Key Provisions to Focus on When Negotiating Senior/Subordinate Co-Lender Agreements

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A co-lender or noteholder agreement is a critical document in any mortgage loan financing involving component notes. This is especially important when the promissory notes are not *pari passu*, but instead follow a "senior-subordinate" tranched structure. In contrast to an intercreditor agreement between a mortgage lender and a mezzanine lender where the lenders hold different collateral, the A/B Co-Lender Agreement deals with the rights and remedies of a senior lender and a junior lender "sharing" the same collateral package for the loan.

Recognizing that each lender (whether the senior noteholder or the subordinate noteholder) has its own requirements to which it strives to adhere during negotiations, the core issues that the parties typically focus on can be summarized as follows.

Qualification OF JUNIOR OR B-NOTE LENDER

Typically, this issue is addressed in the definition of Qualified Institutional Lender (QIL) or Qualified Transferee (QT). A prospective B-note lender will want to carefully review this definition to confirm that they meet the qualifications as they will be required to represent to the A-note lender that they are, in fact, a QIL or QT. Many of the B-note lender's rights and its standing (unless the particular B-note lender holds 49% or less of the B-note) under the A/B Co-Lender Agreement are dependent on this status. If possible, a B-note lender should require the A-note lender (since the A-note lender's counsel is typically the initial draftsperson of the A/B Co-Lender Agreement) to expressly include or "hard wire" the B-note lender and certain of its affiliates into the A/B Co-Lender Agreement as pre-approved QILs. This specific designation affords the B-note lender and its affiliates a level of comfort on this important issue. The senior lender, on the other hand, is cautious about who may be a successor B-note lender to ensure that such lender has sufficient assets to make curative advances and exercise purchase rights under the A/B Co-Lender Agreement, and the industry sophistication to make informed decisions about the loan and underlying asset. Additionally, an overly narrow definition of QIL or QT can restrict the B-note lender's ability to exit its investment.

CURE RIGHTS

The ability to cure defaults under the mortgage loan is a critical element of the A/B Co-Lender Agreement for any B-note lender. A-note lenders will not dispute that B-note lenders must have cure rights, but the length of the cure period and the aggregate number of cure events will often be debated. Under most A/B Co-Lender Agreements, the "waterfall" or priority of payments will "shift" in favor of the A-note lender after an uncured event of default, such that payments of interest and principal owed to the B-note lender will be fully subordinated to principal and interest payments due the A-note lender. Prior to an uncured event of default, the B-note lender will be entitled to receive its agreed upon share of the interest payments and its pro rata share of the applicable principal payments. It is not uncommon to see monetary cure rights limited to as few as 3-4 over the lifetime of the loan and consecutive month cure periods as long as 3-6 months. There is no absolute "right answer" and this point will be discussed by the co-lenders.

PURCHASE OPTION

The right of the B-note lender to purchase the A-note in the event of default under the mortgage loan is a customary feature of any A/B Co-Lender Agreement. However, what, exactly, is included in the "defaulted loan purchase price" and when the B-note lender's rights to purchase the A-note are cut off or cease are often the subject of negotiation. For example, many A-note lenders will not require default interest or late fees be paid by a B-note lender who elects to purchase the A-note, while others will want everything included. The more widely accepted practice is to not require the B-note lender to pay these "extras", especially, when the B-note lender is not affiliated in any way with the mortgage borrower.

CONSENT RIGHTS OVER MAJOR DECISIONS

Most A/B Co-Lender Agreements will designate the B-note lender to be the "controlling holder" or "operating advisor." In this role, the B-note holder will have considerable input in connection with a workout of the loan and other "Major Decisions." Significantly, in the event the value of the B-note lender's position ever erodes by more than 75% through the application of an appraisal test (that is, a "control appraisal event" has occurred), the B-note lender will lose its consent rights and corresponding status as "controlling holder" or "operating advisor" under the theory that it no longer has enough "skin in the game" and shouldn't be influencing the outcome of loan modifications or foreclosure strategy decision-making. Most A/B Co-Lender Agreements will allow the B-note lender who has been "appraised away" to post collateral (either cash or a letter of credit) in an amount sufficient to forestall the loss of the B-note lender's voting and consent rights.

Typically, the A/B Co-Lender Agreement will include a list of "Major Decisions" that require the prior consent of the B-note lender before the A-note lender and/or the servicer may undertake certain steps or actions. Although the list of Major Decisions will vary, common ones include: any workout, restructuring, modification or waiver of the loan which would result in the extension of the maturity date; a reduction in the interest rate or monthly debt service payment; any foreclosure of the mortgage or deed of trust or acceptance of deed in lieu of foreclosure; any substitution or release of collateral; the voting on a plan of bankruptcy of the mortgage borrower; and the approval of leases over an agreed upon size, among others. Depending on the nature of the deal, there may be additional concepts in the underlying loan documents that a B-note lender will want to incorporate into the list of provisions that require the B-note lender's consent.

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Some (but not all) A/B Co-Lender Agreements may also provide for governance provisions with respect to the ownership and control of the property post-foreclosure (or deed-in-lieu). Noteholders may agree in the A/B Co-Lender Agreement to the sharing of costs, pricing strategies, form of ownership (usually through a limited liability company where each co-lender is a member), payment of transfer tax obligations, and operation and management of the property. On occasion, a draft operating agreement will be attached to the A/B Co-Lender Agreement, which may contain provisions for lender capital calls and property budget approvals. Other A/B Co-Lender Agreements will not be nearly as detailed with respect to post-foreclosure protocols and will instead provide that the parties will at the time enter into a limited liability company agreement that generally tracks the rights and interests of the respective parties under the A/B Co-Lender Agreement.

FINANCING OF THE B-NOTE

The B-note lender will commonly require the right to finance its position under a repurchase agreement facility or pledge. The consent of the A-note lender will not be required for such an arrangement so long as the third party financier is a QIL and is not affiliated with the borrower. A-note lenders routinely agree to provide such third parties with certain accommodations, including providing notice of default by the B-note lender under the A/B Co-Lender Agreement and an opportunity to cure.

B-NOTE LENDER AS "AFFILIATE" OF MORTGAGE BORROWER

Most A/B Co-Lender Agreements will provide that in the event an "affiliate" of the mortgage borrower owns a portion of the B-note (the exact percentage of ownership can vary depending on the A-note lender's sensitivity to this issue), the B-note lender's rights under the A/B Co-Lender Agreement will be severely cut back.

FINAL THOUGHTS

A/B Co-Lender Agreements are central documents in any successful mortgage financing where two or more lenders "share" the collateral package pursuant to a senior-subordinate capital stack. They are distinctly different from an intercreditor agreement between a mortgage lender (which holds a mortgage on the underlying property) and a mezzanine lender (which holds a pledge of equity in the mortgage borrower), each of whom has its own separate collateral. The negotiation of A/B Co-Lender Agreements can be complicated, nuanced and greatly influenced by the unique expectations and requirements of the respective parties. We hope the above list of major points is a useful touchstone during your negotiations.

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