The Future of the Intercreditor in 2012 and Beyond

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More than a year after Judge Richard Lowe handed down his industry-rattling opinion in *Bank of America, N.A. v. PSW NYC LLC*,[1] the commercial real estate markets are still pondering its holding. Many in the industry dismissed the *PSW* decision as merely a rogue case,[2] not to be seriously considered in future transactions; however, the case no longer stands alone. A federal court in Arizona recently handed down a decision tracking *PSW* with nearly identical reasoning.[3] Thanks in part to these recent cases, mezzanine lenders are increasingly finding themselves left with fewer opportunities to take action following a default on the senior loan. Some commentators speculate that mezzanine lenders may be among the biggest losers of the "Great Recession," with investors losing more money on their mezzanine debt than any other investment vehicle.[4] While the *PSW* decision severely limited the remedies available to mezzanine lenders, and in many situations deprived them of their bargained-for collateral, the decision simultaneously boosted the confidence of senior lenders facing contentious workout negotiations. Today, as many mezzanine lenders are assessing their increased exposure after *PSW* and its successor, senior lenders and servicers are finding themselves equipped with new leverage and greater security, which should enable special servicers in securitized loans to pursue rights and remedies against both the senior loan collateral and against the mezzanine lender.

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1 *Bank of America, N.A. v. PSW NYC LLC*, 918 N.Y.S.2d 396 (2010) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower until after such lender cured all defaults under the senior loan, which included paying the accelerated balance of the loan totaling near $3 billion).

2 Many commentators disagree with the outcome of *PSW* and believe the applicable Intercreditor in that case merely noted that *after* a foreclosure by the mezzanine lender, any defaults still existing under the senior loan are not extinguished but rather become the obligation of the mezzanine lender. Few commentators interpreted Section 6(d) as requiring the mezzanine lender to cure all defaults under the senior loan *prior to* a foreclosure.

3 *U.S. Bank Nat'l Assoc. v. RFC CDO 2006-1, Ltd.*, Case No. 4:11-cv-664, Doc. No. 41 (D. Ariz. Dec. 6, 2011) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower after the mezzanine lender failed to cure all defaults under the senior loan).

4 Stuart M. Saft, *Mezzanine Financing*, Commercial Real Estate Transactions Database at § 9:10.70 (3d ed. 2011).

The *PSW* Decision

The court in *PSW* faced a senior loan of $3 billion, 11 separate mezzanine loans aggregating $1.4 billion and a fight for control of Stuyvesant Town and Peter Cooper Village, gargantuan housing complexes in lower Manhattan. The senior lender on the property sought to enjoin the mezzanine lender from foreclosing on its equity interest in the mortgage borrower, citing Section 6(d) of the mortgage-mezzanine intercreditor agreement (the "Intercreditor") entitled "Foreclosure of Separate Collateral"—a market standard provision routinely found in nearly all Intercreditors. The section permitted the transfer of interest in the mortgage borrower to a Qualified Transferee subject to "(i) the Senior Loan . . . provided, however, that . . . all defaults under (1) the Senior Loan and (2) the applicable Senior Junior Loans, in each case which remain uncured or unwaived as of the date of such acquisition have been cured by such Qualified Transferee." The court held that the above terms of the Intercreditor were "unambiguous" and enjoined the mezzanine lender from foreclosing on the pledged equity in the mortgage borrower until it cured all defaults under the senior loan.

This decision immediately placed an onerous obstacle in the path of all mezzanine lenders attempting to foreclose on their equity collateral. To complete a UCC foreclosure sale, mezzanine lenders are now required to first cure all defaults under the senior loan, which in *PSW* included paying off the entire outstanding indebtedness of the $3 billion senior loan. As noted above, the *PSW* case does not stand alone. The U.S. District Court of Arizona recently employed the *PSW* rationale and enjoined a mezzanine lender's UCC foreclosure sale, pointing to the identical "unambiguous" provisions of the Intercreditor.[5]

The *PSW* case and its successor have pushed much of the risk once faced by senior lenders onto the subordinate mezzanine lenders. Senior lenders and servicers faced with a stack of mezzanine debt regularly feared a mezzanine foreclosure. Prior to the *PSW* decision, mezzanine lenders would foreclose on their equity interest in the mortgage borrower and vote the borrower into bankruptcy, immediately hindering any efforts by the senior lender to foreclose on the real property. Judge Lowe's opinion, however, suggests that in the face of any maturity default under the senior loan, the mezzanine lender is left with the unpleasant choice to either pay off the senior loan or do nothing, knowing that the senior lender will then foreclose and render the mezzanine lender's collateral worthless. No longer can the mezzanine lender foreclose and push the mortgage borrower into bankruptcy; it now must first cure all of the defaults under the senior loan. Accordingly, a special servicer will negotiate with mezzanine lenders from a much stronger position, as it can now force the mezzanine lender to act earlier or otherwise forfeit any meaningful realization on its collateral.

Pledged Securities as Alternative Remedy

In an effort to avoid the pitfalls of *PSW*, some mezzanine lenders are now focusing on their rights under Article 8 of the UCC as certificateholders of the equity interest in the mortgage borrower. By certificating the pledges, the mezzanine lender can exercise all voting powers over the mortgage borrower as if it were the sole owner of the pledged interests, without foreclosing and without having to cure any defaults under the senior loan. With this kind of control, the mezzanine lender can even vote the entity into bankruptcy, while still avoiding a foreclosure sale under the UCC. This strategy, however, comes with enormous risk. The mezzanine lender risks lender-liability claims as it takes control of the borrower, and any actions of the mezzanine lender in this position may

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5 *U.S. Bank Nat'l Assoc. v. RFC CDO 2006-1, Ltd.*, Case No. 4:11-cv-664, Doc. No. 41 (D. Ariz. Dec. 6, 2011).

well constitute a breach of its contractual covenants under the related Intercreditor and encourage the senior lender to file suit. Again, the special servicer's negotiation position is potentially strengthened. It can exercise leverage over the mezzanine lender to force cooperation that the original sponsor may have wanted to avoid.

PSW's Effect on Servicing

Every servicer should be acutely aware of the outcome in *PSW* as they formulate their default strategies, despite any persuasions by controlling holders or operating advisors to do otherwise. Failure to consider the consequences of *PSW* and any other relevant case law may be viewed as a failure under the servicing agreement to abide by the servicing standard, and if so, when suit is brought, the servicer may not have the benefit of indemnification. Accordingly, servicers of senior loans may soon seek to enjoin foreclosures by mezzanine lenders until senior loan defaults have been cured in an effort to comply with the *PSW* decision. Mezzanine lenders will in turn seek to foreclose and exercise their rights as soon as possible before a default occurs under the senior loan, rendering foreclosure financially impossible. However, as discussed below, a mezzanine lender's bankruptcy strategy may be inhibited even with an early foreclosure.

Limitations on Qualified Transferees

While negotiating the Intercreditors of CMBS 2.0, many senior lenders are focusing on limiting the definition of a "Qualified Transferee." If the mezzanine lender desires to foreclose on its equity collateral upon a default, the mezzanine lender must first satisfy all requirements of a "Qualified Transferee" under the related Intercreditor. Before the onset of the "Great Recession," parties nearly always agreed that the mezzanine lender should be automatically qualified to foreclose upon its collateral. Now, however, new Intercreditor arrangements require the mezzanine lender to meet certain financial criteria before exercising its right to foreclose. Should the real estate market decline and the mezzanine lender fail to achieve those financial thresholds, the mezzanine lender may lose its ability to foreclose. Even if the mezzanine lender is pre-approved as a Qualified Transferee, often the mezzanine lender would prefer to take title to the equity interest in the mortgage borrower in an existing affiliate or a new SPE affiliate. New financial covenants for Qualified Transferees may make it more difficult for a mezzanine lender to foreclose, but these financial covenants assure senior lenders that any transferee will be fiscally sound.

Finding a Replacement Guarantor

Additionally, mezzanine lenders in CMBS 2.0 are nearly universally required to replace the recourse carve-out guarantor before assuming control over the mortgage borrower. In CMBS 1.0, mezzanine lenders usually had no obligation to replace the recourse carve-out guarantor prior to exercising their foreclosure rights on the equity of the mortgage borrower. Without such an obligation, mezzanine lenders could often force the mortgage borrower into bankruptcy without facing any recourse liability themselves. Borrowers and senior lenders alike have lobbied in CMBS 2.0 for the mezzanine lender to appoint a replacement guarantor and release the existing guarantor from liability because such guarantor will have lost all control over the mortgage borrower after a UCC foreclosure. This releases the guarantor from liability due to the actions of the mezzanine lender, but also discourages the mezzanine lender from filing for the bankruptcy of the mortgage borrower and hindering any senior lender from foreclosing, as one of its own—its replacement guarantor—would be liable for breach of the carve-outs.

The Future of the Intercreditor and Mezzanine Lending

Senior lenders and servicers are poised this year to reap the strategic advantages of the *PSW* decision. Unfortunately, the bitter truth for mezzanine lenders after *PSW* is that their only truly effective remedy—foreclosing on the equity collateral and often filing for the mortgage borrower's bankruptcy—is quickly slipping away. Mezzanine lenders cannot foreclose on the equity collateral if they fail to cure all defaults under the mortgage loan (without the consent of the mortgage lenders), fail to fulfill the requirements for a "Qualified Transferee" or fail to provide a replacement guarantor. Regardless of whether the mezzanine lender succeeds in its UCC foreclosure, if it is forced to provide a replacement guarantor for the recourse carve-outs, its ability to prevent or delay a property foreclosure by the senior lender is severely restricted, as it does not want to trigger any recourse liability for its guarantor by declaring bankruptcy. While the mezzanine lender has been rendered essentially an unsecured creditor, the senior lender has gained an additional guarantor, forced to cure the defaults of the borrower for the benefit of the senior lender before seeking any available remedial relief for itself.

These changes grant senior lenders and servicers new protections against mezzanine lenders for the immediate future. Granted, if these additional burdens on mezzanine lenders become customary market terms in 2012, the possibility exists that mezzanine lending will become a less favored form of subordinate lending. This decline in available mezzanine debt may lead to an increase in the use of less desirable subordinated debt structures within the related senior loan or the property, including a reemergence of subordinated participations, junior mortgage notes and/or second mortgages.

Whatever the future holds for mezzanine lending, if the *PSW* case is not overturned, mezzanine lenders must carefully examine and negotiate their rights under each Intercreditor. If the price for a mezzanine lender to foreclose is to cure any defaults outstanding under the senior lender, mezzanine lenders will need to ensure improved information flow between the senior and mezzanine lender and greater consent rights in default situations, so they are adequately informed and prepared to take all necessary action to protect their collateral.

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