Market Trends 2017/18: Mezzanine Financing

A Lexis Practice Advisor® Practice Note by
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OVERVIEW

Mezzanine debt is a financing vehicle that typically serves as a bridge between debt and equity in a borrower's capital stack. While mezzanine debt is used in mergers and acquisitions (M&A), leveraged buyouts, and other contexts, this note will focus on mezzanine lending in a commercial real estate (CRE) context. While more expensive than a senior mortgage loan, mezzanine debt is often less expensive than equity and allows the borrower a certain amount of flexibility, including the ability to maintain control over the property. The impact of governmental regulations and other trends since the economic crisis in 2008 brought a number of new types of lenders to the CRE lending space, a trend that continued through 2017. Many of these new lenders have provided mezzanine loans for construction and development deals. As the president and chief financial officer of RXR Realty (RXR) told the publication *The Commercial Observer*, the company issued mezzanine construction loans "because financing for construction has tightened up a little bit, [so] there will be good projects that need to complete their capital stack, and we'll be able to provide the capital that's above the construction loan and below the equity."

This note will outline certain key areas for the practicing attorney when negotiating mezzanine loan documents, both as lender's and borrower's counsel, and will discuss the current state of the market as well as where the market may be headed in the near term. For further information on mezzanine debt, see Mezzanine Debt Structure.

NOTABLE TRANSACTIONS

One trend of note in 2016 that continued into 2017 was the sustained increase in the number of real estate developers engaging in mezzanine lending. In addition to RXR, the Kushner Companies, Moinian Group, and other real estate developers formed funds for the purpose of providing loans, often mezzanine loans, to fellow developers. According to documents filed with the Tel Aviv Stock Exchange in January of 2018, Moinian Group was engaged in a number of new lending transactions around the United States, of which $84 million was for mezzanine financing.

Foreign investors too have been actively seeking mezzanine financing transactions in the United States, in particular, Korean entities including sovereign wealth funds. In 2017, Fortis Property Group and investor David Werner reportedly closed on a $100 million mezzanine loan to refinance a portion of existing indebtedness on a building in Boston's financial district. See https://commercialobserver.com/2017/05/fortis-david-werner-lock-in-100m-in-mezzanine-debt-from-korean-investor/. For further information on sovereign investment, see Sovereign Entities Practice Guide and Market Trends 2017/18: Sovereign Bonds.

DEAL STRUCTURE AND PROCESS

Deal Process

Unlike a mortgage loan, which is secured by a lien on the borrower's real property, the security for the mezzanine lender is the mezzanine borrower's ownership interest in the fee owner (i.e., the owner of the real property). In a typical CRE mezzanine loan, the mezzanine borrower owns 100% of the ownership interests in the mortgage borrower, and both borrowers are subsidiaries of the sponsor. Mezzanine lenders will typically require both the mortgage borrower and the mezzanine borrower to be single-purpose, single-member limited liability companies (LLCs). Additionally, mezzanine lenders generally require both LLCs to be organized under the laws of the State of Delaware. This is due to a number of factors, including the perception that Delaware courts are more favorable to lenders and that Delaware has established laws in connection with the so-called springing or special member. The Delaware Limited Liability Company Act (6 Del. C. § 18 101 et seq.), as amended from time to time (Delaware LLC Act), permits the springing member to replace the last remaining member of the LLC in the event the single member of such LLC files for bankruptcy, thereby preventing the borrower entity from automatically dissolving by operation of law. For a form of Delaware limited liability company agreement in another context and a form of certificate of formation, see Limited Liability Company Agreement (Securitization Transaction) (DE LLC) and Certificate of Formation (DE LLC).

The mezzanine lender generally will also require that the security interest be perfected (known as opting in) under Article 8 of the Uniform Commercial Code (UCC), and that the mezzanine borrower's ownership interest in the fee owner (or whichever entity acts as collateral for the mezzanine loan) be certificated pursuant to Article 9 of the UCC, which governs secured transactions. Opting in under Articles 8 and 9 permits the mezzanine lender to take physical possession of the membership certificates (for an LLC) and protects against potential bona fide purchaser claims. The mezzanine borrower will then pledge its interest in the fee owner entity to the mezzanine lender via a pledge agreement, which will be reflected in a UCC filing on the public records and the books and records of the fee owning entity. For a form of pledge agreement, see Pledge Agreement. The pledge agreement will state that upon an event of default, the mezzanine lender has the right to foreclose upon the mezzanine borrower's ownership interest and sell the same at a public (or under certain circumstances, private) sale. As a result, the mezzanine lender is entitled to, among other things, the profits which the original mezzanine borrower would otherwise have been due by virtue of its ownership interest. Additionally, upon an event of default, the mezzanine lender will have the decision-making ability and control with respect to the property that the mezzanine borrower previously had.

A primary advantage in providing a mezzanine loan over a mortgage loan is the relative expediency of a UCC foreclosure sale as opposed to a mortgage foreclosure. In contrast to a mortgage foreclosure, which can take months (or more), a UCC foreclosure can be completed in as little as 30-60 days. Additionally, mortgage lenders generally prefer that subordinate loans not constitute liens on the property so that the subordinate lender does not have a competing lien against the real property or claims against the mortgage borrower. For a form of subordinated loan agreement, see Senior Subordinated Note Purchase Agreement.

Timeline

In a typical CRE mezzanine financing, the mezzanine loan may close simultaneously with a mortgage loan or the borrower may request the ability to seek additional subordinate mezzanine financing at a later date. In addition, the mortgage lender may reserve the right to split off a portion of the mortgage loan to create a mezzanine loan. In the current market, more and more mortgage lenders are seeking to split off a portion of their loan and create a mezzanine piece. This is primarily because, as will be discussed further below, traditional lenders (banks and other similar financial institutions) have scaled back their CRE lending and non-traditional lenders have stepped in to help fill the void. As such, a borrower should consider how to limit the potential costs of such a

provision in advance, including a fee cap and a requirement that the mortgage lender use the same counsel for the mezzanine loan documents as used for the mortgage documents. Although the mezzanine loan documents are primarily based on the negotiated mortgage loan documents, preparation can be expensive if a new law firm is retained to create such mezzanine loan documents. A borrower should also consider other additional costs, including legal opinions (such as a Delaware enforceability opinion and other UCC opinions) with respect to the mezzanine borrower as well as the costs of a new UCC policy, which will be discussed in more detail below. For further information on legal opinions in the securitization context, see Legal Opinions in Securitizations. For forms of mortgage documents in various contexts, Loan-Level Representations (Pooled Mortgage Loan in a Residential Mortgage Securitization), Pooling and Service Agreement (Residential Mortgage-Backed Security Transaction), and Custodial Agreement (Residential Mortgage-Backed Security Transaction).

Other Key Issues and Trends

Prior to 2008, Commercial Mortgage Backed Security (CMBS) lending was a primary source of debt for the CRE industry. The peak of the CMBS market occurred in 2007, when, according to Commercial Mortgage Alert, a total of $230 billion in CMBS loans were issued in the United States. In 2008, that number dropped to approximately $12 billion. While steadily increasing each year between 2009 and 2015 (up to approximately $96 billion in 2015), CMBS lending fell back down to approximately $69 billion in 2016. Although CMBS lending had a comparatively strong year in 2017 (a 26.1% increase over 2016 according to the data and analytics provider Trepp), CMBS lending has yet to reach pre-recession levels due to a confluence of events including increased regulation governing traditional banking institutions. As a result, this has created opportunities for non-traditional lenders to enter the CRE lending space. Non-traditional lenders may include private equity firms, hedge funds, real estate developers, and other real estate investment groups. This group of lenders, while they perhaps do not have the same amount of capital available that larger banking institutions may have, generally seek higher returns on their investments. Accordingly, they tend to be more inclined to take a subordinate lender position, which requires far less capital but provides greater returns on their investment. Further, as traditional lenders have focused in the last few years on providing less risky loans with a lower loan-to-value ratio (LTV) than they were providing prior to the downturn in 2008, mezzanine lenders have taken advantage of the reduced mortgage loan proceeds and filled that void in the lending market.

As will be discussed further in this note, if the Trump administration follows through on its campaign promises to roll back certain existing regulations, most notably the Dodd–Frank Wall Street Reform and Consumer Protection Act (111 P.L. 203, 124 Stat. 1376) (Dodd-Frank), that may lead to increased CMBS lending and CRE transactions in general. As a consequence, increased competition can give borrowers and their counsel an upper hand in negotiating. As counsel for the borrower, you should be aware of the general market trends and the level of competition among lenders in order to know when to push back and when to concede. For a discussion of existing Dodd-Frank regulations, see Dodd-Frank Wall Street Reform and Consumer Protection Act Key Provisions.

DEAL TERMS

The Term Sheet Stage

When a lender and borrower are negotiating a term sheet, the parties should consider explicitly stating whether subordinate financing is permitted or will be provided. In certain instances, the borrower will need additional financing to purchase the property, complete their construction project, refinance their existing debt (see the discussion of LTVs above), or otherwise fund the contemplated transaction. If the lender is the party seeking the ability to split the loan between mortgage and mezzanine debt, the borrower's counsel should consider including terms to protect against the potential negative economic impact of the higher interest rate which will be charged with respect to the mezzanine loan. Such impact can be addressed with requirements that the weighted average of the interest rates of the mortgage and mezzanine loans be the same both before and after the split. Also,

counsel should consider requiring that borrower's principal payments from time to time be applied proportionately to each loan so they will not be susceptible to rate creep (i.e., an increase in the cost of the total financing over time).

In states such as New York that have a mortgage recording tax that can be mitigated by assigning an existing mortgage to the new mortgage lender, borrowers will want to receive the maximum benefit of such assignment and will therefore seek to allocate as much of the loan as possible to a new mortgage loan, rather than losing the benefit because of the size of the mezzanine loan. In such states, in the event that the mortgage lender reserves the right to split off a portion of the mortgage loan to a mezzanine piece at a later date, the borrower may lose the benefit of any mortgage recording tax it paid, such that if the borrower refinances its loan at a later date, it may be forced to pay the mortgage recording tax again. Therefore, if you are acting as counsel for the borrower, you will want to negotiate with the mortgage and mezzanine lenders to maximize the benefit of the mortgage assignment. For example, if a borrower in New York paid mortgage recording tax in connection with the purchase of a property with a $100 million mortgage in 2013, and in 2018 seeks a $140 million mortgage loan to refinance the 2013 loan, the borrower should attempt to negotiate that the new mortgage loan be no less than $100 million (or whatever the principal balance is at the time of such repayment) and the mezzanine loan will be no more than $40 million in order to take advantage of the previously paid mortgage recording tax.

Additionally, as more and more lenders enter the mezzanine lending space, borrowers' counsel should consult with their clients early on as to any potential competitors that should be restricted as transferees of all or part of the loan. The reason for this is that such a competitor may purchase the loan with an eye towards acquiring the property through a UCC sale thereby incentivizing potential default claims as lender. If the term sheet permits the mortgage lender to assign a portion of the loan to a mezzanine lender, and the borrower does not object to or create parameters for a permitted transferee, it may be stuck with a mezzanine lender that it prefers not to deal with or with whom it has an acrimonious relationship. This could be of particular importance in a construction loan or other loan with future advances, where the lender will continue to have obligations to provide funds to the borrower. If a borrower has had a bad experience with a particular lender, the borrower should specify early on that such lender will not be a permitted transferee for the loan. Borrowers should also try to cap any costs they should have to incur in connection with such a transfer.

Borrowers may also want to set, in the term sheet, a maximum dollar amount that the mortgage lender can assign to a mezzanine lender. After all, the borrower has decided to enter into a transaction with the particular mortgage lender, ostensibly because they know and/or trust this institution, and the mortgage lender should maintain some minimum involvement and responsibility, especially during the construction phase, if applicable.

The Loan Documents

In a typical CRE mezzanine loan scenario, the principal property-related terms in the mezzanine loan documents will essentially be the same as those contained in the mortgage loan documents, with certain changes to account for the nature of the transaction between the mezzanine borrower and mezzanine lender. For example, if the mortgage loan agreement contains covenants that the mortgage borrower must maintain the property in a certain manner, the mezzanine loan agreement will contain similar provisions, modified such that the mezzanine borrower covenants to *cause* the mortgage borrower to maintain the property in the same specific manner. Because the mezzanine borrower owns all of the ownership interest in the mortgage borrower, the mezzanine borrower has the ability to control the mortgage borrower, and, in turn, can covenant to the mezzanine lender that it will cause the mortgage borrower to comply, as applicable, with the loan documents. For a form of mortgage loan agreement in another context, see Mortgage Loan Purchase and Sale Agreement (Residential Mortgage-Backed Security Transaction).

Additional Mezzanine Borrower-Specific Terms

Another difference between the mortgage loan agreement and the mezzanine loan agreement is that in addition to references to the real property, there will be a need to reference the mortgage financing as well as the pledged collateral (i.e., the mezzanine borrower's ownership interest in the mortgage borrower).

If you are acting as counsel for mezzanine lenders, you will want to include in a mezzanine loan agreement the following additional provisions:

- Representations from the mezzanine borrower that the mortgage loan is not in default
- Incorporation of the mortgage borrower's representations and warranties in the mortgage loan agreement without changes from the specified provisions in the mortgage loan agreement in effect as of the date of the mezzanine loan agreement (and a covenant that any amendments or modifications to the mortgage loan agreement without the mezzanine lender's consent do not bind the mezzanine lender)
- Covenants from the mezzanine borrower to cause compliance with the loan provisions of the mortgage loan documents
- Covenants to turn over to the mezzanine lender (subject to the rights of the mortgage lender pursuant to the terms of the mortgage loan agreement) any insurance proceeds or other amounts (net of certain pre-approved deductions, including amounts payable to the mortgage lender) received by the mortgage borrower in connection with certain so-called liquidation events, such as a sale, casualty, condemnation, mortgage foreclosure, or refinance of the mortgage loan
    - If you are acting as borrower's counsel, include in the pre-approved deductions borrower's costs and expenses incurred in connection with such liquidation event, any net proceeds that mortgage borrower is entitled to use in connection with a restoration pursuant to the mortgage loan documents and amounts of prepayments, and yield maintenance charges or premiums required to be paid to each lender.
- A cross-default provision that provides that a default under the mortgage loan is a default under the mezzanine loan (although, a default under the mezzanine loan should not automatically be a default under the mortgage loan)
- If the mortgage lender permits, a covenant from the mezzanine borrower that any prepayments made to the mortgage and mezzanine loans will be made on a pro rata basis
- If the loans contain an option to extend the maturity date, a condition precedent to such extension of the mezzanine loan that the mortgage loan be extended as well
- In the event that the mortgage loan is repaid, but the mezzanine loan remains outstanding, a provision that the mortgage lender should transfer any money left in any reserve accounts to the mezzanine lender to be held in the same fashion

Recourse Provisions

Similar to most mortgage loans in today's market, real estate mezzanine loans are typically non-recourse, with specific carve-outs for certain bad acts of the borrower. A full discussion of non-recourse carve outs is beyond the scope of this note. However, while the vast majority of carve-outs will be the same (with the borrower references expanded to include the mortgage and mezzanine borrowers), there are a few specific additional carve outs that counsel representing the mezzanine lender should consider inserting into the mezzanine guaranty:

- Full recourse if the mortgage borrower amends its organizational documents such that it no longer is governed by Article 8 of the UCC (since it is important security for the mezzanine lender that the mortgage borrower opt

in to Article 8 to protect against claims of potential bona fide purchasers and others)

- Full recourse if the mortgage borrower or any related party acquires the mortgage loan (since the mezzanine lender relies on the mortgage lender under the intercreditor agreement as discussed below and if the sponsor or an affiliate of the sponsor acquires the mortgage loan, it could take detrimental actions such as creating defaults, ceasing payments for the mezzanine lender, and reacquiring the property via foreclosure, thereby wiping out the mezzanine lender's interest in the property)
- Recourse to the extent of mezzanine lender's losses if the mortgage borrower fails to comply with the provisions related to cash management (since the mezzanine lender does not have direct control of the cash management and a failure by borrower to comply could result in there being insufficient funds to make payments to the mezzanine lender)

In recent years, most lenders have also added a carve-out that a guarantor should be liable for any transfer tax due in connection with the exercise of remedies under the mezzanine loan documents. Many borrowers will push back on this as a recourse item, but mezzanine lenders should be aware that in most states transfers of indirect ownership interest in real property are now subject to transfer taxes so that a transfer tax will be due following a foreclosure and can be significant, and the borrower will almost certainly not have funds to cover such tax, even if made liable for it.

LEGAL AND REGULATORY TRENDS

UCC Insurance

Another consideration for mezzanine lenders is title insurance. While a mortgage lender can obtain a loan policy for its lien on the real property, the mezzanine lender has no such security as its collateral is an ownership interest in the property owner. Instead, they may be able to obtain a "UCC Insurance Policy" (currently only offered by a select few title insurers), which insures the proper creation and perfection of the UCC security interest. It should be noted that some believe this policy to be of limited value since the lender's counsel will run UCC searches against the borrower and will obtain the membership certificates.

In addition to the UCC Insurance Policy, mezzanine lenders may request as an endorsement to the mortgage borrower's title insurance policy, an ALTA Endorsement 16-06 (Mezzanine Financing or Mezzanine Endorsement). This endorsement (i) makes the mezzanine lender an assignee of payments under mortgage borrower's owner's policy (in an amount not to exceed the debt owed to the mezzanine lender), (ii) provides non-imputation coverage to the mezzanine lender such that in the event of a loss, the title insurer will not refuse payment to the mezzanine lender solely by reason of the action or inaction of the mezzanine borrower, and (iii) includes the so-called fairways coverage, providing that the coverage under the policy will not deny liability to the mezzanine lender because of transfer of ownership interest (direct or indirect) in the insured. In the current market, due to the high cost to the borrower of the Mezzanine Endorsement in certain states (e.g., in New York it is equal to 20% of the owner's rate on the amount of the mezzanine loan), many lenders will agree to take, via a collateral assignment document, an assignment of title insurance proceeds and forego the Mezzanine Endorsement. Such an assignment provides that in the event the owner's policy pays a title claim to the mortgage borrower, and the mezzanine loan is still outstanding, the proceeds of such title claim will be payable to the mezzanine lender to reduce the outstanding obligations. The borrower will also agree to cause compliance with all of the terms of the owner's title insurance policy and will appoint the mezzanine lender as its attorney-in-fact to file and enforce any claims under the owner's title policy.

The Intercreditor Agreement

The relationship between the mortgage lender and the mezzanine lender is typically governed by a separate

agreement between the lenders called an intercreditor agreement (ICA). By entering into an ICA, the primary benefits for the mortgage lender are (i) that it gains the comfort of the contractual obligation that the mezzanine loan is subordinate in all respects to the mortgage loan, and (ii) the mezzanine lender is not permitted to commence an enforcement action unless the mortgage lender has done so or the mezzanine lender meets certain predetermined criteria for becoming a successor owner of the mortgaged property. The traditional benefit for the mezzanine lender under the ICA is that it outlines the communication obligations of the mortgage lender, such as delivery of notices, including, but not limited to, any defaults by the borrower under the mortgage loan. In recent years, a number of additional provisions beneficial to the mezzanine lender have been added to many ICAs, including the following:

- Extended cure rights in favor of the mezzanine lender in the event the mortgage borrower defaults under the mortgage loan documents
    - The ICA will typically provide that that the mezzanine lender has a certain period of time to cure a default before the mortgage borrower exercises any foreclosure rights, which in the case of non-monetary defaults may include time for the mezzanine lender to realize upon its collateral and gain control of the mortgaged property.
- Approval rights to the mezzanine lender over certain actions of the mortgage borrower, including over leases, insurance, budgets, property managers, or other property-related decisions
- The ability of the mezzanine lender to enforce separate mezzanine security (i.e., the ownership interests of the property owner), provided the transferee/mezzanine lender takes certain steps or meets certain criteria, including minimum creditworthiness, appointing a qualified manager to manage the property, providing replacement guaranties and indemnities, and curing certain defaults under the mortgage loan

The ICA will also govern permitted and prohibited transfers of the loans by the respective lenders. In certain scenarios, the mezzanine lender may have the right to buy out the mortgage lender's senior position.

Regulations

As discussed earlier, one of the primary reasons that CRE lending in general slowed in 2016 was due to legislation and regulation, including Dodd-Frank, which, among other things, imposes certain risk retention requirements on lending institutions. Many mezzanine lenders are not subject to such requirements, which has provided them an opportunity for making up the shortfall resulting from lesser mortgage proceeds and thereby obtaining higher returns. While scaling back Dodd Frank (or repealing it entirely) could be a lengthy process, the Trump administration, including Treasury secretary Steven Mnuchin, has stated that they intend to "strip back parts of Dodd-Frank and that will be the number one priority on the regulatory side." See http://www.wsj.com/articles/trump-treasury-choice-steven-mnuchin-vows-to-strip-back-dodd-frank-1480513188. In March 2018, the Senate voted by a count of 67 to 31 to ease certain banking regulations, including those affecting smaller banks. If the House passes a similar bill, while a step towards the repeal of Dodd-Frank that the Trump administration has promised, it would still leave most of the law intact. Nevertheless, 2017 was a strong year for CRE due, in part, to continually low interest rates and an improved economy. For an example of other regulatory effects of Dodd-Frank, see, e.g., Dodd-Frank and Private Equity: Then and Now.

MARKET OUTLOOK

There was a resurgence of CMBS issuance in the second half of 2017. According to Trepp, CRE lenders went from issuing no loans in January of 2017 to issuing 335 CRE loans in August totaling $10.65 billion. Notwithstanding that resurgence, alternative lenders continue to play a big role in CRE loan issuance. On February 3, 2017, President Trump signed an executive order that, while vague in its wording, directed the

Secretary of the Treasury to reverse the financial regulatory policies of the Obama administration. While the Trump administration has not yet successfully fulfilled its campaign promise to strip back parts of Dodd-Frank, nevertheless optimism in the overall economy provided a boost for the CRE lending industry, and in particular the CMBS lending industry, throughout 2017. The more lending that exists and the more transactions that take place, the greater the need will be for mezzanine lending. On the other hand, if mortgage proceeds increase (thereby increasing the total LTV for mortgage loans), then the opportunities for mezzanine loans may be for lesser loan amounts. Additionally, as the Federal Reserve continues to increase interest rates, which seems likely in the near term, there is the potential for decreased liquidity in the CRE market.

In addition to the potential regulatory changes, industry experts have pointed in recent years to a "wall of maturities," or a significant number of CMBS loans that came due in recent years. Industry experts predicted that in 2017 almost $140 billion in CMBS loans were expected to mature. See CREFC presentation, *CMBS 101* (February 26, 2016). The reality is that the market responded rather well to the abundance of loans maturing. The Trepp CMBS Delinquency Rate dropped in February of 2018, for the eighth consecutive month. See http://info.trepp.com/trepptalk/cmbs-delinquency-rate-plummets-in-february-for-eighth-consecutive-drop. Rising prices and the increase in types of lenders were contributing factors. See https://www.reit.com/news/blog/market-commentary/other-side-cmbs-wall-maturities. In the near term, as these loans continue to mature, to the extent that there is a shortfall in proceeds or availability of mortgage loans to refinance maturing debt, and as the market continues to improve, mezzanine lending has, and should continue to, help make up the shortfall.

In contrast to the second half of 2017, the first half of 2018 has started off slowly for CRE lending. However, in the current market, with more lenders, but still less transactions than pre-2007 levels, lenders have the upper hand in negotiating provisions in loan documents. If a mezzanine lender knows that the borrower has little or no other options if they wish to proceed with the transaction, the mezzanine lender is dis-incentivized from negotiating certain provisions to its detriment, particularly since it is subordinated and in a riskier position. To the extent that there is greater competition, borrowers may gain back some of the leverage. Therefore, it is important for counsel for both lenders and borrowers to be generally aware of the state of competition in the lending market so that they have an understanding of the kind of leverage (or lack thereof) their client has.

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