Guidelines for intercreditor agreements in UK commercial real estate finance transactions

Paper 2, some commonly negotiated provisions – subordination and payment waterfalls

March 2016

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This is the second of a series of papers, in which CREFC Europe members share their experiences in relation to some of the structures that are being used to finance commercial real estate and some of the commonly negotiated provisions found in intercreditor agreements. The experiences are from a variety of transactions, but it is clearly the case that the category of real estate asset, the leverage (and split between lenders) and the type of lender (debt fund, insurer, pension fund, bank..) as well as the funding structure, will all have bearing on the outcome of the intercreditor relationship.

The first paper in this series (Structured Lending – Real Estate Finance – a glossary of terms and some example structures) described some of the structures that are being used to finance commercial real estate, including senior/mezzanine, A/B loans and (undisclosed tranching of) whole loans and provided a glossary of terms of art that are often used, and often misunderstood, in relation to structured lending.

The focus of this paper is the subordination of payments to the junior finance parties to payments to the senior finance parties and in it we explore how deeply subordinated these should be. The concepts of property protection loans, senior headroom, cash trap (and cash sweep) events, junior payment stop events and escrow of monies that would otherwise have been available to pay amounts due to the junior finance parties (absent the junior payment stop event) will be looked at in this context.

Subsequent papers will focus on:

1. Intercreditor agreements where structural subordination is not available, including whole loan structures - traps for the unwary will be explored, including where the obligors themselves are not party to the intercreditor arrangements (for example a "behind the scenes" intercreditor arrangement, or "agreement amongst lenders") and as such the tranching and pricing is not transparent to the obligors.

2. The security package available to the junior finance parties and their enforcement rights in relation to the same, including concepts of waivers of mandatory prepayment on change of control, use of control valuation events, fair value and credit bidding.

3. Voting rights for the junior lenders in relation to certain changes to the finance documents and also in relation to consents, waivers and amendments required or requested under the finance documents.

4. Some of the other tools in the junior lender's tool kit such as cure rights, the right to purchase the senior debt and options on the property.

5. Intercreditors that involve obligors who are not incorporated in the UK, or whose assets are not situs in the UK.

Each paper will focus on the negotiating stance of the lenders, drawing on experience of CREFC Europe members and will also cover (where relevant) some of the tax and regulatory points that should be considered.

1. STATEMENTS IN RELATION TO RANKING AND PRIORITIES:

The general statement on ranking (of payment of debt from cashflow) and priorities (in relation to proceeds of security) which is usually found at the front end of the intercreditor agreement will often state that all payments to the junior finance parties are subordinated to payments to the senior finance parties. In some transactions it should be considered whether this statement should be qualified by a reference to the pre and post enforcement waterfalls (ie order of payments) and the mandatory prepayment provisions, as there are likely to be circumstances where the junior finance parties are permitted to receive some payments prior to the senior debt having been discharged in full (for example current interest, payments from permitted disposals, proceeds of sale of the assets over which the junior only security is given, payments from equity contributions, or payments ahead of any senior debt that is in excess of the senior headroom concept).

2. PROPERTY PROTECTION LOANS:

Property protection loans usually include: headlease payments, insurance premia, payments due under hedging agreements and amounts to preserve or protect any security asset - including voids, security and heating, landscaping, maintenance capex and other irrecoverable property expenses together with taxes due and payable. In the context of a development facility these may also include payment of cost overruns if needed to complete the development in a timely manner, and step in costs. They are also often the mechanic by which junior cure loans and senior cure loans (where appropriate) are advanced.

Senior property protection loans (and interest thereon) will usually rank ahead of other senior debt as an incentive for the relevant senior lenders to advance funds. However other senior lenders may be cautious of this approach, where they have not participated in the property protection loan. For this reason, the provision of property protection loans by one lender will often be subject to majority or (certainly in the case of pfandbriefbanks) unanimous lender consent. If hedge payments rank behind property protection loans, the hedge counterparties may also request a consent right. (Much will depend on whether the property protection loans are subject to some sort of cap (via senior headroom (see below) or otherwise).

Junior property protection loans (and interest thereon) usually rank ahead of other junior debt (but behind all senior debt). However the junior lender may argue that if the property protection loan has been value enhancing (or even value protecting) that, were the borrower to desire to prepay an amount equal to the property protection loan (given its higher interest rate), this should be payable to the junior lenders that made the loan, prior to any senior prepayment, at least while no junior payment stop event is continuing. If the property protection loan is in fact a payment of a cure amount to the senior lenders (in relation to a senior payment default or senior financial covenant default), and subsequently an amount equal to such property protection loan is repaid, there are arguments that the junior lenders should be the beneficiaries of such payment by way of subrogation or otherwise. In a typical senior/mezzanine structure, where structural subordination is used either: (i) the cure payment will be advanced to the mezzanine borrower to advance to the senior borrower to pay the senior lenders; or (ii) the cure payment will be advanced direct to the senior lenders by the mezzanine lenders by way of cure. The latter would preserve the event of default, borrower facing, although this is achieved to some degree by having the property protection loan repayable on demand (providing the junior lender is free to demand repayment).

We are also seeing the use of transfers of the senior loan to the junior lender (at par and with or without prepayment fee) used as a cure mechanism for financial covenant defaults (where any senior loan held by a junior lender is not counted in the financial covenant calculation unless consented to or required by the junior lenders, and where the junior lender is otherwise (other than in limited circumstances) disenfranchised in its position as senior lenders and agrees to turn over any payment made to it on its senior loan to the other senior lender and be subrogated at the top junior waterfall).

The rate of interest on property protection loans and cure loans is a matter for commercial negotiation, but participants most often find that the interest rate will be the same as that which would be payable for a non-paid amount on the relevant lenders loans (ie interest plus a default rate). Principal and interest should be payable on demand. Some facility agreements provide that majority or unanimous lender consent is required before a property protection loan can be demanded.

Senior lenders should consider the consequences of allowing junior property protection loans or cure loans. If these are payable on demand the senior lenders will need to appreciate that the junior lenders could cure a default in relation to which they would have had little rights to take action and then demand repayment of the property protection loan or cure loan. This would have the effect of changing a default which does not trigger enhanced rights into a non-payment event, which could have more significant consequences. For this reason the right to demand a junior property protection loan is often restricted in the same way as the acceleration of the junior loan is, or at least the senior lenders are given the first right to advance the property protection loan.

For the same reasons, the senior lenders should consider whether junior property protection loans accrue cash pay interest at the default rate (which may put stress on the senior obligors and precipitate a payment default) or whether such interest should roll up at the default rate.

3. SENIOR HEADROOM:

Whether or not a concept of headroom on the senior debt is appropriate (such that amounts of senior debt in excess of the day one senior debt may rank ahead of the junior debt) will be discussed in the early stages of negotiation, as well as whether this concept is in addition to senior property protection loans or whether senior property protection loans are counted as part of the headroom. The ability to advance property protection loans does not enable the senior finance parties to charge additional fees (for example, restructuring fees) or increase the margin (in excess of applying default interest, to reflect any changing risk profile) or advance additional senior debt or capitalise interest (for example, on a restructuring). In times of difficulty, this could make a restructuring without obtaining the consent of the junior lenders much harder to achieve.

Where a concept of senior headroom is agreed, a headroom of 5-10% of the original amount of the senior debt (or if lower the senior debt at that time) is now the generally accepted level, depending on initial leverage. The following should be considered:

(a) Should senior enforcement costs be carved out of the headroom such that these costs rank as senior whether or not within the headroom limits. This will be considered carefully by the junior lenders as it could be a large unknown quantum.

(b) Headroom will commonly be split between (A) principal increases and (B) other increases such as fees and interest (which have a more immediate effect on cash flow) so appropriate amounts for each will need to be agreed.

(c) Should waivers of mandatory prepayments be included in the headroom? If the senior lenders waive a prepayment, the result is that the senior debt is effectively at a higher leverage than if they had accepted the payment, and therefore it should be treated in the same way (unless the mandatory prepayment is instead applied to the junior loan).

4. JUNIOR HEADROOM

This concept may be relevant if there is a risk that the senior lenders will advance more than the senior headroom. However given the likely size of any excess senior debt and the high stakes for the junior lenders, it may be that this point is one that both sets of lenders can be more relaxed on.

5. SENIOR AMORTISATION

Where the senior loans amortise, it is often debated as to whether the senior amortisation should rank ahead of all payments to the junior finance parties or whether junior interest should rank ahead of amortisation until a specific trigger event is continuing. The issue is particularly acute for the junior lender where the senior loans amortise through a cash sweep, but is relevant in all circumstances where the senior loan requires some form of additional payment or retention before junior amounts are paid. The experiences of those who commented varied. Some junior lenders commented that they had been successful in achieving interest payments ranked ahead of senior amortisation, however the common stance was that this would be very difficult to achieve, although carve outs from cash sweeps were more common.

6. ANY LIMIT ON THE AMOUNT PAID TO THE JUNIOR FINANCE PARTIES AS INTEREST AND FEES?

The senior lenders may want to limit the amount that is paid to the junior finance parties from the waterfall ahead of any senior amortisation or payments to the obligors of obligor required expenditure. The **junior required amount** may be the amount that the junior agent notifies the senior agent is payable to the junior finance parties in relation to fees and interest, such amounts to be limited to those that would be payable under the original financing arrangements. Depending on how tight cash flows are, there may even be sensitivity as to gross up, increased costs, and indemnity provisions. Much depends on the cash flow and the ranking of any required senior amortisation.

7. AGENCY FEES

Some intercreditor agreements do not attempt to subordinate amounts owing to the facility agent or security agent presumably on the basis that it is in everyone's interest to ensure such fees are paid. However such agency fees may be wider than periodic fees and may cover the costs of the lenders where the agent acts as agent of the lenders. Further, security agent costs can be substantial on enforcement - senior lenders should therefore consider how much should be payable to the junior agents and in what circumstances such payments are not permitted. See further below on junior payment stop events. The experience of CREFC Europe members suggests that at least periodic junior facility agent fees would rank at the top of the waterfall (alongside the senior equivalent) and in many cases all senior and junior administrative party fees and expenses rank at the top of the waterfall. If this is not the case, agents would be reluctant to act without an indemnity for or prefunding of any costs that fall outside the periodic fee.

8. SERVICER FEES ETC

Where part of the loan is to be securitised care should be taken to ensure that *servicer fees, special servicer fees, liquidity facility fees, liquidity facility interest etc*, are considered at the outset and that they do not feature in the facility agreement or intercreditor waterfall unless this is the agreed position.

9. PFANDBRIEFBANKS AND HEDGING

Note that some Pfandbriefbanks require that where they are the lender and hedge provider, they have the flexibility to allocate amounts received by any of them in the order they choose fit.

10. CASH TRAP EVENTS AND CASH SWEEP

Some senior lenders require a concept of cash trapping to be catered for in the facility agreement and/or intercreditor agreement, whereby upon the occurrence of specified events, payments that would otherwise be made to the obligors' general account from the bottom of the rent account waterfall (after payment of finance parties fees, costs and expenses and the servicing of the senior and junior loans and hedging arrangements) are instead paid to a cash trap account controlled by the security agent.

The **cash trap events** usually include events of default under the senior loan agreement and breach of cash trap financial covenants (ie. financial covenants set at an earlier trigger than the main financial covenants, which act as warning signs that financial prudence may be required).

Senior lenders may require that the trapping of surplus cash continues and that the trapped cash remains trapped for a stabilisation period even after the cash trap financial covenants are no longer in breach (for example for two clear interest periods). And further may require that if the event is not remedied within a certain period (for example two clear interest periods) it shall be swept to pay the senior loans.

The obligors may request that certain amounts be carved out of the cash trap and so made available to the obligors for payment of items such as tenant contributions, irrecoverable property expenses, leasing commissions, operating costs and required capital expenditure ("**obligor required expenditure**"). Such amounts may be subject to a cap (perhaps by reference to the latest quarterly management report that has been agreed by the facility agent). Payments of obligor required expenditure prior to any cash trap will not be required if the relevant amounts are in any case withheld by a managing agent from gross rent prior to payment into the rent account or as a deduction from the top of the rent account waterfall.

The junior lenders may require the right to consent to the amounts of any such obligor required expenditure bypassing the cash trap and to any release of cash trapped amounts, however if the cash trap operates after the servicing of the junior loans there may be only limited sensitivity.

11. PERMITTED JUNIOR PAYMENTS PRIOR TO THE DISCHARGE IN FULL OF THE SENIOR LIABILITIES:

Junior lenders will want to ensure that the cash trap does not operate prior to the junior loan being serviced in full. Not only should the position of the cash trap in the waterfall be checked, but also any wording in the accounts clauses which provide that the security agent or facility agent is only obliged to operate the accounts if there is no default or event of default continuing.

Notwithstanding the general statement on subordination of the junior debt, payments to the junior finance parties of agency fees and interest will be permitted from various sources, but usually with the caveat that no junior payment stop event is continuing (see below). The sources of payment might include:

(a) Junior interest and agency fees (the latter, if not ranked at the top of the waterfall) may be paid from any surplus rent that is available after servicing the senior loan and prior to the payment of obligor required expenditure;

(b) Prepayment of single lender events:

(i) Illegality – payments to repay a specific junior lender if it is illegal to continue being a lender are often permitted but not always. Sometimes the senior lenders will insist that they should instead transfer their loan. However if the funds for prepayment are from equity contributions there should be little sensitivity.

(ii) Increased Costs are often subject to negotiation.

(c) Mandatory prepayment proceeds - where the junior lenders may receive a proportion of the proceeds (for example, the proceeds of disposal of a property).

(d) The junior loans may be permitted to be prepaid from excess rent after the payment of obligor required expenditure (whether this excess resides in an account specified as only for the benefit of the junior lenders (such as a mezzanine only account held by the mezzanine borrower in a senior/mezzanine transaction) or the obligors' general account).

(e) The junior loans may be permitted to be paid in part or in full from the proceeds of equity contributions. This is sometimes seen as more palatable in a senior/mezzanine (or structurally subordinated junior) transaction than it is where the borrower of both senior and junior loans are the same. CREFC Europe members have experienced a wide variety of approaches here, with many junior lenders achieving a right of prepayment prior to senior, at least prior to any junior payment stop event (see below). Arguably, since the underlying credit support for the senior loan has not changed (being the property and the rental income) the senior lenders should not be too sensitive, however it is clear that senior lenders are sensitive in allowing fresh equity to repay the junior loan, which should be considered fully subordinated to the senior loan (at least while a junior payment stop event is continuing). Certainly prepayments should be allowed to cure junior financial covenant defaults, but query whether the senior loan should be the loan that is prepaid in these circumstances, unless the senior lenders waive their right to prepayment, in which case the junior loan could be prepaid. In transactions where the senior lenders benefit from cash reserves, it may be that the senior lenders will be more relaxed about payments to the junior lenders. Where senior lenders are sensitive to any such payments to the junior lenders, consideration might be given to whether transfers of the junior loan (at least to sponsor related entities) should be prohibited.

Where any junior interest is not required or permitted to be paid current and instead is permitted or required to capitalise with the junior loan, such capitalisation of interest should not be categorised as a payment to the junior finance parties, and as such, the capitalisation should be permitted even while a junior payment stop event is continuing. The senior lenders will however require controls over any such capitalised interest being put on demand.

12. JUNIOR PAYMENT STOP EVENTS

There may be circumstances in relation to which the senior lenders require the ability to switch off payments to the junior lenders. **Junior payment stop events** usually include non-payment of amounts owing to any of the senior finance parties, breach of the (senior) financial covenants and insolvency of (senior) obligors, but may include wider events of default too. Senior lenders need to consider any undesirable effects of allowing payments to the junior finance parties while an event of default (that is not also a junior payment stop event) is continuing, for example, regulatory capital treatment. For this reason junior payment stop events in relation to payments of junior principal (even using equity contributions) may also include the cash trap events described above. Care should be exercised here to protect from a soft covenant default resulting in a junior payment default (with enhanced rights for the junior lender). In a whole loan situation (with an undisclosed intercreditor agreement) there may be no borrower facing default and hence no acceleration right and no right to receive default interest.

At any time that a junior payment stop event is continuing, amounts that otherwise would have been paid to the junior finance parties will instead be escrowed in an account controlled by the common (or senior) security agent (the **escrow account**).

Senior lenders may require the stop on junior payments continues and that the amounts in the escrow account remains trapped for a stabilisation period even after the senior financial covenants are no longer in breach (for example for two clear interest periods). However in many cases the senior lenders will allow the stop on junior payments to end as soon as a remedy of the junior payment stop event is effected (by way of junior cure loan or otherwise, and without prejudice to any further junior payment stop event occurring) such that the escrowed amounts are released back to the rent account and run through the waterfall on the next interest payment date. At this point, subject to sufficient funds being available, the junior lenders should be able to "catch up" on the missed payments and any event of default from non-payment should be deemed to be not continuing.

Junior lenders may require a limit on the period during which amounts can be diverted to the escrow account and the amount of time that they are held in such account. It is not unusual to see that, if the senior lenders have not instructed enforcement action after a period of time, (perhaps two clear interest periods or shorter) the payments to the junior finance parties will cease to be diverted and any amounts in the escrow account shall be released to the rent account much as in the paragraph above.

There may be some discussion around what constitutes enforcement action for these purposes. Further, if the relevant event of default is also a trigger for the acquisition right for the junior lender, it can be argued that there does not need to be a time limit on the escrow as the junior lender can exercise its share enforcement rights.

Interest on the amounts still due to the junior lenders due to the operation of the payment stops, should accrue at the default rate. This will need to be explicitly dealt with since the borrower has made the relevant payment, but it will not have reached the junior lender. This may be challenging for the borrower to accept.

The junior lenders may request that certain amounts can be requested to be paid from the escrow account (or paid prior to diversion to the escrow account). Examples include the junior agency fees (including a capped amount for junior restructuring fees) and (in a senior/mezzanine transaction) any overheads of the mezzanine borrower ("**junior required expenditure**").

Note that junior payment stop events may not only stop payments to the junior finance parties from the rent account waterfall or from mandatory prepayment but may also stop payments where the source of such payment is an equity contribution (by way of subordinated debt or subscription of shares) on the basis that when such events persist any new money should be used to pay the senior lenders ahead of the junior lenders.

The documentation should ensure that the payment stop event cannot outlive any standstill period relating to the right of the junior lenders to take enforcement action. Otherwise the junior lenders could be in a position that whilst they can instruct enforcement action they cannot receive the proceeds of enforcement.

13. ENSURING THAT THERE IS A VIABLE CONDUIT FOR THE UPSTREAMING OF CASH TO SERVICE THE SENIOR LIABILITIES AND THE JUNIOR LIABILITIES.

Where the borrower of the junior loans is not a property owner and as such the income from the property cannot be directly used to service the junior liabilities but must first be up-streamed (as is always the case in a senior/mezzanine transaction) the concept of structural intra group loans may be used. These loans are referrable to the loans created on the down-streaming of the junior loans to the propcos (or relevant entity) to put it in funds to purchase the property or repay the existing indebtedness. If these loans are preserved they can be used to facilitate the up-streaming of the cash to the junior borrower to put it in funds to service the junior loans, without relying on the availability of dividends, which may not be available in times of financial stress, or the use of upstream loans, which may not be available in some jurisdictions.

Similarly where the senior borrower is not a property owner, a concept of structural intra group loans may be appropriate.

14. SHAREHOLDER DEBT AND INTRA-GROUP DEBT

On most real estate finance transactions shareholder debt and intra group debt will be subordinated to both the senior debt and mezzanine debt pursuant to a subordination agreement which will contain amongst other things, provisions relating to the subordination of the shareholder debt and intra group debt, permitted payments for monies in the general account which are not earmarked for other purposes (absent a cash trap event or default), turnover of non-permitted payments, non-petition language and the right of the security agent to waive or transfer the subordinated claims.

What is considered intra-group debt and what is shareholder debt may of course differ for the senior lenders and the junior lenders if the junior loan is structurally subordinate. The senior lenders are likely to consider the top senior (or common) obligor in the structure to be the shareholder whereas for the junior lenders, this may be the shareholder of the borrower of the junior loans.

Further, the required payment stop events for intra group or shareholder payments may be different where the junior loans are structurally subordinated. For example it may be appropriate to provide that a payment stop event for payments between common (or senior) obligors is that any event of default is continuing (or on even later trigger such as a distress event) whereas the payment stop event for payments from a common (or senior) obligor to an entity that is not a common (or senior) obligor might be that a cash trap event is outstanding (ie. the stabilisation period has expired) or if there is no cash trap concept, that a default is continuing. In relation to payments between the junior obligors (that are not also senior obligors) the payment stop event might be that a junior default is continuing (unless the junior facility has their own cash trap concept, in which case that concept may be used).

Structural intra-group loans will be carved out of this regime and payments permitted to be made under such loans, but only for the purpose of servicing the appropriate liabilities.

Which lenders control the determination of the payment stop events (or the waiver of) may also be the subject of discussion.

Separate subordination agreements can be used even where these is also an intercreditor agreement, however some lenders prefer to have all the provisions under one document and this is also how the leveraged finance world has evolved.

Advantages in this approach include (i) only one document; (ii) alignment of the terms of subordination – different law firms have different standard forms of subordination deeds, and some do not effectively deal with waiver/release/ transfer of the subordinated liabilities.

15. CONCLUSION

We hope that you have found this paper an interesting account of the discussions that commonly take place around the subordination, cash trap and payment waterfall provisions in intercreditor agreements. We would like this paper to be a "living" document, where comments can be sent to icacomments@crefceurope.org and will then be shared with members in live chat update (currently taking the form of an email group, but we are looking into other media). If you would like to be part of this live chat, please let Carol Wilkie know.

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