

Intercreditor Agreements (Mortgage Lender and Mezzanine Lender)

A Practical Guidance® Practice Note by
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This practice note discusses some of the principal issues that arise when negotiating intercreditor agreements (ICAs) for mortgage and mezzanine lenders, and also discusses recent trends in ICAs as well as predictions as to where such negotiations may be headed.

For a full listing of key content covering commercial real estate, see [First Year Associate Resource Kit: Real Estate](#).

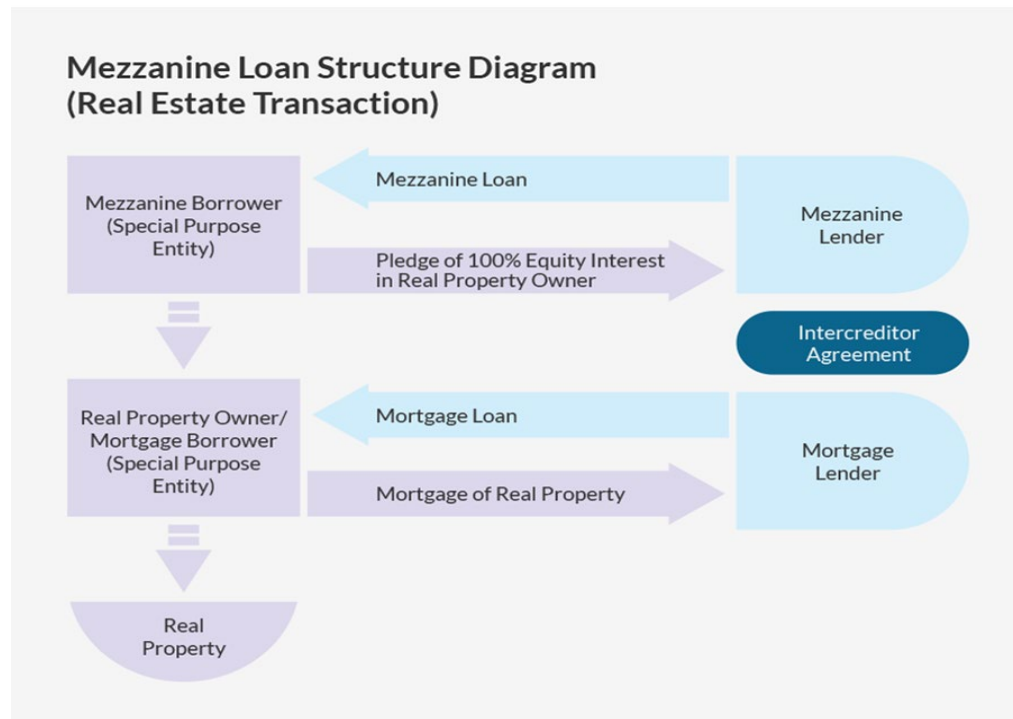
For a full listing of key content covering dispute resolution in construction, see [Mezzanine Financing Resource Kit](#).

For more information of intercreditor agreements in mezzanine financing, see [Mezzanine Loan Structure Diagram \(Real Estate Transaction\)](#), and [Mezzanine Financing](#). For a template of an intercreditor agreement, see [Intercreditor Agreement \(Mezzanine Financing\) \(NY\)](#).

Mezzanine Lending

The ICA is an integral document in any transaction in which there is more than one loan. In the context of commercial real estate (CRE) transactions, this situation arises most frequently when there is a mortgage loan and one or more mezzanine loans.

The diagram below depicts the typical structure of a CRE transaction with a mortgage loan and one mezzanine loan.



Visualization of Mezzanine Loan Structure Diagram (Real Estate Transaction)

The relationship between the mortgage loan and mezzanine loan is governed by the ICA, which establishes, among other things, the subordination of the mezzanine loan to the mortgage loan and defines the rights and obligations of the respective lenders thereunder. Since the 2008 recession, many mortgage lenders limit the amount of their loans to loan-to-value ratios (LTV) of 50% to 60%. This development forced many CRE borrowers to seek mezzanine loans as a way to fill capital stack gaps and avoid having to contribute additional equity into a deal. This was particularly prevalent in recent years, when interest rates were low (including with respect to mezzanine loans). As interest rates increase, and a general slowdown of the CRE lending market continues, it remains to be seen how active mezzanine lenders will be. In that context, mortgage and mezzanine lenders frequently engage in extensive negotiations of the terms of the ICA, as each maneuvers to establish its respective rights and remedies.

The ICA

Necessity of the ICA

The mortgage loan and mezzanine loan are secured by different collateral. The mortgage loan is secured by a lien on real property and the mezzanine loan is secured by a lien on the membership interests in the entity that owns the real property. However, since the value of the collateral securing both loans is derived from the underlying real estate, the rights and remedies of the lenders under the respective agreements affect each other, particularly in relation to uncured defaults and resulting foreclosure rights. As a result of the separate collateral afforded to each of the lenders and the direct contractual agreements established between the mortgage and mezzanine lenders in the ICA, mezzanine loans are often preferred over alternative subordinate financing structures, such as second mortgages.

In a typical CRE transaction with mortgage and mezzanine loans, the mortgage lender has a payment priority over the mezzanine lender. The mortgage loan documents and the mezzanine loan documents will often be substantially similar to one another with respect to the rights and obligations of the respective borrowers and the treatment of the underlying real estate, but the loan documents themselves will rarely address the rights of the lenders with respect to one another. For this reason, the ICA, which is a separate contractual agreement by and between the lenders, is necessary.

Rights and Obligations of the Lenders

In a CRE transaction containing mortgage and mezzanine loans, the mortgage loan is advanced to the real estate owner in exchange for a security interest in the form of a mortgage secured by the underlying real estate, while the mezzanine loan is advanced to one or more of the parent entities of the real estate owner in exchange for a pledge of the equity interests in the real estate owning entity. Mortgage lenders will enter such transactions only on the condition that they maintain certain rights and priorities with respect to their collateral, which includes having some level of control over the equity ownership of the real estate owning borrower and limiting the rights of third parties such as mezzanine lenders. Conversely, mezzanine lenders will accept a subordinate payment priority with the expectation that in exchange they receive certain protections and concessions in the ICA regarding their rights.

Rights and Obligations of Mortgage Lender

The most important benefit of the ICA for the mortgage lender is the subordination of the mezzanine loan and the mezzanine loan documents to the mortgage loan and mortgage loan documents. Typically, the ICA provides that all payments under the mezzanine loan and the obligations secured thereby are subordinated to the mortgage lender's right to receive payments. However, as is explained more particularly below, the mortgage lender generally must follow certain procedures with respect to the mezzanine lender in the event of a mortgage loan default as outlined in the ICA. The mortgage lender is usually obligated to provide notices of default to the mezzanine lender and must permit a certain opportunity to cure the default prior to foreclosing on its mortgage and to allow, subject to certain limitations, payments to be made to the mezzanine lender from available cash from the real estate. The arrangement between the mortgage lender and the mezzanine lender is predicated on the belief that the mortgage lender is comfortable, due to previous operational experience and creditworthiness, that the mezzanine lender (or its permitted transferee) can operate the real estate successfully and keep the mortgage current and free from defaults.

Rights and Obligations of Mezzanine Lender

As discussed above, the primary obligation of the mezzanine lender is to subordinate its mezzanine loan to the mortgage loan and, in return, the mortgage lender gives the mezzanine lender the right to foreclose on the mezzanine collateral once it has satisfied certain conditions, some of which are discussed below in [Key Provisions of the ICA](#). Additionally, some mortgage lenders will accede to mezzanine lenders request for certain consent rights, including the ability to approve particular leases, budgets, alterations to the real estate,

and the use of insurance proceeds and other condemnation awards for the restoration of the real estate.

Mutual Rights and Obligations of Each Lender

The ICA also typically contains certain rights and obligations that are mutually beneficial for each lender. The lenders each make certain representations, warranties, and acknowledgements to the other, including an acceptance of each other's loan documents, representations regarding the existence and status of such loan documents and the loans, and various other warranties, such as that the loan is not cross-defaulted with any other loans other than as set forth in the loan documents. The ICA also typically contains restrictions and protections with respect to the types of loan transfers that are permissible, which is important in the current market, in which both mortgage and mezzanine lenders often sell all or portions of their respective loans to third parties.

Key Provisions of the ICA

Cure Rights

An issue of utmost importance to mezzanine lenders is protection of the value of its collateral and, in particular, notice and cure rights with respect to defaults under the mortgage loan. In recent years, mezzanine lenders have negotiated heavily (and often successfully) for extended cure rights in order to forestall mortgage lenders from exercising their foreclosure rights under their loan documents. In the case of non-monetary defaults, an extended cure period often includes sufficient time for the mezzanine lender to realize upon its collateral and gain control of the underlying real estate.

Mortgage lenders will strive to keep their loans current by requiring monthly debt service payments by the mezzanine lender, but even then, they generally seek to limit cure rights with a variety of measures. Some will negotiate to restrict the number of times over the lifetime of the loan that the mezzanine lender can cure monetary defaults. Most require that the mezzanine lender, as a condition to a mezzanine lender's realization on its collateral, cure all mortgage loan defaults that can be cured without taking possession of the real estate. This can be problematic for the mezzanine lender as it effectively cuts off the mezzanine lender's cure period on the date of its foreclosure or bars the foreclosure until the cure is properly achieved. If some of the defaults by the mortgage loan borrower require the mezzanine lender to take possession of the real estate to cure while other defaults are in the process of being cured but do not require such possession, the mezzanine lender may find itself in a position where it is unable to timely realize upon its collateral and take possession.

Mezzanine Loan Foreclosure

Unlike a mortgage loan foreclosure, a mezzanine loan foreclosure is governed by the Uniform Commercial Code (UCC). The UCC requires that all aspects of the foreclosure process be carried out in a “commercially reasonable” manner. The mezzanine lender and mezzanine borrower will often negotiate the manner in which the foreclosure may take place in the mezzanine loan documents. The advantage of a mezzanine foreclosure over a mortgage foreclosure is that a UCC foreclosure can typically be completed much faster. The mezzanine lender may conduct the UCC foreclosure either publicly or privately, and the winning bidder in the foreclosure sale essentially purchases the equity interests in the mortgage borrower.

The ICA defines the requirements for the mezzanine lender to realize upon its pledged equity collateral (which is typically 100% of the ownership interests in the mortgage borrower). Part of the requirements can be satisfied prior to or concurrently with the mezzanine lender’s realization upon its collateral. Some examples include delivering a replacement carve-out guaranty from a replacement guarantor that meets the mortgage lender’s creditworthiness requirements (such as minimum net worth), curing applicable defaults and delivering a certificate to the mortgage lender that such requirements have been fulfilled. The failure to properly satisfy such conditions will afford the mortgage lender the right to seek injunctive relief to prevent the mezzanine lender’s realization upon its collateral until the requirements are met. The recent trend in litigation involving enforcement of ICAs has shown a willingness of the courts to enforce the parties’ specific contractual agreements, including the right of the mortgage lender to injunctive relief.

One important consideration for mezzanine lenders when negotiating these provisions in the ICA is to be sure that the ICA clearly excludes defaults that are not susceptible to cure by the mezzanine lender (such as the failure by the mortgage borrower to repay the mortgage loan at maturity) from any requirements that exist with respect to the mezzanine lender’s right to foreclose on its collateral. By way of example, a mezzanine lender will be unable to cure the borrower’s failure to obtain consent of the lender prior to entering into a major lease in accordance with the loan documents, even if it takes over operations of the real estate (i.e., it occurred prior to the UCC foreclosure).

Additionally, the ICA may set forth certain requirements that the mezzanine lender must satisfy following a mezzanine foreclosure before the mortgage lender will allow the mezzanine lender to commence the foreclosure action. Some examples include delivering a certificate and new non-consolidation opinion to the mortgage lender regarding the

transferee of the equity interest following such foreclosure, once the identity of the transferee is known. For further information on legal opinions in acquisition loans, see [Legal Opinions in an Acquisition Loan](#). Mezzanine lenders may want to persuade the mortgage lender to allow for the cure of certain defaults post-foreclosure. In some instances, mortgage lenders will permit this so long as (1) the nature of such defaults will not materially impair the value of the collateral, (2) such defaults cannot be cured with the payment of money, and (3) the mezzanine lender has commenced curing the defaults prior to initiating the foreclosure action. Mortgage lenders will also require that, following the mezzanine foreclosure, the transferee appoint a qualified replacement real estate manager that is capable of overseeing the management of the property. While a UCC foreclosure is typically far easier and faster to accomplish than a mortgage foreclosure, the failure of the winning bidder in the foreclosure sale to satisfy the pre- and post-foreclosure requirements can lead to contention including enabling commencement of a mortgage foreclosure which could have a significant chilling effect on a mezzanine foreclosure. Therefore, it is incumbent on mezzanine lenders to be sure that they can meet all such pre- and post-foreclosure requirements in a timely manner.

In the current post-COVID-19 pandemic world, and due, at least in part to the Fed’s increase of interest rates as it attempts to fight inflation, the volume of CRE transactions during the first half of 2023 has so far decreased. During the pandemic shutdowns, many mezzanine lenders were forced to remain cognizant of the various factors that can hamper mezzanine lenders’ ability to realize on their collateral, such as any changes related to companies being able to operate their businesses in the ordinary course due to the effects of COVID-19 and the variants of the virus arose in recent years. As described above, the UCC requires that all aspects of the UCC foreclosure be carried out in a “commercially reasonable” manner. Whether it is possible to have a “commercially reasonable” auction in the midst of a pandemic is a question without a clear answer. In one case, the New York County Supreme Court granted a mezzanine borrower an injunction against the UCC auction in connection with the Mark Hotel on the grounds that the auction was not commercially reasonable. *D2 Mark LLC v. OREI VI Invs., LLC*, 2020 NY Slip Op. 32057(U) (Sup. Ct. 2020). In a similar ruling, the New York County Supreme Court granted an injunction against a UCC foreclosure by finding that the proposed UCC sale was not commercially reasonable and that the mezzanine borrower would be irreparably injured by the loss of their LLC interests. *Shelbourne BRF LLC v. SR 677 BWAY LLC*, Index No. 652971/2020 (N.Y. Cnty.

Sup. Ct.). In addition, other courts have had to consider whether certain executive orders staying foreclosure apply to UCC foreclosures. In any case, it remains imperative that mezzanine lenders take into consideration that courts may continue to require more advance notice to borrowers and negotiate the timing of certain requirements in the ICA accordingly.

Replacement Guarantors

In the context of a mezzanine foreclosure, a significant concern to mortgage lenders is replacing or supplementing the existing guarantor for the mortgage loan. In a typical CRE transaction, the borrower is an entity whose only asset is the mortgaged real estate. See [Borrower as a Single Purpose Entity](#) for a discussion of single purposes entities in CRE transactions. As such, there are a variety of guarantees that a creditworthy affiliate of the borrower will provide in favor of the lender to cover events such as bad acts of the borrower, completion of a construction project, and environmental liabilities. For further information on guaranties in loan transactions, see [Guaranty and Indemnification Agreements in Acquisition Loan Transactions](#). As a result, the mortgage lender will want to ensure that the successful bidder at the mezzanine foreclosure sale provides a creditworthy replacement guarantor (someone who meets the mortgage lender's minimum net worth and liquidity requirements) prior to the mezzanine lender effectuating the transfer of the equity interests and taking control of the mortgage borrower. In the context of multiple bidders at a UCC foreclosure, the mortgage lender will often require that, as part of the mezzanine lender's bidding procedures, a successful bidder sign and deliver a replacement guaranty, as a condition to the transfer. The mezzanine lender, on the other hand, will want to limit the liability of a replacement guarantor to acts first arising after the date that the collateral is transferred to the successful bidder.

Purchase Rights

Mezzanine lenders will also want the ICA to grant the mezzanine lender the right to purchase the mortgage loan in the event of a default under the mortgage loan. The mortgage lender will argue that the purchase price of the mortgage loan should be equal to the outstanding principal balance, and all other unpaid amounts including default interest costs as well as any and all fees and other charges owed. The mezzanine lender should attempt to exclude interest in excess of the contract rate and as many fees as possible, such as late charges, exit fees, prepayment fees, and yield maintenance fees.

Mortgage lenders will also seek other avenues to limit the mezzanine lender's purchase rights. One such limitation is for the purchase right to expire within a definitive period of time following the mortgage loan default, thereby restricting

the time period in which the mezzanine lender can purchase the senior loan. The mezzanine lender should push back on this point as the purchase right can serve as an important protective option in the event that other alternatives (such as cure rights, workouts or a mezzanine foreclosure, all of which can take time to implement) have failed, and having this option remain available is critical to usefulness. In addition, the mezzanine lender should seek to obtain protections against the mortgage lender accepting a deed to the underlying real estate in lieu of a mortgage foreclosure since, at worst, the mezzanine lender can protect itself by bidding at a mortgage foreclosure sale. A compromise between the competing interests of the mortgage lender and the mezzanine lender with respect to the time frame during which the mezzanine lender will have the option to purchase the mortgage loan is that any such purchase option automatically terminates upon the earlier to occur of a transfer of the real estate pursuant to a foreclosure or deed in lieu thereof, and the curing of the default triggering the option to purchase the mortgage loan. In any event, mezzanine lenders should look to negotiate this provision to (1) require the mortgage lender to provide prior notice of its intention to accept a deed in lieu from the mortgage borrower and (2) provide an opportunity for the mezzanine lender to purchase the mortgage loan prior to the mortgage lender accepting the deed in lieu of foreclosure (or thereafter requiring the mortgage lender to convey the property to the mezzanine lender upon payment of the purchase price).

Transfer Rights

ICAs typically provide restrictions on the mezzanine lender's ability to transfer its interest in the mezzanine loan without the mortgage lender's prior approval. Some mortgage lenders even attempt to broaden this approach by limiting the potential group of transferees to those who, from a strict underwriting perspective, the mortgage lender is comfortable transacting with. The mortgage lender will negotiate for the inclusion of certain prohibited categories that will automatically disqualify any potential transferee that meets the proscribed criteria and the mezzanine lender will want to negotiate for the right to transfer to purchasers meeting certain pre-approved criteria. The mezzanine lender should push back against any such restrictions by (1) limiting the qualifications required by the mortgage lender, as applicable, for the transferee to take title or for the replacement real estate managers, as defined in the ICA, to step in and (2) requiring the mortgage lender to set forth in the ICA certain easily verifiable objective criteria for any transferees, thereby affording the mezzanine lender a smoother and more predictable sales process. The mezzanine lender should also have the right to transfer a non-controlling (i.e., up to 49%) interest in the mezzanine loan without mortgage lender consent.

Extension Options

To the extent that the loan documents permit the borrower to extend the maturity date of the mortgage loan, the mezzanine lender should negotiate for the ability, at its option, to extend the mortgage loan in the place and stead of the mortgage borrower in the event that the mortgage borrower is unable to meet the extension requirements set forth in the loan documents. Under such circumstance, the mortgage lender will often agree, that absent other defaults beyond the applicable cure period, it will “stand still” and not initiate any enforcement action during a defined period after maturity provided that it receives a notice from the mezzanine lender that the mezzanine lender intends to realize upon its collateral and exercise the extension rights of the mortgage borrower and meet the conditions to such extension.

Considerations for Loans to Be Securititized

Pursuant to commercial mortgage-backed securities (CMBS) transactions, potential securitization of loans continues to remain a significant factor in the negotiation of ICAs. In particular, mortgage lenders will strive to include language that provides protection in the event they elect to securitize the mortgage loan and other protections meeting rating agency requirements. In order to streamline the negotiating process and facilitate the rating of securitized mortgage loans that were originated as part of a capital stack including mezzanine loans, the parties will often resort (even in the case of non-securitized mortgage financings) to some form of standardized language designed to meet the standards of rating agencies and CMBS investors. As an example of a typical CMBS requirement, in the event that the mezzanine lender forecloses on its collateral and takes over the operation of the real estate, it may seek to appoint a new property manager to oversee operations. In such event, the rating agencies will typically require that the ICA provide for rating agency approval or a Rating Agency Confirmation (RAC) in the event that the new manager for the real estate is appointed that does not meet the minimum requirements set forth in the ICA, regardless of whether the mortgage lender approves such replacement manager. Additionally, rating agencies will require the ability to approve a loan transferee

that does not meet the minimum net worth tests or definition of qualified transferee as set forth in the ICA.

Mortgage lenders will seek to condition many mezzanine lender rights upon rating agency confirmation such as the transfer or financing of the mezzanine loan. Additionally, as is often the case in the current market, mezzanine lenders may elect to pledge the mezzanine loan to another bank or lender that provides it with a credit facility. Mezzanine lenders that intend to pledge their loan should therefore make sure that such a pledge is permitted by the terms of the ICA. The mortgage lender may consent to such a pledge on the condition that such credit line lender meets the required credit ratings applicable for securitizations.

For further information on CMBS loans see, [Representing the Borrower in a CMBS Loan](#).

Industry Developments and Considerations

During the last half of 2022 and first quarter of 2023, CRE transactions have slowed considerably due, at least in part, to rising interest rates. The consistent increase in rates coupled with the concern that additional increases may continue to follow has created much uncertainty in the CRE market. To complicate matters further, some mortgage lenders have begun to impose lower leverage requirements by limiting LTV size. As a result, buyers and sellers have found it difficult to navigate this new terrain. Looking ahead to the remainder of 2023, CRE transactions may continue to stall until there is confidence in the market that rates have stabilized. Given the large amount of CRE debt that is due to mature over the next few years, it also remains to be seen how much of an impact the rise in variable rates will have on borrowers and whether lenders will respond to defaults by electing to foreclose on their collateral or by negotiating extensions and workouts.

Related Content

Resource Kits

- [Mezzanine Financing Resource Kit](#)

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Julian M. Wise is chair of the Real Estate Group, co-chair of the Task Force for Racial Justice Initiatives and a member of the firm's Executive Committee. He has a wide breadth of experience representing institutional and non-institutional lenders, owners/operators and investors in complex commercial real estate transactions, including on the lender side, structuring and negotiation of senior and multi-tranched mezzanine financings, intercreditor agreements, co-lender and participation agreements, joint venture and preferred equity agreements and loan portfolio acquisitions and dispositions and restructurings, and on the owner/operator side, acquisitions, dispositions and financings of office, retail, hotel and multifamily properties. His clients include private equity firms, major financial and commercial lending institutions and developers and owners of commercial, industrial, retail, office, hotel and large-scale residential properties. Julian has represented clients in some of the most high-profile real estate transactions, including, among others, a major national retail grocery chain in connection with its \$2-billion financing of approximately 400 grocery stores and distribution centers in 14 states; a major private equity firm in connection with its multibillion-dollar acquisition of retail properties across the United States; several major private equity firms in over \$5 billion in senior and mezzanine financings across the United States; a private equity firm in connection with its acquisition of AT&T's Yellow Pages (a transaction that was secured by real estate and other assets located across the United States); a real estate fund in the acquisition and subsequent disposition of trophy buildings across the United States, including the Gucci Building located on Rodeo Drive in Beverly Hills, California; and a major private equity firm in the acquisition, financing and disposition of the Innkeepers hotel portfolio. He also represented the previous owner/manager of 230 Park Avenue (the Helmsley Building) in its acquisition, recapitalization and financing of the property, and the building's subsequent \$1.2-billion sale, which was recognized as one of *Real Estate Forum's* "Deals of the Year" and for which Julian was named to the publication's list of "Dealmakers." In addition, Julian was named one of *Real Estate Forum's* 2019 "Financial Influencers" in the industry.

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