Professional Perspective

Intercreditor & Co-Lender Agreements: Post-Covid Impacts

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After the recent cycle of pandemic-related distress, commercial real estate lenders participating in tranched or componentized financing transactions may wish to apply lessons learned to their intercreditor or co-lender documentation.

In the world of commercial real estate finance, tranched debt is common. One common tranche arrangement is senior and mezzanine debt. In this arrangement, a senior lender's debt is secured by a lien on the real property owned by the borrower (typically through a mortgage or similar security instrument) and a second tier—a mezzanine loan—is secured by an ownership interest in the borrower or borrower's parent via a pledge and security agreement.

Furthermore, within any one tranche, the debt may be syndicated or securitized, creating co-lending relationships among lenders within the same tier of debt. That debt may be further structured as pari passu or senior/subordinate in priority. When a financing package is tranched or componentized as described above, lenders customarily enter into intercreditor or co-lending agreements to govern their relative rights and priorities.

Intercreditor Agreements

In the mortgage or mezzanine intercreditor agreement context, the market appears to be shifting. This is especially true for a mezzanine lender's purchase option rights following an underlying mortgage loan default.

Before the Covid-19 pandemic, especially in balance sheet transactions, a mezzanine lender may have had the flexibility following a mortgage loan default to retain a right to purchase the senior loan until the earlier of: consummation of foreclosure, acceptance of a deed-in-lieu of foreclosure (subject to customary standstill time periods), or cure of the underlying default.

Recently, however, more mortgage lenders are pushing to include a bright-line time limitation on a mezzanine lenders' purchase options. This time restriction is to be distinguished from a time limitation for completion of the consummation of the purchase, which is customarily capped at 10–30 days following notice of election to purchase—with options to extend as negotiated in the documents.

The growing trend in the marketplace is for mortgage lenders to seek to limit a mezzanine lender's senior loan purchase option to 30, 60, or in some cases up to 120 days following delivery of the original senior loan purchase option notice. This new time limitation may have resulted from the long enforcement stays during the pandemic that prolonged inactivity on certain assets with long "wait-and-see" periods by various lenders in the debt stack. By capping the purchase option expiration to a date certain, the subordinated lender is forced into a quick decision on whether to buy the senior loan.

From the mezzanine lender's perspective, a truncated purchase option period in which to elect to purchase the senior debt may negatively affect the mezzanine lender's ability to avoid a standstill if the mortgage lender is not swiftly proceeding to structure a workout or proceed to foreclosure. In a scenario whereby a senior default has occurred—a typical trigger for the purchase option notice—if the mezzanine lender has elected not to cure the underlying default and not to purchase the senior debt, the sole remaining recourse of the mezzanine lender is to complete a Uniform Commercial Code (UCC) foreclosure or assignment in lieu thereof. This effectively creates a standstill—the mortgage lender is not exercising remedies, the mezzanine lender's window to cure the senior loan default by purchasing the debt has closed and each party is sitting, with no further in-place remedial right in favor of the mezzanine lender (i.e., the purchase option).

The UCC foreclosure option is often not a desirable remedy for a mezzanine lender unless a deal has been made to modify the senior debt in a way to address the underlying causes of the default, and those deals may take time to negotiate. If the mezzanine lender seeks to sell its note, the new purchaser would likewise have little wiggle room other than to seek to move forward quickly with a UCC foreclosure or negotiate for an assignment in lieu. The new purchaser would have to hope that the mortgage lender may be willing to agree to a modification, or otherwise seek refinancing.

Furthermore, it may be impractical for a mezzanine lender to appropriately underwrite the next steps for bringing the asset back to performing status or to line-up rescue capital before a 30-, 60-, or 120-day cut-off for exercise of the purchase option. As a practical matter, especially if an asset may be impacted by another pandemic or other shut down, 30 or 60 days may simply not be enough time for a mezzanine lender to assess how to best proceed.

Often mortgage lenders make the case that the purchase option has a chilling effect on their ability to sell their note in distress. The counterpoint to this argument is that the purchase price formula, as it applies to purchases 90 days or more after the default, is designed to make the mortgage lender whole.

Mortgage lenders may also take the position that, notwithstanding the unavailability of the purchase option, the mezzanine lender may always offer to buy the senior note—but without the guaranteed protections of the purchase option. However, under this scenario, the mortgage lender has no obligation to sell the note to the mezzanine lender.

Mezzanine Lender Takeaways: Covid-Era Distress

Pandemic-related distress has also shed light on other aspects of intercreditor agreements, including timing for cure, which suggest the need to modify forms. One takeaway from the pandemic is that in many circumstances, lenders took a wait and see approach to modifications or the exercise of remedies, leading to lapsed cure periods. Mezzanine lenders should be mindful of seeking to avoid limits on the number of cure periods they may have during the loan term. They should also request extensions to cure if there may be periods of time where normal operation of the asset may be curtailed due to shut down or stay-at-home orders.

Mezzanine lenders should also consider whether they may have the leverage to request that mortgage lenders release reserve funds for property-level expenses, if the mezzanine lender is otherwise effectuating a cure or actively pursuing an exercise of remedies. Mezzanine lenders may also seek to have the intercreditor agreement provide greater flexibility to force an extension of the loan if a maturity default is looming, provided that the mezzanine lender is willing to cure existing defaults heading into a maturity date.

Particularly for underwriting an assessment of next steps following distress, mezzanine lenders should request that the intercreditor agreement provide the right to obtain copies of all deliverables provided by the sponsor to the senior lender following a distress situation or event of default—including financial reporting, property level reporting, and the like. They should also request the ability for the mortgage lender to share appraisal documentation, reporting, and note sale marketing materials.

Co-Lender Agreement Takeaways

Post-Covid distress has not only impacted the mortgage loan and mezzanine loan relationship but has also shed light on potential weak points in co-lending documentation within same-loan tranches as well.

When co-lenders within the same tranche may have senior and subordinate positions, subordinate co-lenders should be mindful of exactly what events trigger a sequential pay event under the co-lender agreement. A sequential pay event changes the waterfall distribution to preclude collection by the subordinated lender of monthly interest payments until such time as the more senior note is paid in full. Subordinate lenders should try to negotiate away from strict triggers for sequential payment, such as when a loan has been moved into special servicing due to an imminent default—rather than an actual default or event of default.

Also, in response to credit market volatility and the increase across the board in the cost of hedging products, co-lenders, whether pari passu or subordinate, should consider pushing for the right to consent to modifications or waivers of hedge requirements in floating rate loans.

Furthermore, in senior and subordinate co-lending transactions, there has been a slight uptick in loan originators retaining the B note and also keeping the agency function. Counsel for the A note holder may need to re-assess the "Major Decision" concepts within a co-lender agreement to retain protections for the A note holder, which more typically has the agency function.

Conclusion

As is customary, out of periods of distress comes insight into the practical application of transaction documents. The most recent round of workouts and exercises of remedies allow transaction parties to see the effect of their previously negotiated agreements in action.

Post-Covid, mortgage lenders, mezzanine lenders, and syndicate members have gained insight into potential weak points in their intercreditor and co-lending documents and can use this experience to troubleshoot for the future. Moving into the post-Covid world, counsel for mortgage lenders, mezzanine lenders, and syndicate members should take into consideration lessons learned.