© 2019 Thomson Reuters. Originally appeared in the Summer 2019 issue of Real Estate Finance Journal. For more information on that publication, please visit legal.thomsonreuters.com. Reprinted with permission.

Multiple Lender Construction Loans: A Focus on Construction Loan Financing with a Mortgage and Mezzanine Loan Component

*Ellen M. Goodwin**

Demand for mezzanine construction loans remains strong today; however, due to the many non-bank players, such as debt funds, real estate investment trusts and finance companies, that have flooded the mezzanine lending space generally, there are many active mezzanine lenders who are willing to provide subordinate financing for construction projects in order to take advantage of the higher interest rates. This article explains recent developments in multiple lender construction loans with a mortgage and mezzanine loan component.

Mortgage and Mezzanine Lenders Jointly Originating a Construction Loan—Recent Developments

The Rise of Mezzanine Finance in Construction Lending

After the 2008-2009 credit crisis, funds for construction loans were generally unavailable, which spurred a need for new players in the capital stack. High yield lenders emerged in the mezzanine finance position about eight years ago in order to fill this lending gap and reap the benefits of the higher interest rates on the construction loans. These non-bank lenders have been even more present in the mezzanine construction space over the past four years, helping to meet the needs of the construction boom that has occurred in many of the major U.S. cities, because they are not subject to the bank regulatory requirements imposed by Dodd Frank, such as the High Volatility Commercial Real Estate rule within Basel III ("HVCRE") that implements higher capital requirements for bank originated acquisition, development and construction loans. As a result of not being subject to rules like HVCRE, the cost of capital in the context of pre-development, development and construction lending is cheaper for these non-bank lenders.

The emergence of the construction mezzanine loan market has helped increase the leverage on construction projects. A syndicate

*Ellen M. Goodwin is a partner in the Real Estate Finance and Investment Group at Alston & Bird LLP, concentrating her practice on commercial real estate finance. Resident in the firm's New York office, she may be contacted at ellen.goodwin@alston.com. This article previously was published in *The ACREL Papers Spring 2019.*

© 2019 Thomson Reuters

of traditional mortgage lenders (*i.e.*, a bank club group) will lend 50-65 percent based on an "as stabilized" loan-to-value ratio, while a total capital lending stack which includes both a mortgage and mezzanine component may increase leverage on a construction project as high as an 80 percent "as stabilized" loan-to-value ratio. Since a mezzanine construction lender is in the first loss position in a default scenario and may also potentially run the risk of losing its collateral if the senior mortgage lender forecloses its mortgage loan, the subordinate mezzanine lender demands a higher yield for its funds to compensate it for its riskier position in the capital stack. While senior mortgage construction lenders may look for a rate of return on their loans of five to six percent (or 30 day LIBOR plus 300 to 400 basis points), mezzanine lenders are looking for much higher returns on their funds, such as an interest rate equal to at least 11 or 12 percent (or 30 day LIBOR plus 900 to 1000 basis points) plus an origination fee and exit fee. Demand for mezzanine construction loans remains strong today; however, due to the many non-bank players, such as debt funds, real estate investment trusts ("REITs") and finance companies, that have flooded the mezzanine lending space generally, there are many active mezzanine lenders who are willing to provide subordinate financing for construction projects in order to take advantage of the higher interest rates. Active players in this market include Starwood, Blackstone, and Apollo.

When Will the Proceeds of the Mezzanine Loan Be Advanced?

Typically, neither the mezzanine loan nor the mortgage loan proceeds will be advanced until the required equity contribution has been made by the borrower into the mortgaged property. The relationship of when the mezzanine loan and the senior mortgage loan are funded relative to each other is a business decision among the lenders. There is no market standard and there are many tensions driving this decision. Will the entire mezzanine loan be advanced prior to any senior mortgage loan advance or will the loans be advanced on a pari-passu basis? Sometimes the borrower's equity and the mezzanine loan are simultaneously funded at closing. Mezzanine lenders like to advance all loan proceeds at closing so they can begin collecting interest on their full mezzanine loan commitment. Borrowers, however, will prefer that the mortgage loan and the mezzanine loan be funded on a pari-passu basis as construction progresses as opposed to the mezzanine loan being funded in full upfront at closing, because the mezzanine loan bears the higher interest rate and the increased interest carry would be less economically favorable to the borrower.

An issue for mezzanine lenders to also consider with respect to pari-passu funding is that since many of them are non-bank lenders, such as investment funds, they may not be institutionally set up to administer monthly construction draw requests. This could be an administrative burden to some of the smaller investment funds, and many senior mortgage bank lenders also believe that some investment funds may not have the expertise in-house in construction servicing and may not be best equipped to determine if conditions precedent to a draw request are met. So in a pari-passu lending structure who should control the construction draw process if both lenders are funding their pro-rata share of the draw request? In fact, having separate lenders

© 2019 Thomson Reuters

with approval rights over construction draws would be undesirable for the borrower. What happens if there is a disagreement on the contemplated construction draw request between the mortgage lender and the mezzanine lender? This potential conflict could result in a nightmare with timing and the approval process for the borrower. Even though their interests are aligned as lenders, does a specifically designated construction consultant have the final say with respect to these disagreements? A senior mortgage lender may not be comfortable with giving away any control on a construction draw request and will want its ability to fund (or not to fund) draw requests to be unimpeded, as construction loans are risky investments.

Finally, with respect to the sequencing of the funding of the respective loans, the mortgage lender (as the senior lender in the capital stack) likes to see the mezzanine loan fully funded at closing before it funds any portion of its loan. They view the mezzanine loan as credit support for their senior loan in that a greater portion of the project has been completed (and paid for) prior to the senior lender increasing its exposure. Under this structure, the mortgage lender takes full control of the construction draw process and the monitoring of the construction project avoiding any unwanted interjections by the mezzanine lender (although a mezzanine lender may wrangle away a non-binding consultation right in an intercreditor agreement, which is discussed below in greater detail). The mezzanine lender with a fully funded loan at closing is a more passive lender during the construction phase and the borrower interfaces only with one lender on construction draws. If the borrower is willing to move off of its desire to reduce its cost of funds, a full funding of the mezzanine loan at closing with the mortgage lender funding all construction cost advances may be the most optimal and seamless structure from both the borrower's and the lenders' perspective. For these reasons, sequential funding in reverse order to the relative positions of the capital and equity stack is common in the mortgage/mezzanine construction finance market.

Once these business decisions have been analyzed and agreed upon between the mortgage lender and the mezzanine lender, the mortgage and mezzanine loan documents will reflect the mortgage borrower's required equity investment in the mortgaged property and how and when the respective mortgage and mezzanine loan proceeds will be funded. The intercreditor agreement between the mortgage and mezzanine lenders, discussed more fully below, will address the relative priority of the mortgage debt to the mezzanine debt and what type of consent or consultation rights a mezzanine lender has during the loan term. Typically, the mezzanine debt and the mezzanine loan documents are subject and subordinate to the mortgage debt and the mortgage loan documents, with very few exceptions.

Collateral/Security for the Mezzanine Loan

The borrower under the mezzanine construction loan will be the direct equity owner (or parent) of the mortgage borrower or owner of the real estate who will be constructing the improvements. The mezzanine loan proceeds are typically then contributed by the mezzanine borrower to its subsidiary, the mortgage borrower, for use in the construction project. The mezzanine lender is not granted a mort-

© 2019 Thomson Reuters

gage lien on the real estate collateral but is granted a pledge and security interest in 100 percent of the equity interests in the mortgage borrower or property owner. When a mezzanine lender forecloses on its equity collateral, unlike a mortgage lender, it cannot foreclose out or extinguish subordinate liens on the real estate collateral. The mezzanine lender will take subject to such liens and therefore the mezzanine lender must pay very close attention to the conditions precedent for loan advances in the mortgage and mezzanine (if applicable) loan documents, such as the delivery of lien waivers from the general contractor and applicable sub-contractors, to reduce the risk of springing mechanics' liens on the project. The waiver of these conditions to advances by a mortgage lender should require the consent of the first loss mezzanine lender in the intercreditor agreement (discussed below). Additionally, mezzanine lenders will also demand a recourse carve-out guaranty from a deep pocket guarantor which will include personal liability for losses with respect to any mechanics' liens on the construction project, among other traditional nonrecourse carve-outs.

Identity of Mezzanine Lender Is Important to the Borrower

The identity of the mezzanine lender has always been important from a senior mortgage lender's perspective as the mezzanine lender can potentially become the sponsor of the mortgage borrower in a default scenario upon the mezzanine lender's exercise of remedies under the pledge agreement. For this reason, there is a definition of a "Qualified Transferee" in the intercreditor agreement (discussed below), which imposes both financial and experience requirements on the holder of the mezzanine loan, to ensure the senior mortgage lender that a well-capitalized and experienced entity would become the owner of the mortgage borrower upon a mezzanine lender's foreclosure. Similarly, borrowers of construction loans should also make sure that both the mortgage loan and mezzanine loan documents impose a similar financial requirement on the lenders, such as a total assets and net worth test, if both the mortgage and mezzanine lender will be advancing their proportionate share of construction costs. These required financial tests in the mortgage and mezzanine loan agreements will hopefully help to thwart a defaulting lender scenario, which may result if either or both the mortgage lender and the mezzanine lender fail to fund a requested draw; and therefore avoid an interruption of the funding of any component of the construction loan and a delay in completion of the project.

Issues to Consider in the Mortgage/ Mezzanine Lender Intercreditor Agreement

The Delivery of Guaranties upon a Realization Event

Set forth below is a customary provision in an intercreditor agreement between the mortgage lender and the mezzanine lender relating to a mezzanine lender's obligation to deliver a recourse carve-out "bad boy" guaranty as a condition precedent to the exercise of remedies under the mezzanine loan documents (including, without limitation, the foreclosure of or other realization upon the equity collateral or other exercise of active control by mezzanine lender over the mortgaged borrower).

Regardless of whether or not a Realization

© 2019 Thomson Reuters

Event results in the explicit release from future liability of any guarantor, indemnitor, pledgor, or other obligor (each, a "**Third Party Obligor**") under the Senior Loan under any guaranty, pledge or indemnity which may constitute a Senior Loan Document as of the date hereof or that has been approved by Mezzanine Lender (each, a "**Third Party Agreement**"), Mezzanine Lender (or the transferee of its Equity Collateral) shall, as a condition precedent to completing any such Realization Event (other than solely obtaining the appointment of a receiver or similar agent with respect to the Equity Collateral), cause one or more Supplemental Third Party Obligors[1] to execute and deliver at least five (5) Business Days prior to the consummation of such Realization Event to Senior Lender a substitute Third Party Agreement, in each case in a form substantially similar to the original Third Party Agreement that it is supplementing, pursuant to which such Supplemental Third Party Obligor shall guaranty only the Future Third Party Obligations (and only to the extent arising from and after the date of such Realization Event).

"**Realization Event**" means a foreclosure, assignment-in-lieu thereof or other realization upon the Equity Collateral, including, without limitation, obtaining title to the Equity Collateral or selling or otherwise transferring the Equity Collateral, or exercising voting power to direct or cause the direction of the management or policies of the Equity Collateral pursuant to rights granted in the Mezzanine Loan Documents but not any other exercise of remedies by Mezzanine Lender to the extent the same does not result in a realization upon the Equity Collateral (it being acknowledged and agreed that in the case of such voting power, the mere grant of such voting power in the Mezzanine Loan Documents shall not constitute a Realization Event, provided that, the affirmative exercise of such voting power to direct or cause the direction of the management or policies of Borrower by or on behalf of Mezzanine Lender shall constitute a Realization Event).

In addition to "bad boy" recourse guaranties, on a construction loan there are other guaranties delivered to each of or one of the mortgage and mezzanine lenders (as the case may be) by a "deep pocket" individual or well capitalized entity to help mitigate the risks that a construction loan poses. These guaranties may include a completion guaranty, a carry guaranty, and/or a payment guaranty (which may relate to the full principal amount of the debt or a portion thereof). The mezzanine lender's obligation to deliver these additional guaranties on a Realization Event is discussed below.

The Completion Guaranty and Loan Balancing Obligations

Typically, the guarantor will deliver a completion guaranty to both the senior mortgage lender and mezzanine lender guaranteeing the lien-free completion of the project, as well as guaranteeing payment of required balancing payments and deficiency deposits discussed below. As a general matter where there is a mortgage and mezzanine component for a construction loan, upon a Realization Event, the sponsor/guarantor should *not* be released on its completion guaranty for the mortgage loan or the mezzanine loan; such sponsor/guarantor should be held responsible to cause the completion of the project (most likely through its obligation under a liquidated damages clause in the guaranty to pay the cost to complete the project as opposed to actually running the project to completion). Upon a Realization Event, a mezzanine lender will typically agree that it will be liable for "bad boy" acts that it commits from and after such Realization Event, but it will argue that it should not be obligated to deliver a completion guaranty on a Realization Event, because it did not underwrite the risk of completing the project on a sponsor default. Senior lender — go chase the completion guarantor under the mortgage loan! The senior mortgage lender will contend, however, that the mezzanine lender should post a full completion guaranty upon a Realization Event as seeking remedies

© 2019 Thomson Reuters

against the sponsor/mortgage guarantor once the mezzanine lender forecloses and takes control of the construction project is too difficult and riddled with many defenses in favor of the sponsor/mortgage guarantor. The mortgage lender is in the senior position and the mezzanine lender has taken the bottom dollar risk (for a higher yield) and may always pursue the sponsor/guarantor on the completion guaranty that was delivered on its loan to make itself whole. Compromise positions between the mortgage and mezzanine lenders on this issue may include: (i) the mezzanine lender or other acceptable replacement guarantor shall be responsible on a completion guaranty in favor of mortgage lender to the extent of any change in scope of or other change orders to the original plans and specifications made by mezzanine lender on and after the date of the Realization Event or (ii) (a stronger compromise position for mortgage lender) the mezzanine lender shall be responsible for the completion of the remaining portion of the project on and an after the Realization Event (for example, if the project is 75 percent complete upon the Realization Event, the mezzanine lender or replacement guarantor is responsible for the remaining 25 percent of the project to take it to substantial completion), but only in the event that the mortgage lender continues to fund its mortgage loan proceeds for advances to the reconstituted borrower. This is typically a hotly negotiated provision in the intercreditor agreement and currently there is no market standard. There will be many factors to be analyzed/discussed before an agreement is made. Due to the complexity of the issue, it is suggested that the requirement of the completion guaranty on a Realization Event be specifically addressed in any letter of intent or memorandum of understanding between the mortgage lender and the mezzanine lender concerning the origination or purchase of the mezzanine loan.

On and after a Realization Event, the loan balancing obligations of the reconstituted borrower and the replacement guarantor under the mortgage loan (*i.e.*, that the borrower is required to make a deficiency deposit with the mortgage lender if the undisbursed portion of the mortgage loan will not cover the remaining construction hard and soft costs as set forth in the construction budget) must also be addressed in the intercreditor agreement. Many mortgage lenders will demand that the obligation of the mezzanine lender to balance the mortgage loan and deposit any deficiency with respect to the "out of balance" loan/budget for the project with the mortgage lender as a condition precedent to any Realization Event. Without such a deficiency deposit, how will the mortgage lender be assured that there are sufficient funds to complete the project? A mezzanine lender will counter stating that the obligation to balance the mortgage loan and the then in-place budget for the project upon the occurrence of the Realization Event remains an obligation of the original mortgage borrower and ideally, the sponsor/guarantor through the completion guaranty. However, the mezzanine lender or the replacement guarantor, as applicable, will be liable for balancing calls for the mortgage loan only with respect to changes made to the budget by the mezzanine lender and only as a condition precedent to any future advance of the mortgage loan. The mortgage lender (even if it agrees to the mezzanine lender's position) may demand, in addition to the obligation to fund any newly created "out-of-balance" budget occurrences post-Realization Event, that the mezzanine

© 2019 Thomson Reuters

lender also be obligated to fund into a deficiency account with mortgage lender as a condition precedent to a Realization Event as equity the full amount of any undisbursed proceeds of the foreclosed mezzanine loan. Care should be taken by the mezzanine lender to avoid duplication, as unadvanced loan proceeds may account for existing deficiencies. Such proceeds in the deficiency account shall be counted when determining any future shortfalls in the project budget relative to the then contemplated advance (as well as future advances) under the mortgage loan. The balancing obligation of the mezzanine lender from and after the Realization Event also poses many complicated business issues that the lenders must struggle to resolve. The resolution of these opposing positions will be impacted by the yield that the mezzanine lender will be paid for its funds (is it very rich?), the type of project that is being built (*i.e.*, is it a "build to suit" office building with all preleasing satisfied or is it a multifamily apartment building with no leases in place?), and whether other credit enhancements have been delivered by borrower, such as a guaranteed maximum price contract with a nationally recognized general contractor. The answers to these questions may greatly impact the willingness of the mezzanine lender to increase its personal liability on the mortgage loan post-Realization Event.

A mezzanine lender should also understand the implications of the guaranty claim subordination provisions in the intercreditor agreement with respect to its ability to chase the sponsor/guarantor on the mezzanine completion guaranty delivered at closing, as this is a needed "backstop" to the mezzanine lender's new obligations on a Realization Event. If the senior lender will not allow the mezzanine lender to pursue its claim (with seniority) against the sponsor/guarantor, then any funds realized by the senior lender under its guaranty should be applied to reduce the mezzanine lender's obligations under any completion guaranty it delivers to the mortgage lender in connection with a Realization Event.

The Carry Guaranty

Many mortgage lenders will demand that the mezzanine lender post a carry guaranty for debt service, taxes, and insurance on a Realization Event if it is part of the original mortgage loan documentation. The mezzanine lender may agree to this but will argue that it or its replacement guarantor will only have liability for such carry guaranty for the period from and after the Realization Event and that the mortgage lender will have to seek recourse against the original sponsor/guarantor for any claims that arose prior to such date. This is an acceptable position for most mortgage lenders and, if requested by a mezzanine lender, a mortgage lender will usually agree to release the mezzanine lender and replacement guarantor from the carry guaranty on and after "substantial completion" of the project and the satisfaction of certain cash flow and financial tests for the mortgaged property, as the project is now stabilized.

Additionally, if "substantial completion" of the project is not obtained by the mezzanine lender, mezzanine lenders may push a bit by also asking that the obligations of the carry guaranty terminate or burn-off in the event that the mezzanine lender is unable to successfully complete and reposition the project on the mortgaged property after the Realization Event and agrees to either (i) tender a deed

© 2019 Thomson Reuters

for the mortgage property to the mortgage lender, or (ii) cooperate with a consensual foreclosure. The mezzanine lender will argue that since it has committed no "bad acts" and used commercially reasonable efforts to "substantially complete" and reposition the construction project (but failed to do so due to facts and circumstances outside of its control), the mezzanine lender and the replacement guarantor should be released from its carry guaranties — because it is not part of its business deal to ultimately underwrite the risk of a material adverse event or disruption in the submarket where the project is located. A senior mortgage lender may consider a "good guy" release of the mezzanine lender under this scenario, but it may be considered an aggressive position by a mezzanine lender.

The Payment Guaranty

There is a market standard on the obligation for a mezzanine lender to deliver a payment guaranty post Realization Event: the mezzanine lender is never asked to deliver a payment guaranty and the mortgage lender may always pursue its remedies and recourse against the original borrower and mortgage guarantor. The market agrees that this is not an additional risk or an obligation that the mezzanine lender should be obligated to take in connection with its mezzanine loan.

Extension of the Substantial Completion Date

A mezzanine lender should absolutely negotiate in the intercreditor agreement for an extension of time to achieve "Substantial Completion" of the improvements required by the mortgage loan documents. If the mezzanine lender is in the position to foreclose and take over the project, it is almost certain that the project has been delayed. Further, there will be an interruption in the development project due to the time the mezzanine lender will need to foreclose on its equity collateral. There will be additional time delays if the mezzanine lender wants to replace the general contractor, construction manager, and/or design professionals, which may involve mortgage lender consent. A typical time period for the extension of "Substantial Completion" may be four to six months, but is a very fact specific analysis. Similarly, the mezzanine lender should also attempt to negotiate in the intercreditor for an extension of any outside funding dates and additional time to receive loan advances under the mortgage loan documents to dovetail to the extended "Substantial Completion" date. If conditions at the project or defaults by the borrower have triggered any provisions of the mortgage loan documents that would halt funding, the reconstituted borrower's right to receive draws should be reinstated. The mortgage lender may be amenable to such extensions and reinstatement but may demand an extension fee in connection with granting of these requests.

Mezzanine Lender Approval Rights on the Construction Budget, the Construction Draw Request, the Operating Budget, Leasing Activity, and Alterations at the Property

Each of the mortgage lender and mezzanine lender may have consent rights in its respective loan documents over the construction budget, the construction draw requests, the operating budget and, once the project is "substantially completed," leasing activity and alterations at the mortgaged property. Each

© 2019 Thomson Reuters

lender may have differing philosophies or approaches to the foregoing items and such philosophies or approaches may be impacted by each respective lender's position in the capital stack, whether such lender is subject to regulation or not, and the relative size and construction expertise of the related institution. These varied approaches on certain property-level diligence and activity may cause conflicts between the mortgage lender and the mezzanine lender with respect to the approval rights relating to these items. The intercreditor agreement must address the interplay between these various consent rights and minimize conflict so there is no disruption of the development and construction of the project, or subsequent operation of the completed project after "substantial completion," caused by differing strategies between the mortgage lender and the mezzanine lender. Many intercreditor agreements will provide that the mortgage lender is obligated to consult with the mezzanine lender concerning the request by borrower with respect to the diligence item, but such consultation is non-binding on the mortgage lender. The intercreditor agreement shall also further provide that the mezzanine lender shall not unreasonably withhold its consent (to the extent such consent is required under the mezzanine loan documents) to any such construction budget or operating budget (or amendment thereto) or new lease or alteration to the extent that the mortgage lender approves same in its reasonable discretion under the mortgage loan documents. The rationale for this position: the mortgage lender is the most senior lender in the capital stack and its mortgage lien directly encumbers the improvements being constructed by the owner of the property, as opposed to the mezzanine lender who has assumed the first loss position and whose security interest is one step away from the construction project. Thus, the senior mortgage lender has the final "say" on these property level items and activities. This structure also minimizes operational delays at the project due to disagreements between lenders in the capital stack.

Identity of the Mezzanine Lender in the Intercreditor Agreement—Who Is a Qualified Transferee?

Senior mortgage lenders are concerned about the identity of the mezzanine lender as such entity may become the replacement sponsor of the mortgaged borrower upon its completion of a Realization Event. Intercreditor agreements will permit a mezzanine lender to complete a Realization Event without mortgage lender's consent (or a rating agency confirmation if the mortgage loan is securitized) provided the mezzanine lender is a "Qualified Transferee" that satisfies certain "Eligibility Requirements." (See Exhibit A attached hereto for sample definitions of "Qualified Transferee" and "Eligibility Requirements," as well as a sample provision setting forth how and when a mezzanine lender can exercise its rights with respect to Realization Event.) On a construction loan, in addition to requiring a Qualified Manager to be in place (within 30 days of the Realization Event) to avoid senior lender consent to a Realization Event, if the Realization Event is occurring prior to "substantial completion" of the project, a Qualified Developer must also be in place (within 30 days of the Realization Event). A mortgage lender should also pay special attention to the experience test set forth in the definition of "Eligibility Requirements" to ensure that the Qualified Transferee has sufficient construction and development experience in the sub-

© 2019 Thomson Reuters

market where the mortgaged property is located, as they will be stepping into the shoes of the mortgage borrower to complete the project. On the other hand, a mezzanine lender may argue that it can meet this obligation by hiring an experienced construction or development manager or general contractor.

Similarly, a mortgage lender should also be very careful with respect to requests by a mezzanine lender for specific entities to be listed in clause (i) of the definition of "Qualified Transferee" (see Exhibit A), as these specifically named entities are not subject to the Eligibility Requirements upon a Realization Event. Mortgage lenders should underwrite these specifically named entities at closing (by reviewing financial statements, balance sheets, and if necessary, corporate resumes or disclosures); these specifically named entities should be very strong candidates with solid construction experience that meet at closing the total asset and net worth tests set forth in the definition of "Eligibility Requirements." However, senior mortgage lenders do run the risk that these specifically named "Qualified Transferees" may not meet the financial tests upon a Realization Event. For this reason, senior lenders should also avoid "catch-all" language in clause (i) of the definition of "Qualified Transferee" that also includes "Affiliates" of these specifically-named entities, thus further broadening the list of entities that do not need to satisfy the Eligibility Requirements on a Realization Event and increasing the risk of having a poorly capitalized new sponsor taking over a construction project upon a foreclosure of the mezzanine loan. This is not a scenario a mortgage lender wants to encounter when the construction project is crumbling.

Lastly, in order to preserve the required financial capability and experience of a mezzanine lender which is especially important on a construction loan, a senior mortgage lender must be cautious when drafting the permitted mezzanine loan transfers in the intercreditor agreement. Historically, intercreditor agreements only address the restrictions of transfers of the mezzanine loan and typically a mezzanine loan may only be transferred to a Qualified Transferee without the mortgage lender's consent. However, the mezzanine loan transfer section should also address (for the mortgage lender's benefit) transfers *in* a mezzanine lender. If restrictions on transfers in the intercreditor agreement only require that a Qualified Transferee shall hold a mezzanine loan (or at least 51 percent of a mezzanine loan), a transfer of 99 percent of the equity *in* the *specifically named* Qualified Transferee (including the initial mezzanine lender) in clause (i) of the definitions may be permitted (without mortgage lender's consent) to a person or entity that is *not* a Qualified Transferee. Thus, under this scenario the mortgage lender could be in a much weaker position upon a Realization Event than intended. Certain transfers *in* mezzanine lenders that are *specifically named* Qualified Transferees (which are not required to meet the Eligibility Requirements on a Realization Event and do not require mortgage lender consent) may circumvent the restrictions in the mezzanine loan transfer section. These mezzanine loan transfer provisions should be carefully analyzed and reviewed by senior mortgage lenders and their counsel to avoid any unintended consequences on a default scenario.

© 2019 Thomson Reuters

The Default Scenario: What Additional Considerations Does a Mezzanine Lender Have?

Should the Mezzanine Lender Cure the Mortgage Loan Default and What Issues Should the Mezzanine Lender Consider Before It Either Entertains a Mezzanine Loan Restructure or Exercise of Remedies?

Pursuant to the terms of the intercreditor agreement, the mezzanine lender is given the right to cure both monetary and non-monetary events of default under the mortgage loan in order to prevent the senior mortgage lender from foreclosing and terminating the mezzanine lender's security interest in the equity collateral. However, the decision of whether or not to cure is not such a simple one. The mezzanine lender would have to believe that it can remedy the issues at the project causing the existing developer to default on the mortgage loan and mezzanine loan and also rely on a current appraisal that reflects an "as stabilized" value that will cover the outstanding mortgage and mezzanine debt. In that case, the mezzanine lender may elect to cure the mortgage loan pursuant to the intercreditor agreement in order to have a cooling off period to then evaluate whether to (a) structure a work-out of the mezzanine loan with the borrower with no involvement by the mortgage lender (depending on the nature of the default, however, it seems unlikely that if the default is a construction related issue it will be resolved only by a restructure of the mezzanine loan) or (b) foreclose on its equity collateral and take over the mortgaged borrower and the construction project. The economics of this decision must be carefully analyzed by the mezzanine lender and the following considered before any action is taken:

- What is the nature of the default?
- Why did the construction project get off schedule and why is the construction budget "out of balance" or subject to cost-overruns?
- Is the project being mismanaged by the developer?
- Was there a force-majeure event or external sub-market issue that slowed construction or subjected the developer to higher hurdles or unexpected costs to complete the project?
- Will some relief from the mezzanine lender aid the borrower and enable borrower to satisfy its obligations under the mortgage and mezzanine loans?
- What percentage of the project is complete and how far away is the "substantial completion" date?
- Will the mezzanine lender be able to reach the "substantial completion" date (even given any extensions negotiated in the intercreditor agreement)?
- Will the foreclosure of the pledge be subject to borrower defenses and contest?
- How much money will the mezzanine lender have to infuse into the project to get it back on track?
- Will the mezzanine lender be able to pursue the mezzanine completion guarantors for these infused funds to rebalance the mortgage loan and how likely

© 2019 Thomson Reuters

is the mezzanine lender to succeed on these claims?

- Are there mechanics' liens or other liens on the mortgaged property that the mezzanine lender would take subject to with an equity collateral foreclosure?

- Since a UCC foreclosure by the mezzanine lender is essentially the purchase of a business enterprise subject to all the liabilities of such business enterprise, how diligent has the mezzanine lender been in the administration and servicing of its loan prior to default?

- Is the mezzanine lender able with confidence to circle all of the existing liabilities and obligations that the mortgage borrower has with respect to the construction project and the status of the mortgage loan?

- Will a mezzanine foreclosure trigger transfer taxes in the state where the property is located?

- Will the mezzanine lender be able to sell better sponsorship to the mortgage lender in order to provide some relief and a loan restructure at the mortgage level post-foreclosure to enable the mezzanine lender to ultimately obtain "substantial completion" of the project?

These are just a handful of questions/issues a mezzanine lender will need to examine concerning its cure rights and then whether (A) a work-out/loan restructure of the mezzanine loan or (B) a foreclosure of its equity collateral is the most optimal scenario given the existing loan defaults.

Mortgage/Mezzanine Intercreditor Issues That a Mezzanine Lender Will Need to Consider On a Defaulted Loan Scenario While Weighing Its Options

The provisions of the intercreditor agreement may pose difficulties or tie a mezzanine lender's hands with respect to its work-out or enforcement of remedies strategy post-default. Set forth below are a list of matters and questions a mezzanine lender must evaluate in the intercreditor agreement when determining whether to pursue a restructuring of the mezzanine loan or to exercise remedies:

- When is senior lender required to send a senior mortgage loan notice of default to mezzanine lender?

- Will mezzanine lender cure the defaulted senior mortgage loan?

- Will mezzanine lender exercise its loan purchase rights?

- Must senior lender consent, or must a rating agency issue a confirmation, to foreclose on the equity collateral?

- Does mezzanine lender meet the definition of a "Qualified Transferee?"

- Can senior lender ask for financials or other evidence to confirm mezzanine lender is a "Qualified Transferee?"

- Will the definition of "Qualified Transferee" diminish the number of bidders who can participate in the UCC foreclosure sale?

- Does mezzanine lender need to cure senior mortgage loan defaults prior to mezzanine lender foreclosing on the equity collateral?

© 2019 Thomson Reuters

- Does mezzanine lender have the obligation to deliver a new recourse carve-out guarantor, completion guarantor, carry guarantor and/or payment guarantor prior to foreclosing on the equity collateral?

- Are there financial requirements with respect to the replacement guarantor? Net worth? Liquidity?

- Can mezzanine lender pursue a claim against its recourse carve-out guarantor, completion guarantor or carry guarantor if senior lender is simultaneously pursuing a claim?

- If senior mortgage lender is restructuring the senior mortgage loan with mortgage borrower does senior lender need mezzanine lender consent?

- If mezzanine lender is restructuring the mezzanine loan with mezzanine borrower does mezzanine lender need senior mortgage lender's consent?

Given the combination of the complexity and the risks imposed by financing a construction project, a potentially powerful and difficult mortgage lender, a most certainly uncooperative borrower and certain unexpected consequences of an intercreditor agreement, the workout and/or the enforcement of remedies of the bottom dollar risk mezzanine loan will certainly pose challenges in a post-default scenario. The mezzanine lender (hopefully) is being adequately compensated in yield and fees for these significant post-default headaches.

* * *

EXHIBIT A

a. Sample Provision on Requirements to Exercise a Realization Event:

Mezzanine Lender shall not complete a Realization Event without Senior Lender consent and a Rating Agency Confirmation unless (i) the transferee of title to the Equity Collateral is a Qualified Transferee, (ii) the Premises will (a) following the Completion of the Improvements, be managed by a Qualified Manager within thirty (30) days after the Realization Event and (b) prior to the Completion of the Improvements, be developed by a Qualified Developer pursuant to the terms of a development agreement on terms and conditions acceptable to Senior Lender in its reasonable discretion, which agreement is put into effect within thirty (30) days after the Realization Event and such Qualified Development shall (at the same time that it enters into the development agreement) enter into an assignment and subordination of development agreement and development fees in form and substance substantially similar (with such changes as may be agreed to by and among Senior Lender, the transferee of title to the Equity Collateral and the applicable Qualified Developer) to that certain assignment and subordination agreement delivered by Developer to Senior Lender in connection with the origination of the Senior Loan.

b. Certain Applicable Definitions:

a. "*Qualified Transferee*" means (i) the initial named Mezzanine Lender, [________][**insert additional entities negotiated by Mezzanine Lender] [or any entity which is an Affiliate of any of the foregoing entities]** or (ii) one or more of the following:

(A) a real estate investment trust, bank, saving and loan association, investment bank, insurance company, trust company, commercial credit corporation, pension plan, pension fund or pension advisory firm, mutual fund, government entity or plan, provided that any such Person referred to in this clause (A) satisfies the Eligibility Requirements;

© 2019 Thomson Reuters

(B) an investment company, money management firm or "qualified institutional buyer" within the meaning of Rule 144A under the Securities Act of 1933, as amended, or an institutional "accredited investor" within the meaning of Regulation D under the Securities Act of 1933, as amended, provided that any such Person referred to in this clause (B) satisfies the Eligibility Requirements;

(C) an institution substantially similar to any of the foregoing entities described in clauses (ii)(A) or (ii)(B) that satisfies the Eligibility Requirements;

(D) any entity which Controls, is Controlled by, or is under common Control with any of the entities described in clauses (ii)(A), (ii)(B) or (ii)(C) above or (ii)(E) below;

(E) an investment fund, limited liability company, limited partnership or general partnership (a "*Permitted Investment Fund*") where a Permitted Fund Manager or an entity that is otherwise a Qualified Transferee under clauses (ii)(A), (B), (C) or (D) of this definition, investing through a fund with committed capital of at least $250,000,000, acts as the general partner, managing member or fund manager and at least 50% of the equity interests in such Permitted Investment Fund are owned, directly or indirectly, by one or more of the following: a Qualified Transferee under clauses (ii)(A), (B), (C) or (D) of this definition, an institutional "accredited investor" within the meaning of Regulation D promulgated under the Securities Act of 1933, as amended, and/or a "qualified institutional buyer" or both within the meaning of Rule 144A promulgated under the Securities Exchange Act of 1934, as amended, provided such institutional "accredited investors" or "qualified institutional buyers" that are used to satisfy the 50% test set forth in this clause (E) satisfy the financial tests in clause (i) of the definition of Eligibility Requirements, or one or more entities that are otherwise Qualified Transferees under clauses (ii)(A), (B), (C) or (D) of this definition; or

(F) any other lender or Person (including opportunity funds) that has been approved as a Qualified Transferee by the Rating Agencies pursuant to Section 4(a) hereof.

Notwithstanding anything to the contrary contained in this definition of Qualified Transferee, in no event shall Guarantor, Borrower, Mezzanine Borrower, any Borrower Party, any tenants-in-common, any Embargoed Person, any Delaware Statutory Trust or any Crowd-Funded Entity be deemed or permitted to be a "Qualified Transferee."

b. "*Permitted Fund Manager*" means any Person that on the date of determination is (i) one of the entities listed on **EXHIBIT D** [not attached] or any other nationally-recognized manager of investment funds investing in debt or equity interests relating to commercial real estate, (ii) investing through a fund with committed capital of at least $250,000,000 and (iii) not subject to a Proceeding.

c. "*Eligibility Requirements*" means, with respect to any Person, that such Person (i) has total assets (in name or under management or advisement) in excess of **[$600,000,000]** and (except with respect to a pension advisory firm, asset manager, registered investment adviser, manager or similar fiduciary) capital/statutory surplus or shareholder's equity in excess of **[$250,000,000]** (including uncalled and unencumbered irrevocable capital commitments that are available to be called by such Person that is a Qualified Transferee and otherwise (without regards to this parenthetical) meets the Eligibility Requirements as cash capital contributions to such Person) and (ii) is regularly engaged in the business of

© 2019 Thomson Reuters

making or owning (or, in the case of a pension advisory firm, asset manager, registered investment adviser, manager or similar fiduciary, regularly engaged in managing investments in) loans secured by commercial real estate similar in size, scope, use and value as the Premises (including mezzanine loans to direct or indirect owners of commercial properties, which loans are secured by pledges of direct or indirect ownership interests in the owners of such commercial real estate) and which loans are of a size and type consistent with and similar to the Senior Loan and/or the Mezzanine Loan, originating preferred equity investments in direct and indirect owners of commercial real estate properties similar or larger in size and scope to the Property or owning or operating commercial real estate properties similar or larger in size and scope to the Property.

d. "*Qualified Developer*" shall mean (A) in the reasonable judgment of Senior Lender, a Person with management, construction and development experience with respect to properties similar to the Property substantially similar to that of Developer or (B) [**insert entity specifically negotiated by Mezzanine Lender**].

NOTES:

[1]"**Supplemental Third Party Obligor**" means a transferee of the Equity Collateral or a Person who, alone or together with others, Controls, directly or indirectly, a transferee of the Equity Collateral, that either (a) is reasonably acceptable to Senior Lender or (b) collectively with any other Supplemental Third Party Obligors has a net worth (exclusive of its interest in the Premises) of at least $_______ and maintains liquid assets of at least $_______. A rule of thumb on the net worth and liquidity tests: (x) net worth required is no less than the loan amount and (y) liquidity is no less than 10 percent of the loan amount.

© 2019 Thomson Reuters