# Key Provisions to Focus on when Negotiating Intercreditor Agreements

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The Intercreditor Agreement is a critical document in any real estate transaction involving a combination of mortgage and mezzanine financing. While a level of standardization has occurred over the years with regard to a market-standard Intercreditor Agreement between a senior mortgage lender and a subordinate mezzanine lender, these multi-issue agreements continue to evolve and adapt to the needs of market participants and changes in market conditions.

Recognizing that each lender (whether a senior mortgage lender or a subordinate mezzanine lender) has its own "hot buttons" to which it strives to adhere during negotiations, the core issues that the parties typically focus on can be summarized as follows.

## Identity of Mezzanine Lender

Typically, this issue is addressed in the definition of Qualified Institutional Lender (QIL) or Qualified Transferee (QT). A prospective mezzanine lender will want to carefully review this definition to confirm that they fit into the definition, as they will be required to represent to the mortgage lender that they are, in fact, a QIL or QT. All of the mezzanine lender's rights and standing (unless the particular mezzanine lender holds 49% or less of the investment) under the Intercreditor Agreement are dependent on this status. If possible, a mezzanine lender should require the senior lender (since the senior lender's counsel is typically the initial draftsperson of the Intercreditor Agreement) to expressly include or "hard wire" the mezzanine lender and certain of its affiliates into the Intercreditor Agreement as pre-approved QILs. This specific designation affords the mezzanine lender and its affiliates a level of comfort on this important issue. The senior lender, on the other hand, is cautious about who may be a successor mezzanine lender to ensure that such lender has sufficient assets to make curative advances and exercise purchase rights under the senior loan (and, in the case of a construction loan, to make future construction advances), and has the necessary experience to operate the property if it forecloses on the equity. Additionally, an overly narrow definition of QIL or QT can restrict the mezzanine lender's ability to exit its investment.

## Foreclosure of Pledged Equity Collateral

Care must be taken to review the requirements under the Intercreditor Agreement for the mezzanine lender (or its designee) to realize upon its pledged equity collateral (which is typically 100% percent of the limited liability company interests in the mortgage loan borrower) upon an event of default. One of the most important prongs of the test for a proper foreclosure under the Intercreditor Agreement is who will be the replacement guarantor under the mortgage loan and when the replacement guarantees (typically, although not always, a non-recourse carve-out guaranty and environmental indemnification guaranty) will need to be executed. A mortgage lender will typically require its new mortgage loan guarantor to have a minimum net worth and liquidity and to deliver the replacement guarantees when the mezzanine lender (or its designee) has realized upon the pledge equity collateral or otherwise exercised voting control over the mortgage borrower. In addition to increasing the likelihood of repayment under a guaranty, a replacement guarantor with substantial assets makes it less likely that such replacement guarantor will put its assets at risk by triggering recourse events, including, by way of example, causing the filing of a bankruptcy by the mortgage borrower. It is important for the mortgage lender, however, not to be arbitrary about the level of financial covenant compliance that it will fairly and realistically need from the replacement guarantor.

Another key point that has received considerable focus over the years is the extent to which the foreclosing mezzanine lender (or its designee) must cure senior loan defaults in connection with its realization upon the pledge equity collateral. Depending on the identity of the senior lender, the answer to this question can vary. Some senior lenders insist that all defaults must be cured at the time of foreclosure (this is, in the authors' opinion, a minority position), while other senior lenders may not require that senior loan defaults be so cured so long as it is clear in the Intercreditor Agreement that the mortgage lender's rights and remedies are not being waived or delayed in exchange for this more balanced treatment of the foreclosing mezzanine lender's obligations. Other senior lenders require that past due monthly debt service payments be brought current, but do not require that the entire accelerated mortgage debt be cured. This last position is a middle ground of sorts. Any requirement that the mezzanine lender repay the senior lender all outstanding principal, interest, default interest, and other outstanding fees and expenses as a condition to foreclosure makes the exercise of remedies under the Uniform Commercial Code and refinancing the senior debt extremely (indeed, unnecessarily) difficult for the mezzanine lender.

In addition, it is widely accepted that the mezzanine lender (or its designee) will be required to install a "qualified property manager," typically within 30 days after foreclosing on the pledged equity collateral, as part of the foreclosure process under the Intercreditor Agreement.

## Cure Rights

The ability to cure defaults under the mortgage loan is a critical element of the Intercreditor Agreement for any mezzanine lender. Mortgage lenders will not dispute that mezzanine lenders must have these rights, but the length of the cure period or the aggregate number of cure events will often be debated. It goes without saying that the longer the mezzanine lender can forestall the mortgage lender from exercising its enforcement rights under the mortgage loan documents due to the mezzanine lender exercising its cure rights, the better it is for the mezzanine lender, especially in states that allow for a streamlined or quick mortgage foreclosure process. It is not uncommon to see monetary cure rights limited to as few as 3-4 over the lifetime of the loan, and multiple consecutive month cure periods as long as 3-6 months. There is no "right answer" and this point will be negotiated.

## Purchase Option

The right of the mezzanine lender to purchase the senior mortgage loan in the event of default under the senior loan is a customary feature of any Intercreditor Agreement. However, what, exactly, is included in the loan purchase price and when the mezzanine lender's rights to purchase the senior loan are cut off or cease are often debated issues. For example, many senior lenders will not require default interest or late fees to be paid by a mezzanine lender who elects to purchase the senior loan, while others will want everything included. The more widely accepted practice is to not require that mezzanine lender to pay these "extras," especially, when the mezzanine lender is not affiliated in any way with the mortgage borrower. Many senior lenders will require that the purchase option cease upon the delivery of a deed in lieu of foreclosure, while others will extend the purchase option for a period of time even after the senior lender has acquired the underlying mortgage loan collateral — essentially allowing the loan purchase option to convert to a property purchase option. If the loan purchase option is converted into a property purchase option and the mezzanine lender exercises the option, the real property will be conveyed and may be subject to a real estate conveyance tax (which may not apply to a purchase of the mezzanine loan) depending on the jurisdiction.

Note that many "first drafts" of Intercreditor Agreements prepared by senior lenders will not address and be silent with regard to a deed in lieu of foreclosure scenario. It is incumbent upon the mezzanine lender to add this concept to the Intercreditor Agreement to protect itself from the senior lender and mortgage borrower agreeing to a deed in lieu resolution in connection with a defaulted senior loan, which would have catastrophic consequences for the mezzanine lender. A deed in lieu provision would require the senior lender to

provide prior notice to the mezzanine lender of its intention to accept the deed in lieu from the mortgage borrower and an opportunity to purchase the senior loan prior to the senior lender accepting a deed in lieu.

## Consent Rights

The Intercreditor Agreement will also delineate in considerable detail when and which provisions of the loan documents cannot be amended or modified without the opposing lender's consent. As a general rule, the mezzanine lender will, for example, have considerable rights to consent to proposed changes to the senior loan document while the senior loan is performing. These consent rights will be curtailed significantly if the senior loan is in default and/or not being cured by the mezzanine lender. Depending on the nature of the deal, there may be additional concepts in the underlying loan documents that a party will want to incorporate into the standard list of provisions that cannot be amended without its prior consent. It is customary that the consent of the other lender will be required for loan document modifications that will increase the financial obligations of the borrower or stress the performance of the underlying property, or decrease the likelihood of repayment of the opposing lender's loan.

## Financing of Mezzanine Loan

A mezzanine lender will commonly require the right to finance its position under a repurchase agreement facility or pledge. The consent of the senior lender will not be required for such an arrangement so long as the third party financier is a QIL and is not affiliated with the borrower. Senior lenders routinely agree to provide such third parties with certain accommodations, including providing notice of default by the mezzanine lender under the Intercreditor Agreement and an opportunity to cure.

## Mezzanine Lender as "Affiliate" of Mortgage Borrower

Most Intercreditor Agreements will provide that in the event an "affiliate" of the mortgage borrower owns a portion of the mezzanine loan (the exact percentage of ownership can vary depending on the senior lender's sensitivity to this issue), the mezzanine lender's rights under the ICA will be severely cut back.

Intercreditor Agreements are central documents in any successful multi-lender, separate collateral real estate financing. The negotiations can be complicated and nuanced. We hope the above list of major points is a useful touchstone during your negotiations.

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