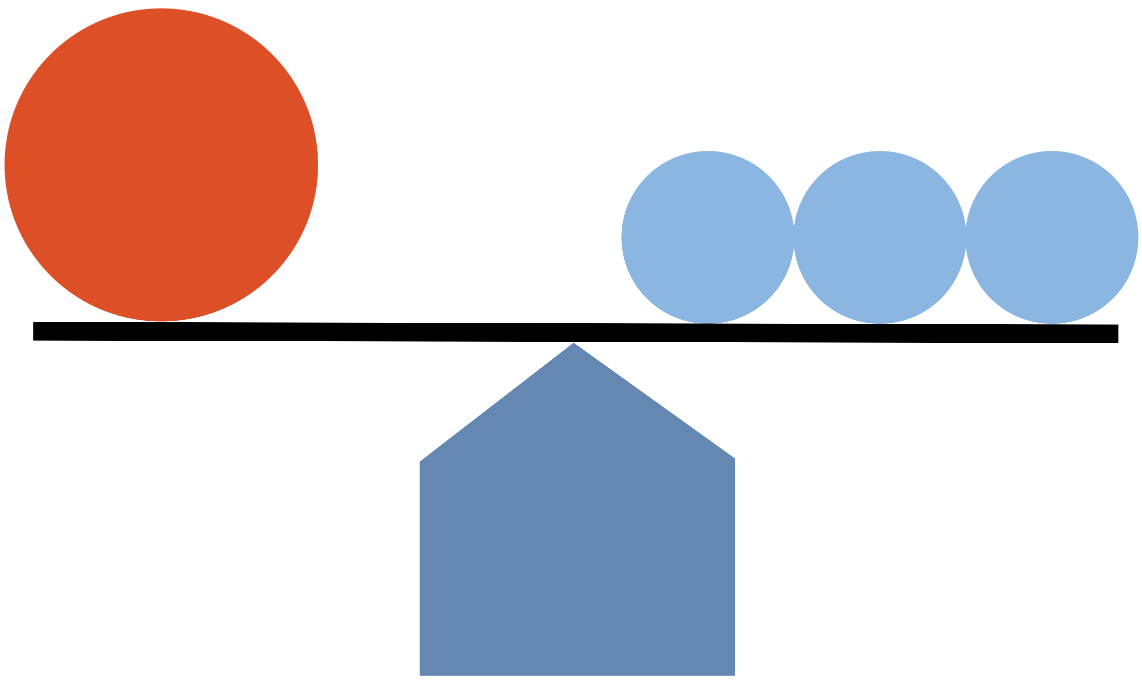
DRIVING FORCE



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Syndication continues to grow in popularity among lenders, which is also introducing a host of legal issues into the market. This second of a special two-part series from Dentons[1] begins to explore the opportunities—and intricacies—of multi-tiered financing.

[Editor's Note: The first part of this series was published in the previous issue Summit Journal in September 2024. The introduction is repeated here for context.]

According to a recent report, commercial real estate and multifamily mortgage borrowings in 2023 were forecasted to reach $645 billion, a slight decrease from the overall total commercial real estate and multifamily mortgage borrowings in the previous two years.[2]

Notwithstanding such overall decrease in volume, commercial mortgage loans have continued to escalate in size and complexity, and as such, lenders have been forced to further develop methods to adequately diversify their risk.

While most mortgage loans are sold into the commercial mortgage-backed securitization (CMBS) market, mortgage loans held for syndication still represent a significant share of the loans made by many real estate lenders. The syndication market provides mortgage originators with an opportunity to create a customized lending product which extends beyond the standard requirements of the rating agencies.

The syndication market has recently gained significant momentum for "value-added" lenders who are willing to: (i) incur above-average risk by placing loans in higher-leveraged loan positions in the capital stack; or (ii) provide financing outside a conduit structure for construction projects, land acquisitions, and/or lease-up projects.

DECISION-MAKING

The agent lender will want the maximum amount of freedom possible with respect to administering the loan and avoiding interference or delay due to co-lender involvement in the decision-making process.

For example, the agent is usually granted the right to make protective advances without co-lender consent (i.e., taxes, insurance and ground lease payments) to maintain the value of the collateral in case of emergency. Co-lenders, on the other hand, will want some degree of control over key issues such as material amendments to the loan documents (e.g., changes in the interest rate applicable to the loan or the maturity date of the facility or increases in the facility amount).

Co-lenders also want control over the management of the collateral, decisions regarding acceleration of the loan after an Event of Default, releases of any collateral, actions that affect the value of the collateral, and appointments of successor agent lenders. Co-lenders are not likely to request control over non-material issues, because they also have an interest in distancing themselves from the burdens of administering the loan. Therefore, negotiations over the granting of authority to the agent to act on behalf of the co-lenders, and over the decisions that will require co-lender consent, are likely to be limited to material decisions affecting the loan and the collateral.

The borrower will only want to deal with one lender for payments and other day-to-day loan administration. For more material decisions and approvals, however, loan syndication documents might require that all or a certain percentage of the participant lenders approve an action before the borrower may act, which can be a time-consuming process, causing the borrower unwanted delay. To minimize the likelihood of decision-making issues arising within the syndicate group, it is imperative to select participant lenders with adequate risk tolerance and expertise for the subject real estate project.

Primary and syndication loan documents may distinguish between decisions requiring unanimous co-lender consent and those only requiring consent from a certain percentage of the syndicate group. Again, the agent lender will generally prefer a lesser percentage of co-lender consent, while the co-lenders will want their votes to count on major decisions. Typically, all decisions regarding the extension of a maturity date, reduction in the interest rate, payment of debt service, and the release of collateral require unanimous co-lender consent.

Other major decisions, such as approval of changes in the controlling interest in the borrower, a borrower's request for change orders in construction loans above certain thresholds, a borrower's request to enter into all leases with respect to the mortgaged property, and any transfers of subordinate loan interests to another lender, can be tied to a qualified majority of the syndicate lenders.

The calculation of the majority percentage is usually based on the individual distribution of participant lenders in the bank group and their respective money at risk, rather than on a headcount of lenders. The percentage of lenders required should be more than 51 percent of the syndicate group, but typically is set at 60 percent or 66.67 percent of the aggregated amounts of all lenders.

In loan structures involving both senior lenders and subordinate lenders, the lender relationship may be arranged such that only senior lenders have the right to be involved in decision-making. The documentation for such structures typically limits the subordinate lender's right to cure existing borrower defaults and the right to buy out the senior lender to gain control of the mortgage collateral. The subordinate lender's motivation and incentive to take control in default situations varies to the extent the current market value of the mortgage collateral still supports the subordinate lender's subordinate position. A/B loan structures may allow for a shift in control of decision-making to the subordinate lender once a default with respect to the senior obligation is cured. In such cases, this shift is only valid for a period during which the subordinate lender can pursue foreclosure of the real estate and pay off the senior lender.

By keeping the decision-making process transparent, and by building consensus where possible, a lending group can head off most potential conflicts.

When a borrower makes a request which requires the consent of co-lenders, the agent lender must process the request before submitting the issue to the syndicate group for approval. The co-lenders then consider the information provided along with any other documentation and due diligence items that may be involved before informing the agent lender of its decision.

To limit the amount of time between a borrower's request and the agent lender's response when co-lender consent is involved, agent lenders will push to limit the amount of time that the co-lenders have to consider the request and related information. Oftentimes, the primary and/or syndication loan documents will include a provision deeming consent given after a certain number of days if no co-lender response is received by the agent lender. Co-lenders will negotiate for as long as possible to consider the issue.

With little existing law in this area, and with the agency provisions of the agreements rarely addressing issues in detail, solutions frequently depend on the judgment and consensus of the parties and their lawyers. The courts have typically deferred to the language in agreements among lenders, and in particular, the decision-making procedures they establish. All parties, therefore, must understand that such agreements will likely form the main—if not the only—foundation for legal judgments in the case of later disputes. The decision-making processes should be considered and established carefully.[3]

Nevertheless, it is incumbent upon the lending group's decision-making parties to respect the implied covenant of good faith and fair dealing. The interests of other members of the lending group should be factored in, and the decision-making party should keep all members apprised of its actions or potential actions. By keeping the decision-making process transparent, and by building consensus where possible, a lending group can head off most potential conflicts. Often, a lending group will enlist a co-agent to review and make objective recommendations on certain substantive decisions. However, in cases where the decision-making authority acts contrary to the co-agent's recommendations, this may be used as damaging evidence in future conflict issues.[4]

Finally, the lending group should bear in mind that, once it becomes a property owner, it will need to make all decisions associated with real estate ownership—leasing, management, tenant terms, ownership structure, and so forth.[5]

INTERCREDITOR AGREEMENTS

Some syndicated real estate loans involve senior and subordinate tranches within a facility that are secured by the same mortgage (A/B loan structures). Because the senior lenders and the subordinate lenders share the same collateral, the respective priorities, and rights of each group of lenders must be set forth in an agreement between such parties. When various classes of lenders are involved in the capital stack, multiple intercreditor agreements may be required. Because the priority and control over the claim against the mortgage collateral are instrumental to each lender's underwriting, the intercreditor agreement is often heavily negotiated.

Likewise, in a multi-tiered financing with mortgage and mezzanine debt (and sometimes with multiple levels of mezzanine debt), the sole document governing the relationship between the two classes will be the intercreditor agreement. Given that this document acts to grant, as well as curb, the rights of each class vis-à-vis the borrowers and the collateral, the intercreditor agreement is a hotly contested document. Real estate professionals should exercise great care when negotiating an intercreditor agreement.

Generally, the senior lenders will agree to provide notice to the subordinate lenders of a borrower default either: (i) contemporaneously with delivery of such notice to borrower; or (ii) at the expiration of borrower's cure period. How much time the senior lenders will afford the subordinate lenders to cure a default remaining uncured by borrower before the senior lenders accelerate the loan or otherwise exercise remedies is heavily negotiated. Subordinate lenders should attempt to bifurcate the cure periods granted by senior lenders into two distinct categories: monetary defaults and non-monetary defaults.

When negotiating the monetary cure period terms, subordinate lenders should seek to be released from the payment of late charges or default interest in connection with their cure of any monetary default. Senior lenders, on the other hand, should limit the number of times a subordinate lender can cure a default by a borrower with respect to the payment of debt service.

When dealing with the duration of non-monetary cure periods, subordinate lenders will want a cure period that is long enough for them to effect a cure. Mezzanine lenders will also want to negotiate additional time with respect to non-monetary defaults that are of a nature that cannot be cured without the ownership of the equity. In such a case, mezzanine lenders should seek enough time under the agreement as is necessary to gain ownership of the equity and to cure such a default. Senior lenders often allow such additional periods provided there is no material impairment to value or use of the underlying collateral.

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If the senior lenders commence foreclosure proceedings, accelerate the loan; or if the senior borrower is a debtor in an insolvency proceeding, the senior lender will allow the subordinate lenders the opportunity to acquire the senior loan. The purchase price will always be at least equal to the sum of the principal balance at par, plus accrued but unpaid interest. However, in portfolio loan documents, the senior lenders will often seek to include default interest, late fees, breakage charges, yield maintenance, and the like.

In securitized transactions and multi-tiered financings, the convention seems to be that such additional items are foregone by the senior lenders. Still, senior lenders would be well advised to prevent the existence of an open-ended option to buy the senior loan at par. Senior lenders can shorten the purchase option by making default interest, late charges and other fees part of the purchase price if the subordinate lender fails to purchase the senior loan within ninety days after notice of a purchase option event.

If the borrower becomes involved in a bankruptcy proceeding, the senior lenders will generally allow the subordinate lenders to file a claim in that proceeding (in the case of mezzanine lenders, only to the extent such a claim is necessary for the mezzanine lender to preserve or realize on the mezzanine lender's collateral) but will rarely allow the subordinate lenders to vote on a plan of reorganization or otherwise act upon their claim. In fact, in most instances, the senior lender is afforded the opportunity to vote on behalf of the subordinate lenders with respect to any proposed plan of reorganization (but only if the proposed plan would result in the senior lender being "impaired" (as defined in the United States Bankruptcy Code)).

While a default under the senior loan documents invariably constitutes a default under the subordinate loan documents, the reverse is almost never the case. When a default occurs under the subordinate loan documents, the senior lenders may allow the subordinate lenders to foreclose upon their collateral, but any third-party transferee at such foreclosure sale (or, if the subordinate lenders bid the collateral in or obtain a deed-in-lieu of foreclosure, any transferee thereof) must generally meet certain eligibility requirements negotiated into the intercreditor agreement.

By empowering senior lenders at the expense of subordinated lenders' ability to influence or oppose proposals, intercreditor agreements reduce decision-making costs in the event of default. However, it is possible for an investor to exploit this imbalance, increasing its own return by damaging other creditors. When considering intercreditor agreements that waive or assign bankruptcy rights, courts are forced to weigh the benefits to the agreement's signatories against the potential for harm to subordinated creditors and non-signatories.[6]

Second-lien lenders face a host of other considerations unique to their status. In particular, they may become a "silent second" by agreeing contractually to refrain from exercising some or all of their rights as secured creditors. The key elements usually included an intercreditor agreement which pertain to "silent second" terms are:

"Prohibitions (or limitations) on the right of the second lien holders to take enforcement actions, with respect to their liens (possibly subject to time or other limitations)

Agreements by the holders of second liens not to challenge enforcement or foreclosure actions taken by the holders of the first liens (possibly subject to time or other limitations)

Prohibitions on the right of the second lien holders to challenge the validity or priority of the first liens

Waivers of (or limitations on) other secured creditor rights by the holders of second liens."[7]

Equally, mezzanine lenders face a host of other issues which are unique to their status. Perhaps the most heavily negotiated and most important provision of the multi-tiered financing intercreditor agreement is the right of a mezzanine lender to pursue a claim against a guarantor which is also the guarantor of the senior loan.

Senior lenders will often prohibit the mezzanine lender from pursuing a claim against a common guarantor while the senior loan is outstanding, or in the alternative, will require the mezzanine lender to turn over to the senior lender the proceeds of any judgment the mezzanine lender obtains from such common guarantor. Mezzanine lenders, however, should seek to eliminate any blanket prohibition on pursuing claims. They should also limit the requirement to turn over proceeds to those instances (i) when the senior lender is simultaneously pursuing a claim against the common guarantor; or (ii) when the senior lender has notified the mezzanine lender that it has a claim against the common guarantor and thereafter pursues such claim within a negotiated time period.

Lastly, intercreditor agreements will include a fair amount of deal-specific provisions. Such deal- specific provisions generally include the right of a subordinate lender to exercise a senior borrower extension option, rights with respect to ground leases, and provisions relating to future funding obligations. The provision that receives the most deal-specific language is often the modification section of the intercreditor agreement. Because any increase in obligations on the part of a borrower of either class of debt can impact the owner of the other class of debt, the modification section of the intercreditor will prevent both the senior and the subordinate lenders from modifying key terms of their respective loan agreements without the consent of the other. Such key terms often include cash management/ cash sweep terms, transfer provisions, interest rates and other payment terms.

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DEFAULTS AND PAYMENT PRIORITIES

The syndication documents typically specify both a pre-default and post-default waterfall. For A/B loan structures or senior/ subordinate note structures, the senior group will be paid first. The subordinate group has taken on more risk by being subordinated to the senior group and will not be paid until after the senior group is fully repaid. Therefore, the subordinate group is usually entitled to collect a higher interest rate in exchange for taking on such risk. Losses of principal and interest due to a default can also be allocated among the senior and subordinate groups. In most cases, the losses will be allocated first to the subordinate group and then to the senior group.

Before an event of default, the agent lender will generally receive its administrative and servicing fees, as well as reimbursement for its legal or other out-of-pocket expenses before reimbursement for further payments (such as protective advances, interest, and principal payments) are distributed to lenders. Interest is paid before principal is repaid, because the primary interest of all lenders is to have the debt paid current. If there are tranches among the lenders, the senior lenders will negotiate to have their interest and principal paid before any payments are distributed to the subordinate lenders, because being paid first is consistent with their lower level of risk.

In some cases, the subordinate lender can negotiate for priority of its interest payments over the principal payments to the senior lender. Such concessions are justifiable in specific transactions in which the borrower does not agree to an accrued interest feature as long as no event of default exists. Such accrued interest rate features shift the multiple interest payments during the term of the loan to a one-time interest payment at the maturity date. This is usually granted in exchange for the calculation of a substantially increased interest rate throughout the term of the loan.

After an event of default occurs, the senior lenders will be even more likely to insist that their interest and principal are paid before subordinate lenders can collect any payments. Administrative and servicing fees (including special servicing fees), collection, and other out-of-pocket expenses of the agent lender will be paid before default interest, late charges, regular interest, and principal to the senior lenders. Subsequently, the interest and principal are paid, all before costs, expenses, fees, and principal of the subordinate group are paid.

Although the lead lender typically has wide latitude in addressing loan defaults, limitations still exist. Certain provisions of the loan documents may require a prescribed vote before the lead lender can act. In other cases, remedies may need to be effected within a certain time period lest the lead lender be deemed to have, through inaction, waived enforcement rights or accepted a de facto loan modification. Participation and co-lending agreements may also restrict the lead lender's options after foreclosure occurs.[8] During this period, several possible "outs" may allow the lead lender to cede its lead lender duties, including a purchase option or a buy-sell option.[9] Each specific contract must be considered and interpreted to determine what, if any, approvals may be needed before action can be taken.

Examining relevant court cases, such as New Bank of New England, N.A. v. Toronto Dominion Bank, one paper argues that US case law preserves unaltered the contractual rights of the creditors among themselves during a debt restructuring process. A creditor's right to enforce its claim against the borrower is not affected by the problems such action may cause other lenders. Similarly, the rights of the lending group's majority are not impacted by an implicit obligation to a minority lender or its interests.[10]

As syndication and multi-tiered financings continue to grow in popularity lenders and their counsel must make themselves familiar with the legal issues surrounding such transactions.

LENDER DEFAULT

When one co-lender fails to perform its obligation to fund its percentage of the loan to the borrower, it has breached its agreement with the borrower (if a direct or regular participant) or with the other lenders (if an indirect participant). In lending relationships with additional funding obligations, such as construction loans or lease-up loans, the mechanism for dealing with a defaulting lender must be clearly set forth in the primary and/or syndication loan documents.

Some loans are structured to allow the non-defaulting lenders to advance the defaulting lender's share in exchange for the benefits associated with that advance. In some cases, defaulting lenders must take a step-down in priority with respect to distribution of payments and fees received from the borrower. In addition, some primary and/or syndication loan documents state that a defaulting lender loses its right to have its vote counted in any decision requiring the consent of co-lenders.

SUMMARY

As syndication and multi-tiered financings continue to grow in popularity among lenders and as the number of syndicated and multi-tiered loans continue to rise, lenders and their counsel must make themselves familiar with the legal issues surrounding such transactions. Particular attention should be given, in the case of syndicated loans, to the relationship between the lenders within the syndicate group, especially between the agent lender and the participant lenders and, in the case of the multi-tiered loans, to the relationship between the senior and the subordinate lenders set forth in the intercreditor agreement.

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NOTES

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[2] TMN Editor, "Commercial/Multifamily Lending to Fall 20 Percent in 2023", May 11, 2023, available at https://www.themortgagenote.org/multifamily-commercial-lending-to-drop-20-in-2023/

[3] Eric M. Schiller, "Co-Lender Issues on Defaulted Loans", March 2010 ACREL Paper, available at https://cdn.ymaws.com/www.acrel.org/resource/collection/A8884E11-BB06-403B-A32B-B5035F9613C3/Schiller_-_S10-Syndicated_Loans_in_Default__Special_Issues_for_Borrowers_and_Lenders.pdf.

[4] Id.

[5] Id.

[6] Edward R. Morrison, Rules of Thumb for Intercreditor Agreements, 2015 U. Ill. L. Rev. No. 2 401, 721 (2015)."

[7] Neil Cummings and Kirk A. Davenport, "A Primer on Second Lien Term Loan Financings," Commercial Lending Rev., Sept.–Oct. 2004.

[8] Schiller, supra note 9.

[9] Hilary Metra Gevondyan, "Keys To Co-Lending Agreements In Commercial RE, Law360, May 16, 2012."

[10] Michael Gruson, Restructuring syndicated loans: the effect of restructuring negotiations on the rights of the parties to the loan agreement. International Law: Revista Colombiana de Derecho Internacional. 3,322-342 (2004), (3):322-342.. https://www.redalyc.org/articulo.oa?id=8240031.