

Stuck in the Middle of the Cap Stack: Intercreditor and Subordination Agreements in Mezzanine Financings

Below is an overview of the key terms and provisions in intercreditor/subordination agreements governing the relationship between a senior secured lender (the “Senior Lender”) and a mezzanine lender (the “Mezz Lender”). Typically, the obligations owing to the Mezz Lender (the “Mezz Obligations”) are unsecured or are secured solely by a pledge of the equity interests in the borrower and/or by a second lien security interest on the Senior Lender’s collateral (which when coupled with the payment subordination applicable to the Mezz Obligations, is frequently referred to as a “silent” second lien).

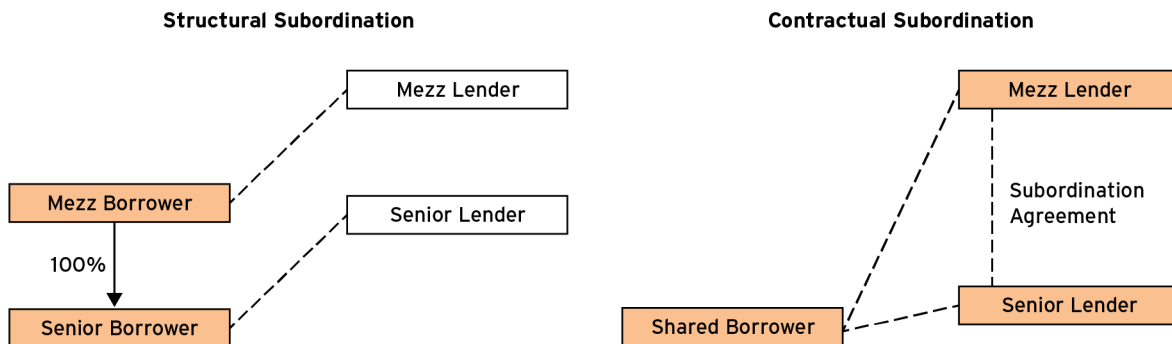
The applicability and negotiation surrounding each of the below discussed points can vary significantly based on the deal structure and the industry-specific experience and business relationships of the parties involved.

Payment Subordination and Blockage

The Senior Lender will require that the Mezz Obligations are subordinate to the payment in full of the obligations owing to Senior Lender (the “Senior Obligations”). The typical arrangement ensures that the applicable borrower will be permitted to make regular payments of interest (and, in some cases, principal or applicable high-yield discount obligation catch-up payments, if applicable) on the Mezz Obligations and to return capital to the preferred equity holder (if applicable) so long as no payment blockage is in effect. The triggers for payment blockage and the length of payment blockage vary by deal and are subject to negotiation. A payment default under the Senior Obligations will always trigger a permanent payment blockage, but other (or any) events of default under the Senior Obligations, such as a default under financial covenants, will also effect a payment blockage that may be negotiated to a limited, specified period (usually 90-180 days).

Lien Subordination - Silent Second Lien and Equity Pledge

If a transaction involves a silent second lien in favor of the Mezz Lender, the Senior Lender will require full subordination of the Mezz Lender’s lien; subordination here meaning that the Mezz Lender will not be entitled to exercise remedies or foreclose on any of its collateral until the Senior Lender is paid in full. A silent second lien transaction requires that the Senior Lender be willing to forego structural subordination and rely only on contractual subordination. Without structural subordination, the Mezz Lender and the Senior Lender provide financing to the same borrower entity (illustrated below), instead of the Mezz Lender providing financing to an upstream holding company or parent entity and the Senior Lender providing financing to the operating subsidiary or entity that is the primary holder of assets related to operations.



The advantage of the silent second lien for the Mezz Lender is that the Mezz Lender will have priority over other unsecured creditors of borrower. There are also certain protections under the bankruptcy code available only to secured creditors; however, the Senior Lender will require that the Mezz Lender contractually waive or assign to the Senior Lender most of these rights and protections (ergo, the “silent” second lien; see *Customary Bankruptcy Provisions below*) in exchange for the aforementioned payment priority.

In contrast, in deals requiring structural subordination, the Mezz Lender will not have a claim in (or participate in) any bankruptcy of, and will be behind unsecured creditors of, the borrower of the Senior Obligations. Similarly, in an unsecured mezzanine financing without structural subordination but also lacking a silent second lien, the Mezz Lender will have a claim in the bankruptcy of, but will be *pari passu* with other unsecured creditors of, the borrower.

If a mezzanine financing involves the pledge of equity in the borrower in favor of the Mezz Lender (regardless of whether the Mezz Lender is structurally subordinated), the subordination agreement will typically permit the Mezz Lender to foreclose and exercise remedies with respect to such pledge without disruption by the Senior Lender upon an event of default under the Mezz Obligations. However, the Senior Lender's approval of such foreclosure may be subject to the Mezz Lender or its designee in foreclosure's satisfaction of specified qualifications demonstrating the ability to operate or manage the property as well as industry-specific conditions, such as the foreclosure having no impact on regulatory permits or licenses. Thus, the Mezz Lender may negotiate for it or its affiliates/designee to be a pre-approved qualified transferee/qualified manager (particularly where the Mezz Lender or an affiliate thereof also holds a preferred or other equity position in the borrower).

Exercise of Remedies/Standstill

The Mezz Lender will typically be subject to a standstill period applicable to its exercise of remedies against the borrower (except for the remedy of foreclosing on the aforementioned equity pledge, if applicable) or a shared guarantor. The standstill period usually lasts for 90-180 days (and terminates automatically upon acceleration of the Senior Obligations or the commencement of bankruptcy proceedings). However, in certain deals, including where the Mezz Lender or an affiliate thereof holds a preferred or other equity position in the borrower, the standstill period may be permanent.

There is typically no standstill or restriction on the exercise of remedies applicable to the Senior Lender. However, in deals where the Mezz Lender has a cure right (see below), the period applicable to the Mezz Lender's cure right effectively serves as a standstill applicable to the Senior Lender as the Senior Lender is barred from enforcing remedies until the expiration or exhaustion of the negotiated cure right.

Subordinate Lender-Favorable Provisions - Cure Right and Purchase Right

An intercreditor/subordination agreement may (subject to negotiation) grant the Mezz Lender a right to cure defaults under the Senior Obligations. Such a cure right effectively results in a standstill of the Senior Lender's right to exercise remedies. A typical cure timeframe is 15 days for a monetary default and 30 days for a non-monetary default, subject to extension (180-365 days) provided the Mezz Lender continues to cure and/or is diligently pursuing a cure. If applicable to the industry (such as hotels, restaurants, other real estate sectors), the Mezz Lender may also negotiate for the right to replace or require a property manager (as applicable) during such cure period to turnaround performance. Both a cure right and a right to require/replace property manager are more likely to be amenable to the Senior Lender where the Mezz Lender has significant access to capital and industry-specific knowledge, such that the Mezz Lender could viably effect a turnaround and cure the corresponding default.

The Mezz Lender may also negotiate for the right to purchase the Senior Obligations following an event of default thereunder. Both the purchase price (whether it is at par or includes prepayment penalties, fees, etc.) and the triggers (the acceleration of the Senior Obligations or the occurrence of specified events of default) for the purchase right vary by deal and are subject to negotiation. The Mezz Lender should consider whether buying the Senior Obligations is a meaningful right given its access to capital.

Debt Caps, Amendments and Other Restrictions

An intercreditor/subordination agreement should cap the maximum amount of the Senior Obligations and the Mezz Obligations permitted to be incurred, including increases in principal and interest and, in some cases, fees. Whether or not protective advances are included in the Senior Obligations limitation may also be raised in negotiations.

Each lender will also negotiate a consent right over certain modifications to economic or other material terms of the other lender's facility. Each lender in the capital stack will want to ensure that the borrower's debt obligations remain unchanged from those agreed to at the time the intercreditor/subordination agreement is signed, as the overall credit of borrower and its affiliates is critical to the underwriting of each lender.

Customary Bankruptcy Provisions

The Senior Lender will require that the Mezz Lender waive certain rights and protections applicable to it in a bankruptcy of the borrower. These are subject to some level of negotiation, but at a minimum, the Mezz Lender will agree not to take any position or actions adverse to the Senior Lender in a bankruptcy. The waivers required by the Senior Lender include:

- The Mezz Lender will not object to priority, enforceability, etc. of the Senior Lender's lien.
- The Mezz Lender will not take a security interest (as applicable) in the assets of the borrower (or in the case of a silent second lien, any assets of the borrower in which the Senior Lender does not have a security interest).
- The Mezz Lender will agree not to vote for any plan of reorganization opposed by the Senior Lender or against any plan supported by the Senior Lender. Otherwise, the Mezz Lender may outright assign its right to vote to the Senior Lender.
- The Mezz Lender will generally retain the rights of an unsecured creditor, the right to make filings to state or protect its claim (subject to negotiated restrictions), and to preserve any separate action(s) of the Mezz Lender to the extent possible.

Other Considerations

- The Mezz Lender may negotiate to restrict the transfer of the Senior Obligations to certain specified transferees (i.e., hedge funds, competitors of the Mezz Lender, and the borrower) and, conversely, for the ability to transfer a non-controlling interest in the Mezz Obligations to any party without the Senior Lender's consent.
- The Mezz Lender may request basic representations from the Senior Lender (key item: the Senior Obligations are not cross-defaulted with unrelated debt of the borrower or its affiliates with the Senior Lender, disproportionately impacting the Senior Lender's leverage against the borrower).
- The Mezz Lender may seek confirmation from the Senior Lender that any consent rights under the Mezz Obligations are preserved, including the following:
 - approval of transfers in the borrower and any guarantor;
 - any change of manager (if applicable);
 - property transfers or peculiar property covenants;
 - reporting/budget approval; and
 - change in use of property.
- An intercreditor/subordination agreement should also establish priority with respect to any common guarantors, typically in the following cases:
 - where the common guarantor is a repayment guarantor, a waterfall to ensure payment is remitted to the Mezz Lender before equity/management; and
 - where the common guarantor is bad act guarantor, the ability of the Mezz Lender to pursue such guarantor for a breach without restrictions by the Senior Lender. The credit of a shared guarantor must be sufficient to support all loans subject to the guaranties.
- If applicable, the Mezz Lender may also require a comfort letter with any franchisor to the extent the Mezz Lender would ever take over property operations.

The above terms and provisions are the subject of discussion due to trends we have seen in intercreditor/subordination agreements in mezzanine financings over the last few years. The terms and provisions highlighted are by no means exhaustive, and are frequently the subject of extensive negotiations resulting in a variety of differing transaction structures and terms.

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