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MEZZANINE FINANCE – LEARNING THE LESSONS FROM THE PAST

By Nigel White and Abigail Hooks

As with many financing transactions entered into more than two years ago involving more than one class of creditors, the relationship between senior and mezzanine finance providers in real estate finance transactions have been under pressure in recent times as the effects of the credit crunch have continued to take their toll.

This pressure has arisen in part from the economic background of falling values, reduced liquidity and higher pricing, and from the legal and documentary position between the different sets of creditors.

The result is that senior and junior parties are frequently poles apart when trying to reach decisions relating to their non-performing exposures and consequently recent trends in the market indicate that a greater clarity and consistency in relation to both the commercial and documentation structuring are required at the outset of any intercreditor relationship.

Historically, the backbone of intercreditor arrangements under English law has been based on the concept that senior lenders are senior in all ways. Accordingly, and in return for higher risk and greater reward, the mezzanine providers would agree to take more of a back seat role in their ability to enforce or recover their debt. Typically this might have resulted in the mezzanine lenders agreeing (subject to very limited exceptions prior to the senior debt being repaid in full) to full subordination with no enforcement rights at all.

However, at the same time during the early and mid 2000's there was also a different more "junior lender friendly" approach. This approach (which reflect a standard position in the US and in CMBS structures) gives increased power to those who are at greater risk in the structure. This depends on where the asset value compared with the amount of the different levels of debt held in the financing structure is at any time so that enhanced control and rights given to the most senior lenders in the structure which could be impaired. This generally resulted in those rights initially sitting with the lenders at the bottom of the financing structure and moving up that structure if (as it turned out, when) the value of the collateral declined.

More recently many of these intercreditor arrangements have been the subject of intense review and negotiation in the context of transactions being restructured or enforced. That review has exposed flaws and weaknesses of past arrangements, perhaps due to the execution of documentation which was not properly considered or understood, or because it was too simplistic to address the factual matrices which are currently being presented. For instance, certain intercreditor arrangements gave no enforcement or cure rights to the mezzanine tranches at all, giving them no right to be at the table on a subsequent restructuring. Conversely, senior lenders have discovered in some of their deals that there was no debt release provision and consequently they were

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not able to enforce, without mezzanine lender consent, against share security held in the property owning vehicle.

The current mezzanine market is showing some tentative signs of improvement and increased optimism as participants focus on the refinancing requirements over the next eighteen months and the likely gap in the market to meet those requirements by way of senior debt. Many investors see this as an opportunity for mezzanine finance (as evidenced by the recent fund raising activities of Duet Group, Pramerica, LaSalle and Longbow amongst others).

What is clear is that a greater understanding of the intercreditor issues (and ideally the emergence of more market standard documentation to deal with those issues) between the senior and mezzanine lenders is likely to improve the documentation/ transaction execution process in the market.

The Loan Market Association (the **"LMA"**) recognised the failure in the broader financial markets properly to address intercreditor issues and introduced a form of intercreditor agreement last year. Although this form is primarily aimed at the leveraged and acquisition finance markets, its principles have subsequently been adopted into various real estate finance transactions. Indeed, its general acceptance in the market has been particularly aided by a revised version issued following particular scrutiny and commentary by the mezzanine lenders themselves.

As a result, we have seen that certain market participants are now actively reviewing and where applicable negotiating some of the more challenging intercreditor issues between senior and mezzanine funders. These issues include:

1. the extent to which a cross-default clause in the event of default provisions in the mezzanine documentation, should be triggered by an event of default under the senior documentation;
2. the level of control that a security agent or trustee has to release security (including that relied upon by the mezzanine lenders) as a part of an enforcement arrangement (particularly if mezzanine lenders are not likely to receive one hundred per cent. return on their participation following a sale);
3. the extent to which a mezzanine lender should be able to block decision making at the senior level, and whether there should be a mechanic enabling a mezzanine lender the right to purchase the senior debt if it disagrees with the decisions made by the senior debt holders;
4. the triggering of a payment stop event (a block on payments being made to the mezzanine lenders by the borrower) and whether this should occur following the serving of a notice or automatically following the occurrence of a particular event (for example, an event of default under the senior loan documentation);
5. the ability of the mezzanine lenders to recover enforcement or restructuring fees following a payment stop event;
6. the extent to which the mezzanine lenders should be able to amend their documentation (for instance, to allow for the capitalisation of interest and payment holidays) and cure rights generally; and
7. the role of the hedging providers and their inclusion in consents and majorities in relation to decision making processes.

The fact that these issues are being properly discussed and negotiated is good news; through dialogue between the parties earlier in the transaction process will ensure that parties properly understand and consider more difficult commercial intercreditor issues prior to them being tested in a stressed environment. This should result in a more stable and consistent documentation structure in the future and fewer unwanted surprises when the deal documents are dusted down and reviewed in earnest long after the closing champagne has lost its fizz.

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