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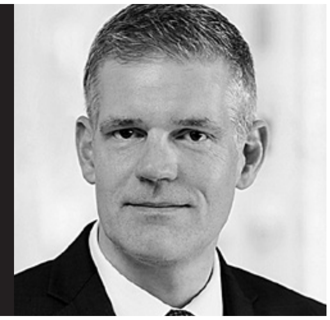
CLO Loan Origination: Avoiding Pitfalls in Structuring Future Mezzanine Debt



An interesting aspect of practicing law in the capital markets space is the ability to see loans at different points in their life cycles. Representing servicers allows a good look back on what to do, and what not to do, when documenting a loan at origination. One thing is clear: not taking the time to consider the myriad life of loan issues can result in additional costs and headaches down the road.

One such issue is execution. We advise clients to assume that any floating rate loan originated by a CRE CLO (Commercial Real Estate Collateralized Loan Obligation) issuer could end up in a CLO pool. If that is the case, parties need to consider securitization standards (i.e., no grace periods for payment dates, eligible accounts, permitted transfers, special purpose entities, etc.) as well as items that need to be considered when dealing with transitional loans, the bread and butter of CRE CLOs.

Loans contributed into CRE CLOs require more attention throughout the term of the loan than conduit loans. Whereas the typical conduit loan is intended to have the initial advance, maybe a few reserves, and a relatively stable cash flow to make monthly payments of interest (and even occasionally, principal), loans originated for and deposited into CRE CLOs will require further infusions of capital to make interest payments and fund tenant improvements, leasing commissions and capital expenditures. Sometimes costs may be even greater than projected at issuance and require further infusions of cash to get the project to perform as intended.

An advantage of the CLO structure as opposed to the REMIC structure is the ability to do much of this in the future, eliminating the need for all funds to be in place at closing, held in reserves and accruing interest from the borrower.

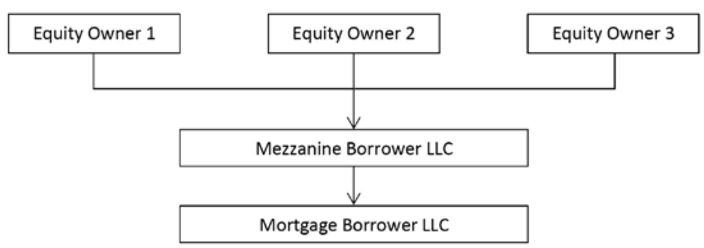
How do we negotiate and draft loan documents that acknowledge this future funding? First, we provide for future advances for capital expenditures, tenant improvements, leasing commissions and even liquidity. These future advances are usually held by a pari passu participation secured by the mortgage and held outside of the CLO trust. Once advanced, these participations may be purchased by the CLO either during a ramp-up period or more often to replace collateral that has paid off.

Sometimes the property needs even more liquidity, which means we allow for additional debt in the future given the right set of circumstances, i.e., improved debt service coverage or debt yield, accretive leasing, etc. Usually this additional debt is intended to be in the form of a mezzanine loan.

Why mezzanine debt? Simply put, future mezzanine debt will be looked upon more favorably by buyers of the CRE CLO notes and the rating agencies rating those notes than, say, an additional participation or a second mortgage secured by the property. One reason is that mezzanine debt is not debt of the mortgage borrower and is not secured, at least not technically, by the mortgaged property. Therefore, there is less risk of an additional creditor or an additional lien on the property in the case of a bankruptcy. Rating agencies take this into account and lenders should as well.

From the mezzanine lender's perspective, there is also the advantage of a cleaner path towards realization on the collateral and more useful and well-established cure rights, than would be available to a second mortgagee or the holder of a B-participation.

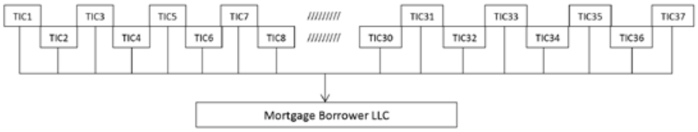
So how does mezzanine debt work? To put it simply, the owner of the mortgage borrower serves as the mezzanine borrower and pledges its equity interest in the mortgage borrower as collateral for the mezzanine loan. In the event of a default under the mezzanine loan, the mezzanine lender can foreclose on the equity interests of the mezzanine borrower and become the owner of the mortgage borrower, and, hence, the mortgaged property. This requires an organizational structure that allows for the mortgage borrower's owner to make such a pledge.



The simplest way to do this is to set up an organizational structure like the one above. The mortgage borrower is a single purpose entity owned 100% by the mezzanine borrower, which is also a single purpose entity. The mezzanine borrower can then pledge its membership interests in the mortgage borrower and should a foreclosure occur, the mezzanine lender can foreclose on those interests and become the 100% owner of the mortgage borrower.

Surprisingly often, even when mezzanine debt is envisioned in the loan documents and the loan documents give the lender the right to create mezzanine debt, the structure is not set up this way. Let's look at two examples, where things can go wrong and how we might be able to address them.

Tenancy-In-Common Structure



In this structure a mezzanine borrower was not put in place at the closing. The loan documents provided that mezzanine debt was allowed. To accomplish this would have required all 37 tenant-in-commons to transfer their interests to a new single purpose entity to act as the mezzanine borrower.

Due to the complexity of obtaining cooperation on 37 transfers, this was not a feasible solution. Not approving the additional capital infusion was not a good solution. The result would have likely been either the loss of the prospective tenant that the funds were to go towards. Alternatively, the loan may have refinanced outside of the CLO, costing the transaction a strong collateral interest, and the originator/issuer, a borrower and client.

Having the tenants-in-common pledge their interests directly as co-borrowers for the mezzanine loan was not a serious consideration. The tenants-in-common would not be single purpose entities and would open additional layers of organizational and bankruptcy risk for the mezzanine lender. For instance, the bankruptcy of even one tenant-in-common could prevent a foreclosure and the ability to gain control of the mortgage borrower.

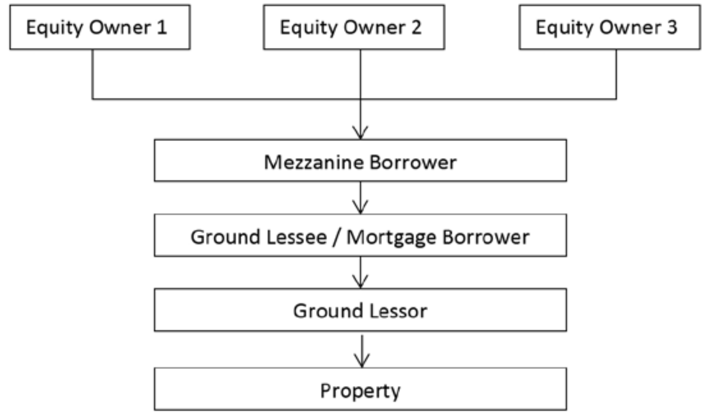
Adding an additional participation to the note already included in the trust was considered. However, the loan had an A-1/A-2 participation structure to enable future financing. An additional participation would have resulted in an A-1/A-2/B structure and required amendments to the participation agreement and an increase in the amount of the first mortgage (as in an A/B structure both the A and B participations are secured by the same mortgage).

Since the new B participation would have been secured by the first mortgage (which also secures the trust collateral), in addition to the complexity of the three-tiered participation, the additional debt would have raised the whole loan LTV and resulted in an increased probability of default under the mortgage.

For these reasons, it was decided to use a subordinate mortgage with an absolute standstill in place until the senior mortgage was repaid. While this approach is often treated negatively by the rating agencies, we used our role as counsel to explain why this was the best course of action for the trust and for all parties involved, even if not the typical or originally anticipated course of action.

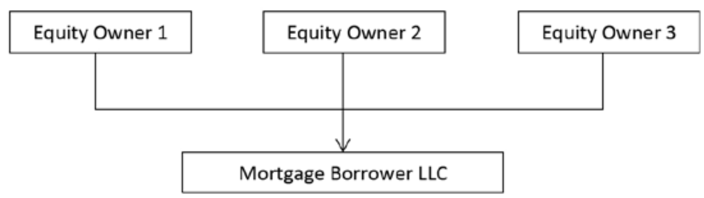
This advocacy and stringent documentation gained approval for the subordinate mortgage, along with the standstill agreement. The cost was higher than it needed to be, if an organizational structure conducive to mezzanine debt was implemented at closing.

Ground Lease Structure



A similar scenario presented itself shortly after the tenant-in-common scenario above. This time the issue was not due to a complex tax-driven organizational structure but instead due to the ownership of the land and the interactions of the legal documents and the ground lease conveying the leasehold interest to the borrower.

Again, the borrower was not set up with a mezzanine borrower in place at closing, despite having negotiated the ability to obtain mezzanine debt under the senior mortgage documents. In this instance, the equity owners would have had no issue internally creating a mezzanine borrower and inserting it into the structure as shown on the below chart.



The problem arose with the terms of the ground lease. Pursuant to the ground lease a transfer of equity in the ground lessee (the mortgage borrower) was considered an unpermitted transfer of the ground lease. It was arguable whether inserting a new single member limited liability company would be considered a transfer were it to be litigated. If it was though, an unpermitted transfer could be an event of default under the ground lease.

This highlights another common issue in loan originations. Failure to understand all of the interactions between various parties to a loan transaction and how those interactions may vary over the life of the loan.

Unfortunately, the ground lessor was unwilling to consider the request to permit this transfer. One could speculate on the reasoning why and perhaps a deal could have been negotiated at a steep price. Still, the likelihood was the mortgage borrower either being unable to obtain the additional financing or refinancing with a new lender, at the cost of a solidly performing loan and borrower.

Again, complexity and the increased probability of default led us to dismiss the option of restructuring the participation.

A similar approach, as above, was chosen with a subordinate mortgage, which was permissible under the ground lease. Again, it worked despite added costs, thanks to parties, other than the ground lessor, working together to find a solution. Although, terms of the subordinate mortgage were severely restricted and marketability was likely impacted.

How could this have been different? Consider if the structure was put in place when the ground lease was signed. The mortgage borrower/ground lessee would have been able to obtain the ground lessor consent upfront, when the mortgage borrower had leverage in their negotiations. In all likelihood, no objection would have been made had the ground lessee had one more limited liability company (the future mezzanine borrower) in its organizational structure.

Alternatively, a transfer to a mezzanine borrower could have been set forth as a permitted transfer under the ground lease. This may have been preferable if the mezzanine loan was less likely to occur and possibly would have saved some transactional costs upfront.

Summary

These are just two examples of issues to keep in mind when structuring loans that may be securitized in a CRE CLO. While CRE CLOs offer more flexibility than a CMBS loan, they are not balance sheet loans and future issues can become complicated with numerous parties at the table. Looking ahead to envision problems that may arise and addressing them prior to securitization can save both time and money.

One positive to consider, despite the sometimes negative view of the CMBS and CLO servicing market, while there are difficulties with securitized loans and it can be complex, the securitized model did work in both instances for the borrowers, despite not addressing concerns upfront. To that end, the alignment of interests for the parties and an incentive to make the transaction work enabled it to do so.