

REAL ESTATE LAW AND PRACTICE
Course Handbook Series
Number N-574

REIT and Real Estate M&A Restructurings and Recapitalizations 2010

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COMPLEX REAL ESTATE FINANCINGS IN
THE CMBS ERA: HOW CMBS AND MULTI-
TRANCHE STRUCTURES ARE IMPACTING
DISTRESSED REAL ESTATE WORKOUTS

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I. OVERVIEW

A. Introduction

The advent of the securitization of commercial mortgage loans in the early 1990's has had a profound effect on commercial real estate finance. According to statistics published by the Mortgage Banker's Association,² as of the second quarter of 2009, approximately 21% of the \$3.47 trillion of commercial mortgage debt outstanding was held in securitized format (not including multifamily mortgage loans backing MBS issued by the GSEs). While that number is substantial in itself, the CMBS market has driven structuring innovations in mortgage finance well beyond the securitized mortgage market. Structures designed to meet the standards of rating agencies and CMBS investors have become common in non-securitized mortgage financings as well.

It is important for real estate practitioners to understand these CMBS-inspired structures. Particularly in today's distressed real estate market, the interplay of various creditors exercising varying rights under these structures will play a central role in the outcome of work-outs and foreclosures.

This outline will describe the predominant structures for tranching real estate debt: securitized A notes or A participations, "rake" bonds, B notes and B participations and mezzanine loans. It will describe the rights of the various lenders under these structures, as well as the roles of master servicers, special servicers and trustees. It will also give an overview of CMBS structures generally, and the processes and procedures built into CMBS structures to guide work-outs and foreclosures of defaulted mortgage loans.

B. Structuring Flexibility

CMBS lenders generated profits by lending on real estate and structuring the debt for resale in the secondary market. These lenders created an arbitrage by lending at prevailing "whole loan" interest rates and financing the lending activity at relatively more efficient rates available in the capital markets. For larger real estate financings, the debt may have been divided into various portions or "tranches"

2. Press Release, Mortgage Bankers Ass'n, Commercial/Multifamily Mortgage Debt Outstanding Declines in Second Quarter 2009 (Sept. 24, 2009), available at <http://www.mbaa.org/NewsandMedia/PressCenter/70422.htm>.

for sale in various secondary markets. Because it was not always clear at the time loans were funded which structures and which markets would provide the best execution on secondary market debt sales, the lenders typically retained the flexibility to restructure debt after loans were funded. One of the primary factors that dictated the ultimate structure of a real estate capital stack was the rating agency subordination levels assigned to that financing. If the overall financing were to be tranching “horizontally” from senior to junior, how much of the debt could achieve an investment grade rating? How much would be “AAA”?

Although many lenders possessed a sophisticated understanding of the rating agency models used to determine subordination levels, the ratings process was subjective enough that there was uncertainty at the time a loan was funded as to what the ultimate structure would be. In addition, the ultimate subordination levels assigned depended on exogenous factors such as whether the loan would be pooled with other loans in a CMBS execution and, if so, the composition of the rest of the pool. This is the reason that lenders retained the unilateral right to require borrowers to cooperate in restructuring their debt after they borrowed. Large “whole loan” mortgages were sometimes divided into multiple portions. Portions of the debt might be structured or restructured into mezzanine loans, not secured directly by the real estate, but by equity in a special purpose company that, directly or indirectly, owned the real estate.

The various tranches of debt were then sold to different investors in different ways. The most senior tranche of debt would typically be securitized in a CMBS transaction, where the debt was further tranching into multiple classes of CMBS bonds. The junior portions of the mortgage loans, as well as any mezzanine loans, might be sold to investors such as real estate debt funds. The debt funds often financed these purchases using various forms of leverage, including real estate CDO’s.

The end result is that most large real estate financings put in place during the last 10 years, many of which are experiencing distress, are likely to be held by myriad investors through differing structures with differing rights and priorities.

II. TRANCHED MORTGAGE LOAN STRUCTURES

A. Different Structures for Tranching Mortgage Loans

A/B Notes and A/B Participations. As briefly described above, large mortgage loans originated in the CMBS environment were frequently divided into one or more senior portions, which are typically securitized in CMBS transactions, and one or more junior portions, which are often held by various lenders and not securitized (although some junior portions may be pledged to secure real estate CDOs). All tranches of a mortgage loan benefit from a lien on the related real estate. Whole mortgage loans were divided into multiple tranches in one of two ways: either the borrower issued two or more notes (each designated as an “A note” or “B note”) or a single mortgage note was divided into multiple participation interests (each designated as an “A participation” or “B participation”). In general, rating agencies preferred the participation structure to the note structure because it is thought to be more secure from the point of view of the senior lender. Junior lenders waive their right to participate in a borrower bankruptcy proceeding, including the right to vote on a plan of reorganization. Certain caselaw suggests that the effectiveness of such a waiver may be challenged if the lender who waived the rights is a noteholder, because a noteholder is in direct privity of contract with the borrower.³ However, if the senior tranche of a mortgage loan was to be included in a public, S.E.C.-registered, CMBS transaction, the multiple note structure was generally used. This is true because the S.E.C. takes the position that loan participations may be securities and may require separate S.E.C. registration under the Securities Act of 1933 in order to qualify for inclusion in an S.E.C.-registered securitization transaction. S.E.C. registration of an interest in an individual mortgage loan is generally a non-starter for a number of reasons.⁴

In general, the fixed rate CMBS conduit market developed as a public S.E.C.-registered market, while the floating rate large loan market developed as a 144A market. For this reason, large floating-rate commercial mortgage loans were typically tranced using the

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3. See, e.g., *Bank of America, N.A. v. North LaSalle Street Limited Partnership (In re 203 North LaSalle Street Partnership)*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).
 4. See, e.g., *Asset Backed Securities*, Securities Act Release No. 8518, 70 Fed. Reg. 1506, 1529, n. 173 (Dec. 5, 2005).

participation structure, while large fixed-rate commercial mortgage loans typically used the multiple note structure.

The rights of senior and junior lenders in these structures are governed either by a co-lender agreement (in the case of notes) or a participation agreement (in the case of participations). These documents set forth the priority of payments among the various lenders as well as the lenders' rights with respect to administration of the loan, foreclosure, and other matters including cure and purchase rights, as more specifically described below.

“Rake” Bonds. In some cases lenders determined that, although the best execution for a particular large mortgage loan may be to divide it into separate senior and junior interests, it was desirable to structure the junior interests as one or more classes of CMBS securities rather than as a B note or a B participation. In these cases, rather than divide the whole loan into multiple tranches governed by a noteholder or participation agreement, the entire whole loan was deposited in a securitization and the tranching of a senior portion and junior portion was accomplished by creating “rake bonds” within the securitization. Rake bonds are classes of CMBS issued in a transaction that solely relate to one particular mortgage loan. The economics of this structure are similar to an A/B note or A/B participation structure, with the senior or “A” portion of the loan contributing its cashflow to the general “pooled” CMBS classes on a senior basis, and the “rake bonds” receiving remaining proceeds from the loan on a junior basis. A “rake bond” structure is similar to that of an A/B structure, but the mechanics and co-lender rights are contained in the securitization pooling and servicing agreement, rather than a separate intercreditor agreement.

Securitized Whole Loans. It bears emphasis that the A/B note, A/B participation and rake bond structures were generally used only on the largest, most complex mortgage financings. The overwhelming majority of securitized commercial mortgage loans were not tranced on a loan-by-loan basis, but rather were contributed to CMBS pools in their entirety. The CMBS pools were tranced, however investors in each tranche of CMBS owned an undivided interest in the entire pool of underlying loans and could not track their investment to any specific loan or group of loans. Investors in the most junior classes of CMBS in these generic structures were exposed to the first risk of loss on all loans in the pool, up to their full principal balances. They therefore received

certain rights to influence the servicing of the loans, as more fully described below.

B. CMBS Securitization Structures

Overview. Although there are many variations, the predominant CMBS structure is a pass-through trust. Each transaction involved the establishment of a new trust and, most often, the election to treat the trust as a REMIC for federal income tax purposes. Loans were contributed to each trust and interests in the trust, called pass-through certificates, were sold to investors. Although these pass-through certificates were generally referred to in the market as “bonds” because they were structured to perform as fixed income securities, they technically represent fractional ownership of the CMBS trust and its underlying assets.

The Trustee. The Trustee is the nominal owner of all of a CMBS trust’s assets, holding them in trust for the CMBS investors, and is the lender of record for the underlying mortgage loans. Any modifications to securitized mortgage loans are made in the name of the trustee, although often the master servicer or special servicer executes the documents by power of attorney. Foreclosures occur in the name of the trustee, with the result that the securitization trust becomes the owner of the foreclosure property (subject to the ongoing rights of any B note or B participation holders). The trustee is also responsible for making monthly distributions to the CMBS investors, producing periodic investor reports and general administration of the trust.

One Servicer Per Loan. Although mortgage loans in CMBS format are often tranching into multiple interests held by multiple investors, they still represent interests in a single loan secured by a single property or pool of properties. For this reason, investors do not have their own separate servicers for their portions of a mortgage loan. There can only be a single master servicer and special servicer for any mortgage loan. Even loans that were broken up to be securitized in multiple CMBS transactions designated a single “lead” master and special servicer. It would be illogical to have multiple servicers, and potentially multiple servicing strategies, for a single loan and collateral package. The servicers are required to adhere to the “servicing standard” which requires servicers to service each mortgage loan in a manner that benefits all of the lenders, as a collective whole, with a view towards maximization of proceeds on a net present value basis.

The Master Servicer. The master servicer is responsible for the day-to-day servicing of performing mortgage loans. This includes collecting payments, processing borrower requests, monitoring compliance by the borrowers with the requirements of their loans, including maintenance of property insurance and payment of property taxes. The master servicer is also responsible for preparing loan and property-level reports for the trustee, which the trustee includes in its periodic investor reports.

In addition, the master servicer is responsible for advancing, from its own funds, any delinquent payments on the underlying loans so that the CMBS holders do not experience shortfalls as a result of borrower delinquencies. The master servicer also advances any property protection expenses necessary to protect the lender's interest in the collateral, such as delinquent taxes or overdue insurance premiums, as well as any other costs associated with servicing or enforcing the loans. This is true even for loans that have been transferred to special servicing. The master servicer's right to be reimbursed for these advances is "super-senior". Advances are repaid from the first funds realized on a defaulted loan and if, for any reason, the advance is not recoverable from the proceeds of the loan on which the advance was made, the master servicer may reimburse itself from the proceeds of other loans in the CMBS pool. Master servicer advances are intended as liquidity for the CMBS, not credit support. B notes and B participations do not benefit from master servicer advances, although rake bonds often are entitled to advances.

The Special Servicer. The special servicer is responsible for servicing defaulted mortgage loans or loans that are designated as "specially serviced" as a result of credit events. Special servicers are the primary point of contact for borrowers hoping to work-out and restructure distressed real estate financings. Special servicers are also responsible for exercising remedies on defaulted loans and for managing (through independent property managers) and disposing of foreclosed properties.

C. The Controlling Holder

Who is the Controlling Holder? Most CMBS structures will designate one investor as the "controlling holder" of a mortgage loan, with rights to influence the servicing of the loan, as further described below. The controlling holder is generally the holder of the most junior tranche of the mortgage debt that is still "in the money", as determined with reference to an appraisal. The concept of giving

servicing control to the most junior investor is unique to CMBS. In most other forms of lending, the senior lender has control in a default situation. But in CMBS, the most junior investor was thought to have the most at stake in a default and was thought to be the most motivated (and perhaps sophisticated) lender, best positioned to achieve a favorable result in a default scenario. Mezzanine lenders can never be controlling holders of the mortgage, as they have their own distinct collateral and may have very different motivations from mortgage investors.

Servicing control can shift from the most junior investor upward in the capital stack as a result of an appraisal. A “control appraisal event” will occur if, following application of “appraisal reductions” from the bottom tranche of the mortgage loan upward through the capital stack, the current controlling holder is not deemed secured in an amount at least equal to 25% of its portion of the loan balance. Appraisal reductions are calculated, generically, by comparing 90% of the appraised value of the property, on the one hand, to all amounts owed on the related loan and all expenses to be reimbursed from the loan or the collateral, on the other. If 90% of the value is insufficient to pay all such amounts, then the negative difference is called an “appraisal reduction amount.” Appraisal reduction amounts are applied to all tranches of the mortgage loan, whether in the form of B notes, B participations, rake bonds or junior pooled bonds, in inverse order of seniority. They are not applied, however, to mezzanine loans, as mezzanine loans do not technically share the mortgage collateral with the mortgage loan investors.

What Rights Does the Controlling Holder Have? The consent of the controlling holder of a mortgage loan is required for various material actions that a master servicer or special servicer may propose to take with respect to the mortgage loan. Most controlling holders have consent rights over a short list of significant servicing decisions for performing loans, but if a loan is in default, the controlling holder’s consent rights increase dramatically. A master servicer generally needs the controlling holder’s consent to take the following actions on a performing loan: approval of a material lease, waiver of a “due-on-sale” or “due-on-encumbrance” clause, release of collateral for a mortgage loan and waiver of insurance requirements under the loan documents. Actions requiring controlling holder consent on defaulted loans generally include: modification of monetary terms of a mortgage loan, foreclosure on any mortgage loan, accelerating the maturity of a mortgage loan, release of any

collateral or any obligor (including a guarantor), replacement of a property manager and waiver of any borrower defaults.

D. How Do CMBS Structures Handle Distressed Loans?

REMIC Restrictions on Modifications. CMBS deals are usually structured as Real Estate Mortgage Investment Conduits (or REMICs) to avoid attracting a corporate-level tax, which would make the deals un-economic. Until recently, the REMIC rules prohibited most loan modifications from being performed after the closing date of the REMIC and prior to default (or reasonably foreseeable default) unless the subject modification was not a “significant modification” under the treasury regulations. Modifications following default or reasonably foreseeable default are permitted, as well as modifications in connection with an assumption of a loan, waiver of a “due-on-sale” or “due-on-encumbrance” clause, or conversion of the interest rate by a lender pursuant to the terms of a convertible mortgage.

In September 2009, the REMIC rules were modified to permit changes to collateral and credit enhancement relating to a mortgage loan (even a performing mortgage loan) so long as the mortgage loan remains “principally secured” by real property after the modification. Principally secured means either (1) that the mortgage loan has a loan-to-value ratio (taking into account only the real property collateral) of 125% or less or (2) for mortgage loans with loan-to-value ratios above 125%, that there is no reduction in the fair market value of the real property after the modification. The principally secured test applies to all releases, including those contemplated by the parties when a loan was closed, and releases on loans in default or as to which default is reasonably foreseeable. This latter requirement may present difficulty to servicers who are often obligated under mortgage loans originated prior to these REMIC rule changes to release property if the borrower meets certain specified conditions under the mortgage loan without regard to whether the “principally secured” test is satisfied. The securitization industry has requested the IRS to modify these rules to prevent difficulties for servicers and potential liability for securitization trusts.

In addition, for any significant modification, the IRS has interpreted “reasonably foreseeable” to permit “significant modifications” if there is a “significant risk of default” based on a diligent contemporaneous determination of that risk. Specifically, the IRS clearly indicated that the fact that a mortgage loan may have a

significant remaining term before maturity is not itself a bar to a determination that default is reasonably foreseeable.

Notwithstanding the recently released IRS guidance on the ability to modify a mortgage loan in a REMIC, the REMIC restrictions on modifications continue to restrict many restructurings of loans (such as material changes in the interest rate or payment dates) absent a default or reasonably foreseeable default.

Contractual Restrictions on Modifications. In addition to considerations of whether a modification can be performed from a REMIC standpoint, CMBS pooling and servicing agreements typically constrain the ability of master and special servicers to modify loans prior to their designation as “specially serviced” loans. Master servicers are permitted to make immaterial modifications such as waivers of minor covenant defaults, immaterial grants of easements and other routine modifications. Certain modifications may require the master servicer to obtain the controlling holder’s consent, such as the entering into of a significant lease at a mortgaged property. Generally, master servicers have the latitude to perform day-to-day administration of the mortgage loans, but not to engage in major modifications.

Transfers of Loans to Special Servicing. Once a “servicing transfer event” occurs, the servicing of a mortgage loan is transferred from the master servicer to the special servicer who can provide specialized attention and real estate workout expertise and focus on the particular issues causing a loan to underperform. Servicing transfer events vary from deal to deal, but broad categories include material monetary defaults that continue for a certain period of time (typically 60-90 days), failure of a borrower to repay the mortgage loan at maturity, borrower bankruptcy, material non-monetary defaults that remain uncured and certain other events that constitute loan defaults. Master servicers also can decide to transfer mortgage loans to special servicing to the extent they believe there is an imminent risk of default. Notwithstanding the liberalization of the REMIC restrictions on modifying performing loans described above, the contractual provisions contained in CMBS pooling agreements still pose significant limitations on the ability of CMBS master servicers and special servicers to consider loan restructurings where loans are not either in default or on the verge of default.

The transfer of the mortgage loan to special servicing has financial consequences to the various lenders. Because the special servicer is entitled to special servicing fees and additional fees if it

negotiates a successful workout or liquidates the mortgaged property, and such fees have a “super-senior” priority of payment, such fees will likely cause losses to the most junior investors, even if the workout or liquidation of a mortgage loan results in a full recovery of amounts due thereunder.

Once a loan is transferred to special servicing, the special servicer has considerably more latitude to consider options to restructure the debt. Generally, special servicers are required to determine various options for addressing defaulted mortgage loans, including restructurings as well as foreclosures, and pursue the strategy that they deem likely, on a net present value basis, to achieve the better financial result for the investors. Most pooling and servicing agreements contain outright prohibitions on certain types of loan modifications, however, especially as they relate to extensions of maturity. Some deals contain more meaningful restrictions than others.

The Asset Status Report. Once a mortgage loan becomes specially serviced, the special servicer is required to prepare an “asset status report,” which sets forth the summary of the status of the mortgage loan and mortgaged property or properties, a discussion of any legal and environmental concerns, the most recent appraised value of the mortgaged property or properties, and recent property-level information such as occupancy levels and property revenues. The special servicer also must recommend a course of action to address the default. The asset status report is an important tool for the various lenders since it also analyzes how the proposed recommendations are likely to produce a greater recovery on a net present value basis than other possible courses of action.

Before implementing any recommended action, the special servicer must obtain the controlling holder’s approval of the asset status report. Controlling holders are given certain time periods within which to approve an asset status report, object or make alternative suggestions on how to resolve a default. Some pooling and servicing agreements allow the special servicer to determine the course of action to be taken even if the controlling holder disagrees, while others permit the controlling holder to direct the course of action.

It is important to note that although the controlling holder may influence the course of action to address any particular default, the special servicer has considerable discretion to reject any suggested

course of action that it determines is not in accordance with the servicing standard.

In any case, a special servicer may not take any action that would violate the servicing standard, violate law or the REMIC rules on modification of mortgage loans.

The “Fair Value” Purchase Option. In order to comply with the accounting rules which govern whether CMBS trusts are treated as off-balance sheet vehicles (which rules will no longer be applicable as of January 1, 2010), most CMBS transactions were structured to give very little opportunity for special servicers to dispose of defaulted mortgage loans. The only manner in which a defaulted loan may be sold is in accordance with the so-called “fair value purchase option.” The fair value option provides to certain prescribed parties to the transaction (generally beginning with the controlling holder) an assignable option to purchase a specially serviced mortgage loan at a price equal to its “fair value,” for a certain period of time following determination of that value.

Fair value of a specially serviced mortgage loan is determined by the special servicer upon receipt of an appraisal, as well as various other factors such as the length and amount of the delinquency, the occupancy level and physical condition of the mortgaged property and the expense involved in foreclosing on the mortgaged property. If a purchase option is not exercised within the prescribed time periods, the special servicer must pursue other resolution strategies.

E. Payment Priorities for B Notes, B Participations and Rake Bonds

In A/B note or A/B participation structures, the priority of payments prior to a loan default generally differs from the allocation of cashflow after a default. Prior to a payment default or other material default on the mortgage loan, all debt service payments and other amounts paid on account of a mortgage loan (after payment of certain expenses) are generally paid *first*, to the senior A holder on account of current interest, *second*, to the senior A holder on account of its pro rata portion of principal, *third*, to the junior B holder on account of current interest, and *then*, to the junior B holder on account of its pro rata portion of principal. All other amounts are then split among the lenders on a senior/subordinated basis (*i.e.*, prepayment premiums would go first to the senior A holder, and then to the junior B holder). But after a payment default or other material default on a mortgage loan, all amounts collected on the mortgage

loan or from the liquidation of the collateral (net of certain expenses) go to the senior A holder first, until its principal balance is completely repaid, before the junior B holder is entitled to any payments of any kind.

By virtue of these payment priorities, the junior B holder will always absorb all losses until its principal balance is reduced to zero. Additionally, the consequences of any modifications that affect the original payment terms of a mortgage loan will be borne by the junior B holder.

Some rake bond structures differ in payment priorities from that described above. Rake bonds are often entitled to the benefit of master servicer advances. In these cases, rake bonds typically continue to be entitled to current payments of interest even following a default on the underlying mortgage loan. They generally will not be entitled to any principal amortization, however, until the senior interest in the loan has been fully paid off.

F. Other Rights of B Note/B Participation Holders

Cure Rights. Upon the occurrence of monetary or non-monetary defaults by a borrower, the junior B holder (or multiple junior B holders if the capital structure has more than one junior B holder) will have the right to cure the default by the borrower within certain rating agency prescribed time periods (typically 5 business days for monetary defaults, or 30 days for non-monetary defaults). The effect of the cure right is to delay enforcement action and stall the mortgage loan from being “specially serviced.” This is important for the junior B holder since once the mortgage loan becomes specially serviced, additional servicing fees accrue, which will reduce the amount available to the junior B holder (which would result in a loss to its position). Additionally, if the mortgage loan is considered “specially serviced,” the post-default waterfall of funds will be imposed which will result in the junior B holder not receiving any proceeds from the loan until the senior A holder is paid in full. Rake bond holders do not typically have any cure rights.

Purchase Rights. If a mortgage loan is in monetary default or is “specially serviced,” the junior B holder (or multiple junior B holders if the capital structure has more than one junior B holder) will have the right to purchase the senior A holder’s position (and any more senior B holder’s position) at a price equal to par, plus accrued interest (generally excluding yield maintenance), and plus accrued expenses of the servicers and any outstanding advances made by the

servicers (plus interest thereon). These purchase rights often extend through (and sometimes for a short period beyond) the date of foreclosure on the defaulted mortgage loan.

III. MEZZANINE LOANS

A. General

Mezzanine loan structures were used to add subordinate leverage to a commercial real estate financing without (in theory) increasing the likelihood of default on the related mortgage loan or the likelihood of losses on the mortgage loan if default does occur. Unlike B notes and B participations, mezzanine loans are separate and distinct loans that are not directly secured by the mortgaged property. Rather, the borrower under a mezzanine loan, which is typically the direct or indirect parent of the mortgage borrower, has pledged its direct or indirect equity interests in the mortgage borrower as collateral for its mezzanine loan.

Because mezzanine loans are not secured directly by the related real estate, they do not increase the loan-to-value ratio of the mortgage loan, and were therefore preferable from a rating agency modeling perspective and a CMBS marketing perspective. If a mezzanine borrower defaults under the mezzanine loan, the mezzanine lender may foreclose on its collateral (i.e., the equity interests pledged to them), which will result in a change of ownership of the related borrower: the mezzanine lender becomes the borrower of the related mortgage loan. To the extent that mezzanine debt was sold to institutional investors with real estate sophistication and access to capital, such investors were viewed by CMBS buyers almost as “back-up sponsors” for the property who were thought to be ready to step in and resurrect a failing real estate venture if the original sponsor proved unwilling or unable to do so.

The various rights of the mortgage lender and the mezzanine lender are governed by an intercreditor agreement. As discussed below, intercreditor agreements set forth the relative priority of a mortgage loan and a related mezzanine loan, and generally set forth rights of the various lenders with respect to their own loans and the other loans in the capital stack.

B. Cross Default

Mezzanine loans are cross-defaulted with the related mortgage loans insofar as a default on the mortgage loan will also cause a default on the mezzanine loan. However, a default on the mezzanine loan will not cause a default on the mortgage loan. This structure is often referred to as a “one-way cross.”

C. Structural Subordination

Pursuant to the terms of the intercreditor agreement, the mezzanine lender agrees to completely subordinate its mezzanine loan to the related mortgage loan. To the extent that the mortgage loan is performing, the mezzanine lender is permitted to receive debt service payments. However, if a default occurs on the mortgage loan, the mezzanine lender will not receive any payment on account of its loan until all of the mortgage loan obligations are satisfied.

Furthermore, mezzanine loans are “structurally subordinate” to mortgage loans in that they are secured by the equity in the real estate rather than the real estate itself. Since no distributions will be made to equity unless the related debt is current, even following foreclosure of a mezzanine loan, the related lender (now turned owner) remains firmly subordinate to the mortgage debt.

Another consequence of this structure is that a lender foreclosing on a mezzanine loan will gain ownership of the property subject not only to the related mortgage loan, but also subject to any other liens on the property, including any junior mortgages, mechanics’ liens, judgment liens, etc. Unlike foreclosure in a real estate proceeding, the property is not “cleansed” of the claims of other creditors.

The complete subordination of mezzanine loans is intended to protect the related mortgage lenders, which contributes to the security of CMBS trusts holding the mortgage loans.

D. Servicing/Administration of Mezzanine Loans

Since mezzanine loans are separate and distinct loans, mezzanine lenders have separate and distinct servicing arrangements, rather than being subject to the mortgage loan servicing arrangements. Therefore, mezzanine lenders may have more control over their loans than investors in tranching mortgage loans, where one servicer acts for multiple lenders.

E. Mezzanine Intercreditor Agreements

The Commercial Mortgage Securities Association has published a form of mezzanine intercreditor agreement, which formed the basis for many mezzanine intercreditor agreements used in transactions where the mortgage loan might be securitized. Although the forms were modified in negotiations, the base line model had approval from the rating agencies and provided some measure of consistency across the market.

Transfer Restrictions. Pursuant to the terms of a typical mezzanine intercreditor agreement, the mezzanine lender is prohibited from transferring a controlling interest in its mezzanine loan without rating agency approval unless the transferee qualifies as a “qualified transferee.” A qualified transferee is an entity that is a sophisticated real estate investor (including banks, REITs, pension funds and investment funds) and that has total assets and net worth meeting certain thresholds (typically \$600,000,000 and \$250,000,000, respectively).

Rights with Respect to the Mortgaged Property. In many cases mortgage lenders and mezzanine lenders have overlapping approval rights under their respective loan documents with respect to the borrower’s management of the property. Annual budgets, major leases, property modifications, changes in property management and other significant matters often need to be approved by both the mortgage and mezzanine lenders. The mezzanine intercreditor agreement attempts to coordinate the process for granting or withholding these approvals. For example, in loan structures where hard cash management mechanisms are already in place, a mezzanine intercreditor may specify that the mezzanine lender has the right to approve the annual budget prior to the mortgage lender. The approved annual budget may then be submitted to the mortgage lender, at which point any modifications requested by the mortgage lender will be implemented.

Limitations on Mortgage Loan and Mezzanine Loan Modifications. The mortgage lender’s right to modify the mortgage loan documents and the mezzanine lender’s right to modify the mezzanine loan documents may be subject to approval of the other lender, as the case may be. For example, for so long as a mortgage loan is performing, a senior lender may not increase its principal balance (*i.e.*, put more debt ahead of the mezzanine debt), cross-default the mortgage loan with any other indebtedness or increase the monetary obligations of the borrower without obtaining the consent

of the mezzanine lender. However, if that mortgage loan is in default and the mezzanine lender is not curing the default as further described below, the mortgage lender has broad latitude to modify its mortgage loan without the consent of the mezzanine lender, other than increasing its principal balance or extending the lockout/yield maintenance period.

Similarly, without the consent of the mortgage lender, the mezzanine lender may not increase its interest rate or principal amount, shorten the scheduled maturity date, convert the mezzanine loan into other indebtedness of the mezzanine borrower or provide for any additional contingent interest or provide for any so-called “equity kicker”. However, unlike the mortgage lender, upon an event of default on the mezzanine loan, and in connection with a workout, the mezzanine lender may still be required to obtain the consent of the mortgage lender for many significant modifications.

Cure Rights. Upon the occurrence of monetary or non-monetary defaults by the mortgage borrower, the mezzanine lender will have the right to cure the subject default within certain rating agency prescribed time periods. Mezzanine lenders typically have 5 business days to cure a monetary default and the same time period to cure as does the mortgage borrower under the loan documents with respect to a non-monetary default. The non-monetary cure period can be extended if the mezzanine lender is diligently pursuing the cure and the property is not impaired during the cure process. If the mezzanine lender is curing a default, the mortgage lender is not permitted to take enforcement action under the mortgage loan documents.

Purchase Rights. If a mortgage loan is accelerated or becomes specially serviced, the related mezzanine lender has the right to purchase the mortgage loan at a price equal to par, plus accrued interest (generally excluding yield maintenance), plus reimbursement of various other amounts such as accrued expenses of the mortgage servicers and any outstanding advances made by the servicers (plus interest thereon).

If the mortgage loan is bifurcated into one of the A/B structures discussed above, and the co-lender or participation agreement provides a cure or purchase right for the junior B note/participation holder, the cure or purchase right afforded to the mezzanine lender generally supersedes the right of the B note/participation holder. However, if the mezzanine lender does not exercise its cure or purchase right, the B note/participation holder will be permitted to cure or exercise its purchase option.

Foreclosure of Mezzanine Loan Collateral. The “standard form” intercreditor agreement permits the mezzanine lender to foreclose on its separate collateral (*i.e.*, the equity interests in the borrower) at any time after a default. However, because the mortgaged property still serves as collateral for the related mortgage loan, the intercreditor agreements have certain requirements related to foreclosure. A foreclosing mezzanine lender is required to meet certain financial criteria as well as certain thresholds for real estate sophistication. A foreclosing lender may also be required to put in place a qualified manager, institute a hard lockbox at the property and post adequate reserves for taxes and insurance and perhaps other reserves, in each case, to the extent that such protections are not already in place.

Foreclosing mezzanine lenders are also generally required to provide recourse carve-out guarantees for “bad boy” acts similar to the guarantees required of the original borrowers when the related mortgage loans were originated. Foreclosing mezzanine lenders are also often required to deliver new nonconsolidation legal opinions to the rating agencies and senior mortgage lender.

Perhaps the most significant obligation of a foreclosing mezzanine lender, however, is the obligation to cure any ongoing defaults on the related mortgage loan. This obligation may be express in the mezzanine intercreditor agreement or not, but continuing defaults on the mortgage loan will likely lead to a foreclosure of the related mortgage, depriving the mezzanine lender-turned-owner of the benefits of the property. The ability or willingness to cure mortgage defaults is the single biggest impediment to foreclosure on many mezzanine loans. To the extent that a mortgage loan has matured, the only way to cure the loan is to pay it off or convince the mortgage lender to extend the maturity. In situations where the property values have deteriorated below the principal balance of the related mezzanine loan (net of the debt senior to it), there may be little incentive for a mezzanine lender to pursue foreclosure.