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DEBT PURCHASES

Although real estate sales themselves remain shaky, the market for distressed real estate debt has turned bullish. But entering into such a venue, with complicated capital stacks, calls for attention to detail and an awareness of intricate rules that may not apply to simpler forms of asset transactions. Here the author breaks down the advantages and disadvantages of the distressed loan market for all parties. He maps out participants' rights and options and examines the steps that must be carried out to consummate a successful purchase.

Web of Debt: Navigating the Capital Stack as a Purchaser of Real Estate Loans

BY ERIC D. LEMONT

In response to the distressed real estate market, real estate investors have increasingly focused their attention on purchasing existing commercial real estate loans. In addition to obtaining the loans at a discount, purchasers may have the opportunity to obtain control of the underlying property in the event of a borrower default.

Prior to the current credit crunch, as borrowers sought to increase their leverage, it had become increasingly common for multiple layers of mezzanine debt to be added to the capital structure. The morphing of the traditional "two-tiered" mortgage and mezzanine loan capital stack into multiple tiers of subordinate debt, documented by A/B notes, and intercreditor, co-lending, and participation agreements, has yielded a web of complex inter-relations among lenders. Purchasers of debt often enter this capital stack in some form of subordinate position, from a junior participation interest or mezzanine position to a "senior" mezzanine position—senior in priority to additional junior

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mezzanine lenders but subordinate to the senior mortgage lender.

Prospective purchasers of "junior" debt interests need to ensure that proper attention is paid not only to monetary provisions, such as interest rates and payment priority, but also to the purchaser's rights and obligations vis-à-vis the other lenders in the capital structure. The following are examples of issues that must be understood by purchasers of real estate debt:

- Consent rights in relation to a senior lender, junior lenders, and/or participants;
- Rights of the various lenders to transfer their loans;
- Loan purchase rights;
- Rights to exercise remedies; and
- Resizing rights of the senior lender

The following discussion addresses provisions commonly appearing in agreements used where the senior mortgage loan was securitized (or was intended to be securitized). Because specifics will vary across transactions, it is imperative that the provisions in each agreement be reviewed carefully and in their specific context.

What Are My Rights? As Mezzanine Lender: Our broad Standard form intercreditor agreements vest mezzanine lenders with consent rights over amendments to material mortgage loan provisions, including

increases in the amount of indebtedness or interest rate, shortening of the maturity date, and modifications to cash management arrangements. A prospective mezzanine loan purchaser's ability to negotiate the above consent rights is dependent on the existing loan architecture. If no mezzanine loan currently exists and the mortgage lender is carving a new mezzanine loan out of its existing mortgage loan, the purchasing lender may have greater ability to negotiate the terms of the intercreditor agreement. Similarly, if the same lender holds all tranches of existing debt, the purchasing lender may be able to negotiate amendments to existing documents, including the intercreditor agreement. Otherwise, however, if multiple lenders hold tranches of debt, the mortgage lender will have no incentive to make revisions to the existing intercreditor agreement, the selling mezzanine lender will have no ability to force modifications to the existing intercreditor agreement, and the purchaser will need to buy its interest in the debt subject to the terms of the existing intercreditor agreement.

As Participant: Consent rights among holders of participation interests in a single loan are analyzed differently. Although participants may share in the economics of the loan on a *pari passu* basis, in which participants receive principal and interest payments and share losses in accordance with their respective percentage interests in the loan, participations recently have been structured as a senior "A" participation interest (e.g., the "A Holder") and one or more increasingly subordinate participations. The A Holder has legal privity with the borrower as the note holder and the holder of the security (be it a mortgage or a pledge of interests) and has priority with respect to payment distributions. The junior holders have no legal privity with the borrower—all of their rights are obtained through the participation agreement—and receive payment only after each more senior holder has been paid in full. However, as discussed further below, because the most subordinate participation holder is most at risk with respect to actions regarding the loan, it typically is identified as the "controlling holder" and possesses the ability to approve major decisions with respect to the loan.

Consent rights among holders of participation interests turn on both the participation agreement and, as often applicable, the servicing agreement. The servicing agreement grants the loan servicer authority to service and administer the loan on behalf of the participation holders subject to the provisions of both the underlying loan agreement and the participation agreement. The participation agreement, in turn, generally classifies the most subordinate participant holder as the "controlling holder," with approval rights over a broad range of "major decisions," including modification of monetary loan terms and release prices, waiver of defaults, exercise of remedies after an event of default, approval of extraordinary expenses, release of reserve funds, termination or replacement of the borrower's property manager, and approval of annual budgets.

Although the "controlling holder" is initially the most subordinate participant, purchasers of such interests in highly leveraged loans—especially in today's environment—must pay careful attention to provisions in the participation agreement regarding loss of controlling holder status. Upon a borrower bankruptcy, uncured payment default, or other trigger event enumerated in the participation agreement, the servicer will be

required to order an updated appraisal of the collateral. Subject to the rights of the controlling holder to challenge the appraisal of the collateral and/or to post additional collateral, the principal balance of the controlling holder will be reduced if, and to the extent, all amounts due under the loan exceed 90 percent (or in some cases 100 percent) of the appraised value of the underlying property. If such an "appraisal reduction amount" results in a reduction of the controlling holder's portion of the principal loan balance to a specified percentage (generally 25 percent of its original principal loan balance), the next most junior lender will become the controlling holder. In such event, because the original controlling holder is deemed to be "out of the money" with respect to any potential recovery from the distressed loan, it likely will lose not only its authority to approve or direct major decisions by the servicer administering the loan but also its discretion to cure underlying loan defaults and its ability to approve decisions regarding workouts and foreclosures.

Purchasers of junior positions should also appreciate that, notwithstanding the controlling holder's broad rights, the senior participants retain their own independent approval rights over a subset of major decisions. These approval rights usually include amendments of the loan reducing senior participants' principal balance or interest rates, votes in favor of a borrower bankruptcy or reorganization, releases of collateral or reserves, extensions of the loan's maturity date and a number of additional consent rights that vary by agreement. Participation agreements are not uniform in how they resolve deadlocks arising in connection with major decisions on which multiple participants have approval rights. Depending on the agreement and the relevant major decision, the agreement may vest the controlling holder with the ultimate authority to make major decisions in the event of a deadlock, or it may allow the servicer itself to take action in the event of a deadlock, but only in accordance with accepted servicing practices.

As Co-Lender: Co-lending agreements regulate rights and responsibilities among multiple lenders having a common borrower. However, unlike a participant structure, in which only the A Holder has direct privity with the borrower, each co-lender holds a note executed by the borrower. As in participation agreements, the relationship among lenders in co-lending agreements can be either "pari passu" or "junior/senior." Approval rights in junior/senior co-lending arrangements are structured in a fashion similar to junior/senior participation agreements. In a *pari passu* co-lending agreement, the approval of the lenders holding a specified percentage of the total loan (typically a simple majority or a supermajority of 66 2/3 percent) is required to approve decisions collectively as the "Lender." A unanimous vote among the lenders is required to approve major decisions. Depending on the number of lenders and each lender's percentage ownership of the loan, decision-making can get bogged down. If deadlocks can't be resolved within a specified time period, the approving lenders may be provided the opportunity to buy-out the non-approving lender's interest in the loan.

How Can the Loan Be Transferred? Prior to a securitization of the loan, the ability of the holder of a mezzanine loan governed by an intercreditor agreement to sell a majority interest in its loan to a prospective purchaser is conditioned upon the prior consent of the ap-

plicable senior mortgage lender. After a securitization, rating agency approval is required. If, however, the prospective purchaser is a “Qualified Transferee” (an entity satisfying a host of legal and structural requirements set forth in the intercreditor agreement), the loan usually can be sold free of such consent requirements. To avoid uncertainty and delay in the closing process, a prospective purchaser should confirm as soon as possible that it satisfies the capitalization and structural requirements for Qualified Transferees as set forth in the applicable intercreditor agreement. If it has an eye toward reselling the loan, the loan purchaser should determine as well whether its own prospective transferees are Qualified Transferees.

Not surprisingly, the above-referenced consent obligation is not reciprocal; intercreditor agreements generally allow the senior lender to transfer the mortgage loan without the mezzanine lender’s consent. While likely not negotiable, the purchaser of the mezzanine interest should at least be aware that it will lack certainty as to whom it must deal with as the senior lender in the event of a senior loan transfer.

Transfers of participation and co-lending interests generally require the consent of the other participants and/or co-lenders, with similar exceptions for transfers to Qualified Transferees.

What Is Required in Foreclosure of Junior Loans? As Mezzanine Lender: A single mezzanine lender, whose relationship with the senior mortgage lender is governed by a standard intercreditor agreement, can typically foreclose on the mezzanine borrower’s pledge of equity interests without first obtaining senior lender consent (or rating agency consent if the loan is securitized) if certain requirements are met. The two primary requirements are that the entity taking title be a Qualified Transferee and that the replacement property manager (if the existing property manager is not retained) be a “Qualified Manager,” a management entity with requisite experience managing properties of similar size and class. The foreclosing mezzanine lender also will need to review the terms of the intercreditor agreement to determine if it will be required to issue replacement/additional guarantees in favor of the senior lender.

In instances where there are multiple mezzanine loans in the capital structure, one or more junior mezzanine lenders can similarly foreclose on their respective pledged equity interests without the consent of the next most senior lender provided the transferee entity is a Qualified Transferee and any additional requirements set forth in the intercreditor agreement are satisfied.

As Participant: In the context of a mortgage loan subject to a participation agreement, the power to foreclose varies by agreement. In some instances, the controlling holder has the option following a default to approve the servicer’s commencement of a foreclosure action or exercise its rights under the participation agreement to cure the underlying default. In other cases, the other senior participants may be vested with consent rights as well, subject to any cure rights of the controlling holder.

If multiple holders possess overlapping authority to approve a foreclosure as a major decision, the parties can’t agree on whether to do so, and the controlling holder cannot or does not want to exercise its cure rights, the participation agreement may vest the ser-

vice with the discretion to commence foreclosure proceedings unless jointly directed by the holders not to do so.

As Co-Lender: Foreclosure in junior/senior co-lending agreements are analyzed similarly to participation agreements. However, if the mezzanine lender is subject to a pari-passu co-lending agreement, the decision to foreclose likely will require the unanimous consent of all co-lenders. In situations where all of the lenders can’t agree on the decision to foreclose, the approving lenders may need to buy out the non-approving lender. Assuming unanimous agreement is reached, the co-lending agreement should be reviewed to determine the structure of the entity that will operate the property post-foreclosure and how rights and obligations will be allocated among the lender-owners. It is not uncommon for a pari-passu co-lending agreement to include a form of post-foreclosure operating agreement as an exhibit to the agreement.

Pursuant to most intercreditor agreements, if there is a default by the borrower under a senior loan (either a mortgage loan or a senior mezzanine loan), the senior borrower declares bankruptcy, or the senior loan is otherwise accelerated, each junior lender may elect to purchase the loan. If more than one junior lender elects to purchase such senior loan, the most junior lender is granted the right to purchase the defaulted loan—as long as it purchases all intervening senior loans as well. The loan purchase price includes the outstanding balance of each senior loan purchased, accrued and unpaid interest (at the non-default rate), and, in some instances, protective advances. Prospective loan purchasers should review the intercreditor agreement to determine whether the purchase price also includes exit fees, prepayment premiums/yield maintenance premiums, and default interest. Special servicing and liquidation fees to special servicers are typically owed if the purchasing lender does not close on the sale of the loan within a specified time period of delivering notice to do so, usually 60 to 90 days.

The loan purchase price includes the outstanding balance of each senior loan purchased, accrued and unpaid interest (at the non-default rate), and, in some instances, protective advances.

Purchase of Senior Loan. Intercreditor agreements may provide the purchasing lender with as few as 10 business days to complete the purchase of all such loans. This may pose timing challenges, particularly where the consent of a co-lender is required under the applicable co-lending agreement or participation agreement.

In the context of a mortgage loan participation, the junior holder also typically has the right to buy out each senior holder’s participating interest in the mortgage loan upon a default by the borrower. If there are mezzanine loans in the capital structure, however, the junior participant’s rights will be subject to the applicable intercreditor agreement and, as a result, the junior participant will only be able to purchase the senior holder’s

participation interest if none of the mezzanine lenders have exercised their rights to purchase the mortgage loan (and each intervening junior loan).

Resizing. In addition to transfers, intercreditor agreements often allow each senior lender to resize and carve-out additional tranches of its loan, allowing for intervening lenders between such lenders and the remaining junior lenders. Although there are protections against such “slicing and dicing” resulting in changes to the loan’s aggregate principal balance, overall weighted interest rate, and other material economic loan terms, resizing introduces new and potentially unknown lenders to the table and can slow down required consents and approvals in connection with workouts and the exercise of remedies.

A junior lender should attempt to limit the ability of the senior lender to resize its loan so that only one intervening loan tranche is created. Some purchasing jun-

ior lenders have been successful in adding language to the intercreditor agreement that, upon a resizing, all lenders, including any new intervening lenders, enter into a replacement intercreditor agreement on terms no less favorable to the junior lender than existing terms.

Conclusion. The continued formation of new funds devoted to purchasing commercial real estate debt demonstrates that such acquisitions remain attractive as a means of accessing real estate assets. The increasing capital targeted at such acquisitions underscores investors’ belief that opportunities in the commercial real estate debt purchase arena will grow as the market bottoms and larger waves of debt move toward maturity. Prospective purchasers who appreciate the relative benefits and drawbacks of each loan’s position in the capital stack will be best positioned to bid effectively and maximize their investment.