purpose entity (“SPE”) owned by the sponsor and its affiliates that will be the owner of the property being constructed. The project sponsor also obtains a mezzanine loan to the SPE from a life insurance company or other lender which will provide approximately 25% of the cost of the project and will be secured by security interests in the ownership interests in the SPE and not by liens on the property. Finally, the project sponsor makes or obtains conventional equity investments from its own resources or third parties for the remaining approximately 25% of the cost of the project. Each tranche of this contemplated financing has different priorities and economic characteristics that are discussed below.

The lender of the construction loan senior financing would be entitled to receive principal, interest and an origination fee in accordance with then customary underwriting requirements, except that the construction loan would constitute a lesser percentage of the total capital required for the project.

The lender of the mezzanine loan junior financing would typically be entitled to receive principal, interest and an origination fee, typically at somewhat higher rates in recognition of the higher risk being assumed by the mezzanine lender than the senior lender. Some mezzanine lenders also charge prepayment or exit fees equal to a percentage of the sale or refinancing proceeds received by the borrower. These issues are addressed in some greater detail below.

The equity investors would receive the remaining economic benefits from the project, with the sponsor typically receiving a promoted interest in those benefits after the third-party investors have received a return of their investment and a return on their investment in an agreed percentage.

C. Cost Overruns and Operating Deficits.

The developer will usually be responsible for overruns in the “hard costs” of constructing the project in both true equity transactions and mezzanine loan transactions. On the other hand, the parties to an equity transaction will often agree to be jointly responsible for bearing overruns in the so-called "soft costs" of developing and/or rehabilitating and stabilizing a project in accordance with their respective residual profits percentages. A project's "soft costs" include all other categories of costs required to develop, complete and stabilize a project, such as architectural, engineering, legal and other professional fees, permitting fees and other entitlement costs, financing fees and interest costs, marketing and lease-up costs and operating expenses incurred during the development and lease-up period. In retail, office or industrial projects, soft-costs can also include leasing commissions and leasehold improvement costs. These soft costs are subject to variances for events such as changes in regulatory policies, fluctuations in interest rates and delays in implementing the lease-up of a project over which the developer cannot exert much, if any, control. Accordingly, the parties will often agree to shoulder a proportionate mandatory contribution obligation for cost overruns in these categories. Contributions for such soft-cost overruns will usually be characterized as being reimbursable out of future distributions of net cash flow or net proceeds of sale or refinancing as described below. Sometimes, however, the parties agree that such proportionate contributions will be recouped, if at all, simply from the residual distributions of profits.

In most situations, the developer and investor involved in an equity transaction will agree that contributions required to defray operating deficits which are incurred after the construction or renovation of the project is completed and lease-up has been accomplished will be funded by the parties in accordance with their ultimate residual ownership percentages in the partnership. The obligation to make such additional contributions is often characterized as being a non-recourse liability, however, which is enforceable only by means of a dilution or loss of the defaulting partner's interest in the partnership. Dilution provisions are often difficult to negotiate because of (i) uncertainty as to the projected equity value of the project to be used as the denominator of the dilution formula and (ii) differences of opinion as to the weight to be given defaulted contributions by the developer and the investor in comparison with each other, in light of the fact that the investor's original contributions are usually in the form of cash and the developer's original contributions are usually in the form of so-called “sweat equity” and/or a disproportionately small amount of cash. This difficulty is often resolved by using a “default loan” procedure under which a defaulting partner's share of an additional capital contribution is provided by other partners by means of a deemed loan to the defaulting partner that is paid (with bonus interest) from amounts that would have otherwise been distributed by the equity venture to the defaulting partner in the future.

In a soft-debt participating or mezzanine loan transaction, on the other hand, the absence of a partnership structure requires that special attention be paid to the issue of whether and how the participating lender should make contributions to defray soft costs overruns and operating deficits. This issue is compounded by the fact that the interest on the participating debt financing will ordinarily be payable at stated rates and intervals, as opposed to the distribution of a preferred return as and when available as would be the case in a true equity transaction. Sometimes, this funding question is addressed by making additional loan proceeds available, while other lenders prefer to provide for an interest accrual feature under which interest that would otherwise be payable on the loan can be accrued to the extent it exceeds operating cash flow, ordinarily subject to some maximum amount of such accrual. The soft-debt investor will often also allow the developer to obtain reimbursement from future sale or refinancing proceeds prior to the distribution of residual proceeds from such transaction with respect to some or all of the contributions which the developer may make to defray soft cost overruns and operating deficits.

D. Stated Maturity Date.

One typical economic distinction between a true equity situation and a soft-debt transaction is that there will usually be no time agreed upon by which the equity is required to be returned, while the debt will have a maturity date. If the project has not been sold prior to the maturity date of the debt, the project entity will be obligated to retire the debt and pay the participating lender an agreed percentage of the amount by which the appraised value of the project at that time exceeds the sum of the principal and accrued interest on the mortgage debt against the project and the participating debt which is secured by the interests in the ownership entity. If the mortgage debt on the project is refinanced prior to the maturity date of the participating debt financing, the mezzanine lender may have an option either to obtain the full amount of its participating interest at that time based on the appraised value of the project or to receive the net refinancing proceeds for application toward the participating interest at that time and retain the right to receive the balance of the participating interest in connection with a future sale or refinancing or at the maturity of the participating loan.

It should be noted that the developer usually does not guarantee the return of either the principal or preferred return of equity capital contributions or the principal or interest of mezzanine loans. The developer and its principals customarily do provide guaranties of overruns of hard costs and at least some soft costs, as well as completion, environmental liabilities and “carve-out” obligations for the benefit of both equity investors and mezzanine lenders.

Because of potential usury concerns with the characterization of participating interests in profits in connection with mezzanine loans, such transactions have usually been characterized as being governed by the laws of states other than Texas which do not have usury limitations. These concerns may have been ameliorated to some extent by the amendments of the statutory provisions regarding the calculation of interest which were enacted by the 1997 session of the Texas Legislature and are now embodied in Chapter 306 of the Texas Finance Code. See, Acts 1997, 75th Leg., ch. 1396, section 1 et seq., effective September 1, 1997.

Under the provisions Chapter 306 of the Finance Code, the concept of a "qualified commercial loan" is created, which is a commercial loan of either $3.0 million or more that is secured by real estate or $250,000 or more that is not secured by real estate or a renewal of either type of loan regardless of the amount of the loan at the time of renewal. Of particular importance here is the fact that the provisions of Chapter 306 expressly authorize and exclude from the definition of "interest" various forms of profit participation, equity participation and similar features.

E. Complying with the HVCRE Rules.

Under the original Basil III rules governing High Volatility Commercial Real Estate Rules ("HVCRE"), equity of at least 15% of the appraised value of a new project must be invested in the project before the loan funds can be advanced. See, High Volatility Commercial Real Estate (HVCRE) Exposures https://www.fdic.gov/regulations/capital/capital/faq-hvcre.pdf. As a practical matter, that rule probably does not add much to the customary lending underwriting rules applicable to our hypothetical situation pursuant to which the funds available for the project would be required to be expended by the SPE in the order of equity, mezzanine loan and construction loan.

A difficult situation would be presented under the current HVCRE rules if the mezzanine lender does not make the mezzanine loan to the SPE that owns the project but makes the mezzanine loan to the owner or owners of the SPE that owns the project so that the proceeds of the mezzanine loan can be used to make equity contributions to the SPE. The HVCRE rules prohibit the SPE that owns the project from making any distributions to its owners until the construction loan has been converted to a permanent loan. As a result, even though it is contemplated that SPE that owns the project will generate net cash flow after operating expenses and debt service on the construction loan before the construction loan and mezzanine loan mature, the HVCRE rules would not appear to permit that SPE to distribute any portion of that net cash flow to its owners to use for making debt service payments on the mezzanine loan. For that reason, it seems advisable to make the mezzanine loan to the SPE that owns the project, even though the loan would be secured by the ownership interests in that SPE.

A bipartisan bill was introduced in the U.S. House of Representatives in April of this year that would alleviate this problem, as well as others. See, H.R. 2148, introduced by Congressman Robert Pittenger (R-NC) and Congressman David Scott (D-GA) on April 26, 2017, currently pending in the House Committee on Financial Services; see, also, Mattson-Teig, "Clarification May Finally Be Coming for HVCRE Rule," National Real Estate Investor, May 17, 2017. This legislation would permit a borrower to make distributions to its owners if the property owned by the borrower is completed and is generating net cash flow equal to at least the expenses and debt service of the property.

F. Perfecting Security Interests in Collateral for Mezzanine Loans.

A mezzanine lender will need to determine if it wants to treat the ownership interest securing the loan as a general intangible" as defined in §9-102(42) of the UCC or a "payment intangible" as defined in §9-102(62) of the UCC in which a security interest can be perfected by filing a financing statement. In that event, the lender may want not only to file such a financing statement but also obtain an agreement from the issuer of the ownership interests that it will not treat such ownership interests as "investment property" as defined in §9-102(49) of the UCC. On the other hand, the lender want to treat the ownership interests as "certificated securities" in which a security interest can be perfected only by control or delivery under §§8-106(a) and (b), 8-301(a), 9-106, 9-313(a) and 9-314(a) of the UCC or as "uncertificated securities" in which a security interest can be perfected only by control or delivery under §§8-106(c), 8-301(b), 9-106, 9-313(c) and 9-314(c) of the UCC. In that event, the mezzanine lender may want the issuer to opt in to Chapter 8 of the UCC and agree to treat the ownership interests as investment property until the lender has agreed otherwise, See, Thalheimer, "Mezzanine Lending," 27th Annual Advanced Real Estate Law Course (State Bar of Texas, 2005).

IV. SELECTED ISSUES PERTAINING TO INTER-CREDITOR AGREEMENTS

A. Notice and Opportunity to Cure Defaults on Senior Financing.

Perhaps the most common threshold issue which must be negotiated between a senior lender and a junior lender involves the concept of providing the junior lender with notice and opportunity to cure defaults on the senior financing. It should be noted in this connection that there is currently no requirement in Texas for a senior lender to notify a junior lender of such defaults, or of foreclosures resulting from such defaults, absent the existence of a contractual obligation to that effect between the lenders. See, American Savings & Loan Association v. Musick, 531 S.W.2d 581 (Tex. 1975). No state action is involved in a private contractual non-judicial foreclosure sale by a trustee. Notice would be required for a judicial foreclosure,

A typical senior lender will initially not want to be responsible for giving the junior lender any notice of defaults by the borrower and will want the junior lender to rely on the borrower to provide the junior lender with copies of default notices sent by the senior lender to the borrower. Some senior lenders will agree to send copies of default notices concurrently to the junior lender and the borrower, and to allow the junior lender the same period for curing defaults that is granted to the borrower, but it is rare that a senior lender will agree to give a junior lender a separate notice and opportunity to cure defaults which is in addition to the notice and cure period granted to the borrower.

A junior lender, on the other hand, will want the senior lender to agree to provide notices of the borrower's defaults directly to the junior lender and to grant the junior lender a supplemental period of time in which to cure such defaults if the borrower does not do during the primary cure period. Generally, however, a junior lender will be satisfied to receive concurrent notices of default and to have the benefit of the same cure period which is going to be granted to the borrower. A junior lender will also want the senior lender to agree to provide the junior lender with notices of foreclosure of the senior liens by the senior lender.

One problem that often arises in this context involves the situation where the senior lender has agreed to give the borrower notice and opportunity to cure some types of defaults, such as compliance with non-monetary covenants, but has refused to give the borrower notice and opportunity to cure other defaults, such as defaults in making regularly scheduled payments on the senior financing. In such instances, senior lenders are sometimes willing to agree to provide junior lenders with a very limited separate notice and opportunity to cure defaults by the borrower in making payments on the senior financing. In other transactions, however, the senior lender may refuse to give such separate notice and opportunity to cure to the junior lender, which necessarily imposes on the junior lender an obligation to utilize some sort of mechanism for policing payments by the borrower on the senior financing to be sure that they are being made as and when due. The junior lender may require, for example, that the borrower provide the junior lender with good funds for such payments several days in advance of the due date of the payments in order that the junior lender can remit those funds to the senior lender itself on the due date and assure that the payment is made (or make the payment itself if the borrower does not do so and declare a default on the junior financing if reimbursement is not received in a timely manner).

The junior lender will generally want the senior lender to agree to accept a cure from the junior lender of any type of default by the borrower. To the extent that the default involves a purely objective matter, such as making payments on the senior loan or complying with specific covenants in the senior financing documents for items such as payment of insurance premiums and property taxes, it will often be possible for the lenders to agree on that issue. Difficulties may be encountered, however, in connection with other defaults by the borrower which the senior lender considers to be incurable by the junior lender. A typical example of that type of default is a situation where a senior lender insists that it is providing the senior financing because of the reputation and expertise of the principals of the borrower and that it would be unwilling to extend or continue such financing if those principals die or become insolvent, are removed from the management of the property or the borrower or experience any other materially adverse change, even if the senior financing is not otherwise in default. In many cases, therefore, it may be necessary for the junior lender to negotiate the right to cure objective defaults coupled with an agreement by the senior lender not to unreasonably withhold its approval of proposals by the junior lender to cure such more subjective defaults.

One issue which often arises in this context relates to the concern of a junior lender that it may not have adequate access to the mortgaged property to cure certain defaults (such as restoration and repair obligations) within the relatively limited amount of time which the borrower is granted to cure the defaults under the senior financing documents. A junior lender may argue, for example, that its period for effecting any cures should be extended by any periods during which the borrower may have stayed the enforcement of the junior liens or other rights of the junior lender by means of injunctions or bankruptcy filings. This issue may be particularly troublesome to a junior lender in jurisdictions other than Texas where the customary period of time for concluding a mortgage foreclosure may be lengthy. Although a senior lender may have some degree of sympathy for the plight of a junior lender with respect to such issues, the senior lender will often insist on some relatively short period of time in which the junior lender must complete its cure efforts, regardless of the steps which the borrower may take during that period of time to delay the junior lender's enforcement actions.

In the author's experience, although senior lenders and their counsel once worried a great deal about the potential problems which might arise if required notices of default were inadvertently not given to junior lenders, these issues are increasingly being viewed with a more liberal attitude by some of the more enlightened senior lenders. They understand that the typical junior lender will not only be anxious to assure that defaults on the senior financing are cured in order to preserve the junior financing, but will also often be in a much better position to effect such cures than the borrower itself. Moreover, such senior lenders believe that the junior lender will usually be in a position to exert a great deal of influence in concert with the senior lender in encouraging the borrower to cure defaults which have occurred with respect to the senior financing. On balance, therefore, these senior lenders appear to have concluded that it is in their best interests, as well as in the best interests of the junior lenders, to be open to requests that their inter-creditor agreements contain generous provisions in favor of junior lenders regarding notice and opportunity to cure defaults.

B. Effects of Default with Respect to Junior Financing.

A junior lender will want a senior lender to agree that defaults on the junior financing do not automatically constitute defaults on the senior financing. Moreover, a junior lender will want a senior lender to agree that the junior lender may pursue remedies for such defaults on the junior financing, including foreclosure of any junior liens and removal of the borrower from the project, without creating a default on the senior financing, or violating any "due on sale" provisions in the senior financing documents.

A senior lender will often be willing to agree that defaults on the junior financing do not automatically constitute defaults on the senior financing. Depending on how strongly a senior lender feels about the identity of the borrower and its principals, the senior lender may or may not be willing to agree that the junior lender may exercise its foreclosure or other remedies without the senior lender's consent without creating a default on the senior financing.

A senior lender will generally want to require a junior lender not to exercise its remedies of foreclosure in a manner which will result in the termination of leases or other contracts pertaining to the mortgaged property which are of material importance to the senior lender.

A senior lender occasionally may attempt to condition its agreement to permit a junior lender to exercise its remedies on the junior lender's willingness to assume liability for the senior financing and the senior lender's approval of the creditworthiness of the entity which will assume that liability. A junior lender will usually be unwilling to agree to that condition and the senior lender will often conclude that it is better to have a junior lender which is motivated to cure any defaults on the senior financing than to risk losing that benefit by insisting that such cure be conditioned on assuming the entire debt.

In some situations, however, the borrower and its principals may have negotiated an agreement with the junior lender which requires the junior lender to obtain releases of the borrower and its principals with respect to loan guaranties pertaining to the senior financing as a condition to the exercise of remedies which the junior lender may otherwise be entitled to pursue with respect to the junior financing. Such agreements are probably encountered more often with respect to performance or impasse issues in connection equity transactions than they are in connection with payment or other default issues with respect to transactions involving debt secured by junior liens on real property or security interests in the ownership of the borrower, but they can occur in any situation involving junior financing. In those situations, the junior lender will almost certainly be required to assume liability for the senior financing and to provide a creditworthy guarantor of the senior financing in order to obtain releases of the loan guaranties by the borrower's principals and exercise the junior lender's remedies with respect to the junior financing.

A junior lender will generally want to be able to continue to make scheduled payments on the senior financing after a foreclosure of the junior liens without being subject to late charges or default interest rates. A junior lender will sometimes want to have the right to purchase the senior financing at its option in the event a default has occurred on the junior financing. A junior lender will probably be reluctant, however, to agree to have an obligation to purchase the senior financing.

A senior lender will sometimes want the junior lender to agree to give the senior lender notice and opportunity to cure defaults by the borrower on the junior financing, as well as notice of foreclosure actions by the junior lender. Although a foreclosure of the liens securing the junior financing would not directly affect the senior liens, the senior lender may want to preserve the opportunity to preclude an enforcement action being taken with respect to its borrower where the senior financing may or may not be in default but a default has occurred with respect to the junior financing.

C. Effects of Default with Respect to Senior Financing.

A junior lender will almost certainly insist that a default (or even a potential default) with respect to the senior financing will constitute a default with respect to the junior financing, even if the junior financing would not otherwise be in default according to its own terms. This position is mandated by the junior lender's need to be able to initiate its remedies under the junior financing documents before the senior lender forecloses the senior liens on the mortgaged property and wipes-out the liens securing the junior financing. Some senior lenders will not want the ownership of the mortgaged property to be subjected to a disturbance by the junior lender's exercise of its remedies by reason of defaults under the senior loan documents which the senior lender has not viewed as justifying the initiation of its remedies. Accordingly, such senior lenders will require that the junior lender's right to consider a default on the senior financing as a default on the junior financing be limited to material matters (such as non-payment), subject to an overriding agreement that the acceleration of the senior financing will automatically result in the acceleration of the junior financing.

A senior lender may ask a junior lender to agree that, if a default under the senior financing has occurred and is continuing, the junior lender will not seek to exercise its remedies against the borrower or the mortgaged property with respect to defaults on the junior financing, or initiate or join in bankruptcy proceedings involving the borrower or the mortgaged property, without the prior consent of the senior lender. It is difficult to identify a situation in which such an agreement on the part of a junior lender would not have materially adverse consequences for the junior lender.

D. Modifications of Financing Documents and Terms.

Both senior lenders and junior lenders will have a high degree of sensitivity to the issue of modifying the documents and terms of the other financing involved in a transaction of this nature. Such concerns are probably unwarranted in many cases, although there are clearly issues as to which such concerns are relevant.

A senior lender will generally want to have the freedom to modify the senior financing documents and deal with the borrower in such manner as the senior lender deems appropriate without obtaining the consent of the junior lender or undermining the effect of the subordination of any junior liens securing the junior financing. Included in the senior lender's objectives in this regard would be the liberty to increase the amount of the senior financing without the junior lender's consent, with any junior liens to be subordinated automatically to such increases in the senior financing.

The junior lender, on the other hand, will be concerned about possible changes in the terms and conditions of the senior financing. The most obvious issue of this sort would involve increases in the amount of the senior financing to which the junior lender's position would automatically be subordinated. The junior lender will often be willing to agree to subordinate its position to future advances which the senior lender elects to make for expenses such as taxes, insurance and repairs in order to protect the mortgaged property, although the junior lender may want to impose a maximum limitation on the extent to which the senior lender may make such future advances. The junior lender will be most concerned, however, with other possible increases in the amount of the senior financing which is secured by prior liens on the mortgaged property, especially increases which are in reality related to funding for other properties and do not result in a commensurate increase in the value of the mortgaged property in which the junior lender has an interest. The junior lender could have the same concerns with respect to additional advances under the senior loan to defray operating deficits on the mortgaged property other that debt service on the junior loan.

A related issue that will need to be addressed by the lenders in this context relates to the effect of advances by the senior lender which exceed any maximum limitation which the lenders have agreed upon in the inter-creditor agreement. The senior lender will want the effect to be limited to the fact that the excess advances will be subordinate to the junior lender's position, without totally undermining the subordination of the junior lender's position to the permitted level of senior financing. The junior lender may be willing to agree with that approach, but may also want to have an understanding that an appropriate portion of repayments by the borrower to the senior lender are to be remitted to the junior lender if excess advances have been made by the senior lender.

The junior lender will also not want the interest rate on the senior financing to be increased by means of modifications of the senior financing documents beyond the level contemplated in those documents at the time the inter-creditor agreement is executed.

Changes in the principal amortization period with respect to the senior financing may be viewed differently by different junior lenders in specific situations. In some cases, the junior lender may not want the amortization period to be shortened because that would leave less net operating income being available for debt service on the junior financing. In other cases, the junior lender may not want the amortization period to be lengthened because that would result in a slower build-up of the equity cushion which the junior lender wants to see increase for the purpose of providing additional security for the junior lender's position.

E. Insurance and Tax Escrow Provisions.

Junior financing documents will generally provide that the junior lender cannot require escrow deposits for insurance and taxes if the senior lender is requiring such deposits to be made. Such a prohibition may also be incorporated into an inter-creditor agreement.

Both lenders may also attempt to negotiate a provision in the inter-creditor agreement which prevents the lender that holds such escrow deposits from applying the deposits to its financing in the event of default by the borrower. Each lender may want such escrow deposits to be applied, instead, to the payment of the ad valorem taxes and insurance premiums for which they were deposited in the first place. The senior lender will argue, however, that the application of escrow deposits which it holds to the senior financing does not materially affect the position of the junior lender, while the application of deposits held by the junior lender to the junior financing would affect the senior lender in a materially adverse manner. In other words, since the junior lender's position is subordinate to both the senior financing and the ad valorem taxes, the use of the escrow deposits by the senior lender to pay one or the other has the same relative effect as to the junior lender. On the other hand, the senior lender would be harmed by the junior lender's use of escrow deposits to pay the junior financing, to which the senior lender's position is not subject, instead of the ad valorem taxes, to which the senior lender's position is subject.

F. Use of Insurance and Condemnation Proceeds.

A borrower will usually attempt to negotiate provisions in both the senior financing documents and the junior financing documents under which the borrower will have broad latitude to use insurance and condemnation proceeds to rebuild and restore the mortgaged property. An inter-creditor agreement should address the issues which may arise between the senior lender and the junior lender where the borrower's ability to use such proceeds is subject to the lenders' approval.

A senior lender will typically want to have sole control over the decision to permit the borrower to use such proceeds to rebuild the property or to apply the proceeds to the senior loan without the concurrence or consent of the junior lender.

A junior lender may not be able to negotiate a change in the senior lender's position on this issue, but the junior lender will be particularly motivated to try to succeed in such negotiations where the junior financing is non-recourse and the senior financing is recourse and guaranteed by the borrower's principals. In such a situation, the junior lender would argue that the preservation of the junior lender's position requires that the property be rebuilt and that the senior lender's discretion over the issue must necessarily be circumscribed to take account of that difference in the positions of the parties.

G. Partial Release Issues.

In some transactions, such as a retail center development with sales of individual pad sites being contemplated, issues pertaining to partial releases may need to be negotiated between the lenders.

A senior lender will, again, typically want to have sole control over the decision to permit the borrower to obtain partial releases and will want the proceeds of the transactions giving rise to the partial releases to be applied entirely to the senior financing. The senior lender will, moreover, want the junior lender to be obligated to concur in granting any such partial releases that have been approved by the senior lender.

A junior lender will want the partial release criteria to be specified in the financing documents and the inter-creditor agreement and will want the proceeds of the partial release transactions to be applied in some equitable manner (presumably prorata) to both the senior financing and the junior financing in conjunction with the granting of the partial releases.

A possible compromise position would involve specifying in the documents the objective criteria which must be satisfied by the borrower in order to obtain partial releases, such as minimum per square foot release prices or minimum percentages of the net proceeds of sales, and providing for the partial release amounts to be applied prorata to the senior financing and the junior financing, with the senior lender to have the final right of approval over any subjective criteria, such as the configuration and location of partial release tracts and the adequacy of access to unreleased portions of the property.

H. Approval of Tenants and Lease Terms.

One area where there seems to be little room for negotiation on the part of the junior lender involves the approval of tenants and lease terms. To the extent that the approval of the lenders is required on such matters, it seems that the senior lender can be permitted to exercise total control over the decision without impairing the position of the junior lender. That is not to say the junior lender does not have an interest in such matters or that there is no possibility of a conflicting position on particular issues. In most cases, however, the interests of the lenders will be sufficiently congruent that the administrative benefits of allowing the senior lender to make the final decision will outweigh the remote possibility of some prejudice to the junior lender. These same considerations apply to the execution of non-disturbance agreements requested by tenants, where the views of the senior lender should presumably control in most cases.

I. Lien Subordination vs. Debt Subordination.

Inter-creditor agreements in situations where the junior financing is secured by junior liens on the mortgaged property will invariably involve the concept of the subordination of the liens securing the junior financing to the liens securing the senior financing. Consequently, a purchaser at the foreclosure of the junior liens will take the mortgaged property subject to the liens securing the senior financing, while a purchaser at the foreclosure of the liens securing the senior financing will take the mortgaged property free and clear of the junior liens.

Absent specific agreement on such issues, however, the lien subordination provisions of a typical inter-creditor agreement do not in themselves restrict or prevent the prepayment of junior financing prior to the payment of senior financing. Consequently, inter-creditor agreements can, and often do, address the quite different issue of the subordination of the repayment of the junior financing to the repayment of the senior financing. The basic idea of this concept is that the senior financing must be satisfied prior to the satisfaction of the junior financing.

Although regularly scheduled payments on both debts may be permitted as long as the senior financing is not in default, different rules are followed if an event of default on the senior financing has occurred and is continuing. In the default context, the junior lender would not be permitted to accept any payments from the borrower prior to the payment in full of the senior financing and would hold in trust for the senior lender any payments which are received from the borrower. If bankruptcy proceedings ensue, as discussed further below, dividends on both debts would be applied to the senior financing first and then to the junior financing.

Some senior lenders may insist that no payments of any kind be made to the junior lender until the senior financing is satisfied in full, although junior lenders would presumably resist such a position. Some senior lenders may permit interest payments or preferred return distributions to be made to junior lenders but prohibit principal prepayments or capital distributions to junior lenders. If payments may be made to a junior lender prior to default, but not thereafter, the junior lender will want to qualify that provision so that payments would be prohibited only after the senior lender has given the junior lender notice of the default and the junior lender would not be required to remit any prior payments to the senior lender.

In situations where the senior lender is seeking to obtain a subordination of the junior financing itself, as opposed to just the subordination of the junior liens, the senior lender may want to include various supplemental provisions in the inter-creditor agreement. Included in such provisions might be representations by the junior lender as to matters such as the ownership, amount and status of the junior financing. Also included in such provisions might be covenants by the junior lender with respect to actions such as not transferring the junior financing without informing the transferee of the existence of the debt subordination provisions; not accepting prepayments of the junior financing from the borrower; not effecting a conversion of the junior financing into equity; not canceling or forgiving the junior financing; not amending the junior financing documents; and not initiating or joining in collection or bankruptcy proceedings against the borrower. Some of these covenants may apply at all times, and some may be limited to a post-default context.

In connection with the subordination of the junior financing itself, as opposed to the subordination of only the junior liens securing that financing, there is a related issue which may need to be considered by counsel for the senior lender. The subordination of the junior financing may be construed as creating a security interest in the junior financing for the benefit of the senior lender which must be perfected by the filing of a financing statement under the Uniform Commercial Code in order to be enforceable against the junior lender's other creditors or against a bankruptcy trustee in the event of the junior lender's bankruptcy.

J. Bankruptcy Issues.

Concerns about bankruptcy by the borrower are usually very important in the negotiation of an inter-creditor agreement. It appears, however, that some of these concerns may be misplaced and may be leading the parties to some ill-advised conclusions.

Senior lenders have traditionally been very concerned about permitting junior lenders to encumber the mortgage property with junior liens because that would allow the junior lenders to have a secured creditor's position in the event of the borrower's bankruptcy. It appears possible to include an enforceable provision in an inter-creditor agreement under which the senior lender can control the votes of both the senior lender and the junior lender on a borrower's proposed plan of reorganization or other issues which may arise during the course of bankruptcy proceedings. Nevertheless, many senior lenders have simply refused to allow junior lenders to have junior liens on the mortgaged property and have insisted that the junior lenders structure the junior financing either as debt which is secured by the ownership interests in the borrower or as equity contributions to the borrower. Such positions may have been shortsighted.

Inter-creditor agreements involving senior financing and junior financing which are both secured by liens against the mortgaged property may include provisions under which the lenders agree that any bankruptcy dividends with respect to either debt will be applied first to retire the senior financing and then to retire the junior financing. This potential benefit for the senior lender would not be available if the junior financing is not secured by liens on the mortgaged property but by the borrower's ownership interests and would not be available if the junior financing is characterized as an equity contribution to the borrower. Consequently, by permitting the junior financing to be secured by junior liens on the mortgaged property, the senior lender may have realized a potential advantage over other third-party creditors of the borrower without impairing in any material manner the senior lender's priority position with respect to the junior financing.

Therefore, contrary to what has become the traditional view among many senior lenders, the more reasoned position may be that a senior lender should not only insist that the junior financing be secured by junior liens on the mortgaged property but should also demand that the junior financing not be converted into equity or forgiven, canceled or prepaid without the senior lender's permission.

The senior lender will also want the junior lender to agree to file a claim in bankruptcy with respect to the junior financing and post-petition interest on the junior financing or to include a provision in the inter-creditor agreement which authorizes the senior lender to file such a claim on behalf of the junior lender.

IV. CONCLUSION

The issues which can arise in connection with the negotiation and preparation of mezzanine loan documents and inter-creditor agreements are complex and varied. The manner in which these issues are resolved depends on a number of factors, not the least of which is the relative bargaining power of the borrower and lenders involved in a particular transaction. In counseling such parties, however, care needs to be taken to assure that the terms of the financing documents and the inter-creditor agreements reflect the real interests of such parties rather than some conventional wisdom about how multiple sources of financing should be structured in such situations.