INTERCREDITOR ARRANGEMENTS IN RESPECT OF WHOLE LOAN TRANSACTIONS

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DRAFT COMMENTARY – INTERCREDITOR ARRANGEMENTS IN RESPECT OF WHOLE LOAN TRANSACTIONS

This is the third 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 or other) as well as the funding structure, will all have bearing on the outcome of the intercreditor relationship.

The first paper in this series (Guidelines for intercreditor agreements in UK commercial real estate finance transactions – Paper 1 - 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 second paper provided commentary on the subordination of payments to the junior finance parties to payments to the senior finance parties and in it we explored 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) were considered.

The focus of this paper is whole loan structures in particular 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.

Subsequent papers will focus on:

1. 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.

2. 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.

3. 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.

4. 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. INTRODUCTION

1.1 History

(a) In 2012 the Commercial Real Estate Finance Council (Europe) (**CREFC**) published draft guidelines for intercreditor agreements in UK commercial real estate finance transactions (the **2012 Draft Guidelines**). The aim of publication was to encourage principals, service providers and advisers in the European commercial real estate industry to promote greater consistency in, and understanding of, intercreditor issues which arise in the context of commercial real estate finance transactions.

(b) On 10 June 2014 the Loan Market Association published a standard form intercreditor agreement (the **LMA ICA**) which has been useful as a starting point on many transactions in the last few years, providing reliable boiler plate and a structural framework.

(c) Whether an intercreditor agreement is based on the LMA ICA or another form, commercial arrangements between senior and mezzanine lenders have been subject to on-going discussion and development and so, to supplement the 2012 Draft Guidelines, CREFC has been hosting a series of discussions, where those regularly involved in negotiating intercreditor agreements can share their experiences and try to establish whether any common themes are developing.

(d) The aim of these sessions is to collate any themes and identify any traps for the unwary, with a view to devising a set of guidelines for negotiation of intercreditor agreements, which are available to CREFC Europe members and the wider CRE community, with the ultimate aim of assisting the transaction management process to ensure speedy and efficient execution.

(e) The 2012 Draft Guidelines and the LMA ICA contemplate a transaction structure where two loans are advanced to finance commercial real estate assets: a senior loan to the property owning entity (the propco) and a mezzanine loan to a mezzanine borrower (who is the sole shareholder of the parent of the propco). The effect of this structure is to structurally subordinate the mezzanine loan to the senior loan.

1.2 The whole loan structure

(a) Neither the 2012 Draft Guidelines nor the LMA ICA contemplate the utilisation of a whole loan structure where a single loan is made to the propco and, at some point at or following origination, is tranched into senior and junior interests with or without the involvement of the borrower.

(b) At the time of publication of the 2012 Draft Guidelines it was felt that whole loan structures would not find market favour. However, from the discussions that CREFC Europe have hosted, it has become clear that not all intercreditor relationships are based on a structural subordination model and it has become apparent that certain lenders and equity sponsors have a preference to utilise whole loan structures when constructing debt finance packages.

(c) This is because whole loan structures can have certain advantages over structural subordination models - both for the borrower and the lender. For example, on the borrower side it reduces cost and complexity of incorporating and maintaining a number of limited purpose entities (which are required to achieve structural subordination). On the lender side additional flexibility is offered to arrangers in being able to originate a whole loan and determine the sizing and pricing of the tranching at a later stage. Quicker execution may therefore be available if a whole loan structure is used. For other examples of the advantages and disadvantages of a variety of CRE finance structures, see the first paper in this series entitled "Paper 1 - Structured Lending – Real Estate Finance – a glossary of terms and some example structures".

(d) The difference in structure does not affect the negotiating position of the participants and participants entering into whole loan arrangements should be able to apply the majority of the principles set out in the 2012 Draft Guidelines and the concepts discussed in the other papers in this series, when considering their intercreditor relationships.

(e) However, the structural differences between whole loan and structural subordination arrangements need to be recognised and the aim of this paper is to cover some of the additional commercial and drafting points to be aware of in whole loan structures.

(f) This commentary is not to be read as an exhaustive list of issues to be considered but rather a guide to some issues which, if not addressed, can result in unintended outcomes. These issues include:

(i) availability of acquisition rights;

(ii) credit risk considerations;

(iii) possible characterisation as a re-securitisation;

and where the tranching is not disclosed to the obligors, may also include:

(iv) payment imbalances/mismatches in blended interest rates;

(v) differentiation of events of default (senior and junior) and resulting triggers;

(vi) avoiding automatic cross defaults;

(vii) absence of borrower facing events of default; and

(viii) taxation considerations.

2. KEY STRUCTURAL ASSUMPTIONS – WHOLE LOANS

2.1 The structure chart set out at figure 1 below illustrates a typical whole loan transaction structure. Not all of these features will be present in all whole loan transactions and the final structure will depend on (a) the drivers behind the structuring and (b) each party's negotiating position.

2.2 Whole Loan Facility Agreement

(a) We assume for the purpose of this commentary that there will be one loan (the **whole loan**) documented in one facility agreement which finances the relevant property (the **property**) and is advanced by the originator (the **original lender**) to the owner of the property (the **borrower**).[1]

(b) The borrower and the parent of the borrower (the **holdco**) are likely to be limited purpose entities: the borrower's main assets being the property and the holdco's main asset being its ownership interests in the borrower plus any rights it has as creditor of loans owed to it by the borrower.

(c) The holdco shall be wholly owned by a sponsor (the **sponsor**). It is not necessarily the case that the sponsor will be a limited purpose entity.

2.3 Tranching of the whole loan

We further assume that on or following origination of the whole loan, the original lender will, pursuant to the terms of an intercreditor agreement, tranche the whole loan into a senior tranche (the **senior loan**) and a subordinated tranche (the **junior loan**). On or following the tranching of the whole loan the original lender will sell either the senior loan, the junior loan or both to new lenders (the **senior lender** and the **junior lender** respectively)[2]. The intercreditor agreement will regulate the relationship between the senior lender and the junior lender.

2.4 Security structure

(a) Common security:

We assume that the security package granted to secure the whole loan will comprise the following:

(i) security (in the form of registered mortgages and full fixed and floating charges over all their assets) granted by each of the borrower and the holdco; and

(ii) if the propco owes any debt to any related entity other than holdco, limited recourse assignments over such receivables[3];

((i) and (ii) together being referred to as the **security**) in favour of a security trustee who will hold the

[1] To aid simplification we refer to one borrower financing one property but the structures contemplated in this paper are similarly applicable to multi - borrower and multi - property structures.

[2] We refer to one senior lender and one junior lender but multiple lenders could participate. Moreover, it is possible to further sub-divide the senior loan or the junior loan (which would require additional intercreditor regulation between those lenders).

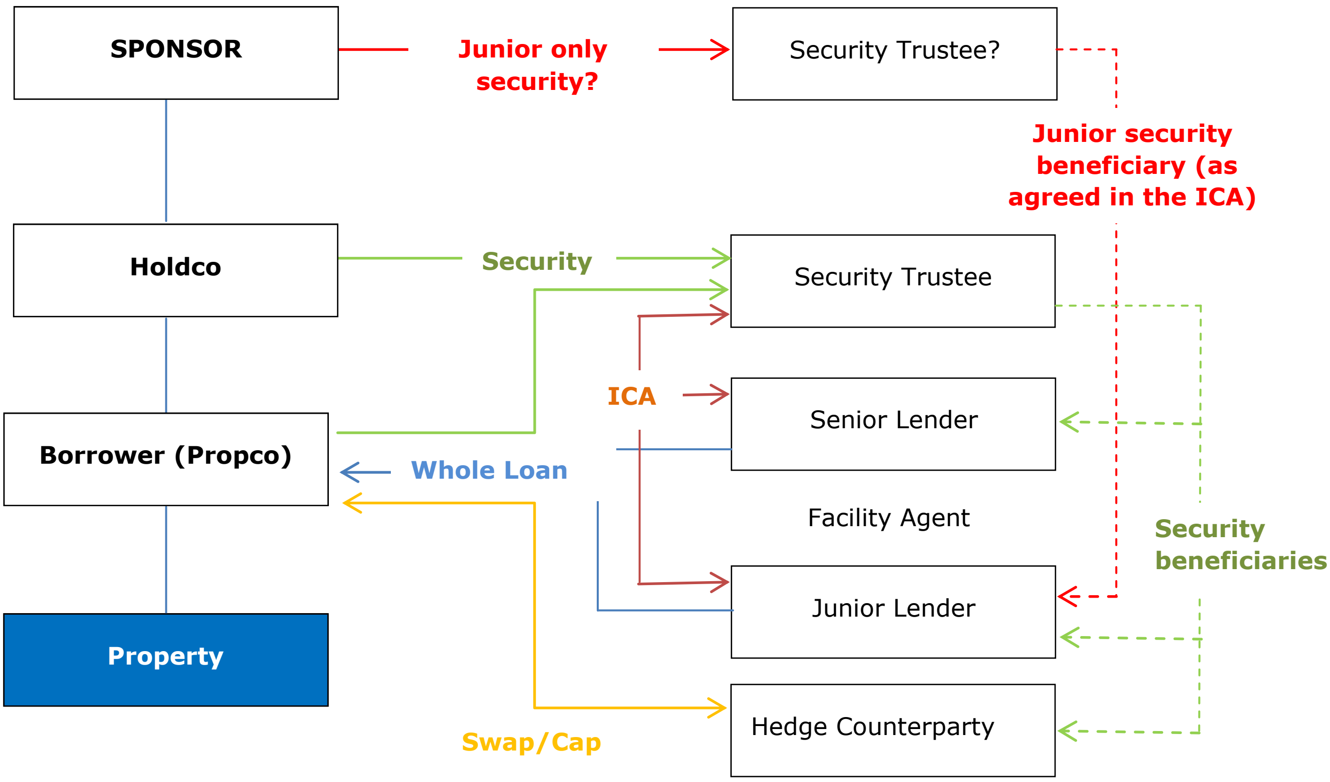
[3] Such receivables are likely to be subordinated in right of payment to the whole loan, such subordination to be recorded in the ICA or a separate subordination deed.

security granted to it on trust for the finance parties including (a) the senior lender and (b) the junior lender in each case to be held and applied according to the payment and ranking of security provisions of the intercreditor agreement.

(b) Junior only security:

It is possible that the originator will be able to negotiate with the sponsor to provide a second layer of share security (albeit limited recourse in nature) over the shares in the holdco granted by the sponsor together with, if holdco owes any debt to the sponsor or any related entity, limited recourse assignments over the right to receive payments of such debt granted by the relevant creditor. While this security would likely be created for all finance parties it is possible for the parties to the intercreditor agreement to agree that this security is for the benefit of the junior lender only (i.e. junior only security).

Figure 1: Structure diagram



3. GENERAL STRUCTURE

3.1 Drivers behind the structuring

(a) There are a number of motivational factors that can drive the choice to use the whole loan model rather than a structural subordination model.

(b) On the borrower side, equity sponsors could have concerns in accepting a structural subordination arrangement owing to the number of companies that would need to be established and maintained and the cost and complexity that results from this.

(c) On the lender side, the construction of the lending platform itself can be influential in dictating the type of structure to be utilised. For example, lenders who are looking to exit through the secondary (including capital) markets but have not yet determined the proportion of the whole loan to be allocated to senior and/or junior tranches may require flexibility at origination and this may not be possible or efficient through utilisation of a traditional structural subordination approach where the senior and mezzanine debt amounts are fixed on day one.

(d) These motivating factors will often influence the outcome of the commercial and structural issues raised below.

(e) For example, if the structure of a transaction is dictated by the borrower's demands for simplicity, it may be the case that the borrower will agree to lender requirements to neutralise payment imbalances and for junior lender only security to be granted (both referred to below).

(f) If the structure of a transaction is dictated by the lender's motivational factors a borrower may be less likely to agree to any such additional lender requirements, although if the pricing works, there will be room for negotiation.

(g) See the first paper in this series (A glossary of terms and some example structures) for some further examples of motivating factors.

3.2 **Disclosed or Undisclosed tranching and intercreditor arrangements?**

(a) In the first paper in this series, we refer to a whole loan structure as one where the tranching and intercreditor arrangements are "behind the scenes" such that the obligors are not privy to them. In these circumstances the intercreditor arrangement will typically only be entered into by:

(i) the facility agent and security trustee;

(ii) the senior lender; and

(iii) the junior lender.

(b) However, certain borrowers may require that they are a party to the arrangements so that they have visibility on the agreement that has between struck between the lenders as to payment, restructuring and enforcement rights (although there is nothing preventing lenders entering into additional separate bilateral arrangements in any event).

(c) It may be impracticable to require the borrower to join as a party to an intercreditor arrangement which is entered into after the origination of the loan unless the borrower is incentivised (for example it will receive some of the interest saving) or legally bound to do so (for example where the requirement to enter into such arrangements has been drafted for, including the relevant parameters of the effect on the commercial position of the borrower).

(d) Additionally, any hedge counterparty providing hedging to the borrower in respect of all or part of the whole loan may be a party to the arrangements where:

(i) its rights to payment in respect of any part of the hedging arrangements (such as any part of the hedging arrangements providing interest rate protection for the junior tranche of the loan) are being subordinated to senior interests (be that senior loan or hedge); or

(ii) if the hedge counterparty takes the view that its rights *vis a vis* decision making processes are better protected if it is a party to the intercreditor arrangements as well as the whole loan agreement, although if the hedge party is to be granted any voting rights, it should ensure that these are provided in the loan agreement, otherwise it will have no leverage.

If the hedging is by way of a cap, the hedge counterparty may not require these protections.

4. PAYMENT IMBALANCES/MISMATCH IN BLENDED RATES

4.1 **General observations**

(a) One of the most important differences between whole loan and structural subordination arrangements is the nature of the borrowing group's obligations to its lenders.

(b) In a structural subordination arrangement the borrowing group enters into one set of loan arrangements with the senior lender and a separate set of loan arrangements with the mezzanine lender.

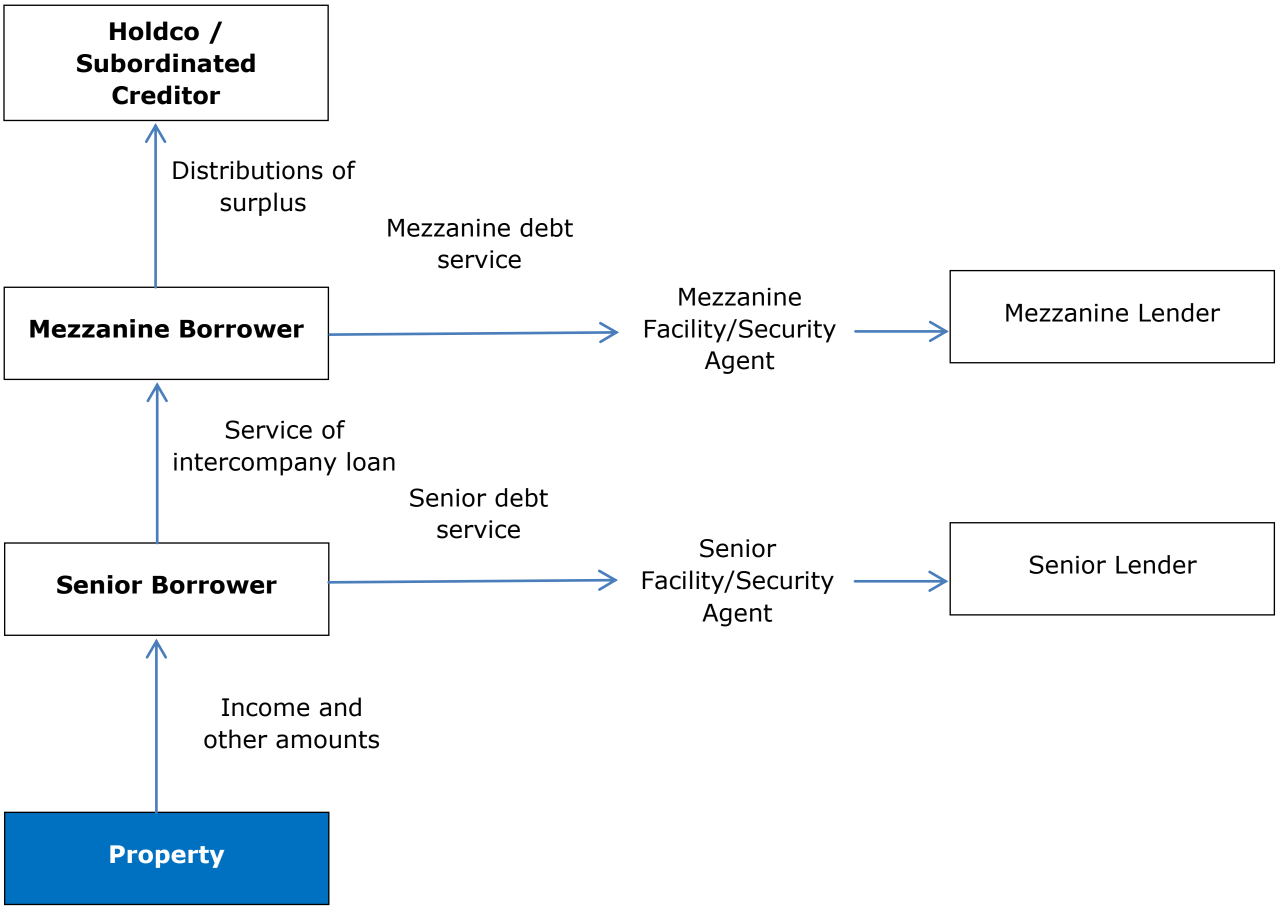
(c) The borrowing group has full visibility on the arrangements between the senior and mezzanine lenders and how it will be affected by the way that the lenders elect to regulate economic returns on their respective credit exposures.

(d) A typical whole loan structure such as the one summarised at paragraph 2 above is fundamentally different in that such arrangements will comprise one loan to the borrower which is then tranched behind the scenes between the senior lender and the junior lender.

(e) One of the most significant results of the lack of transparency created by behind the scenes arrangements flows from the way that payments flow from the underlying real estate to the lenders.

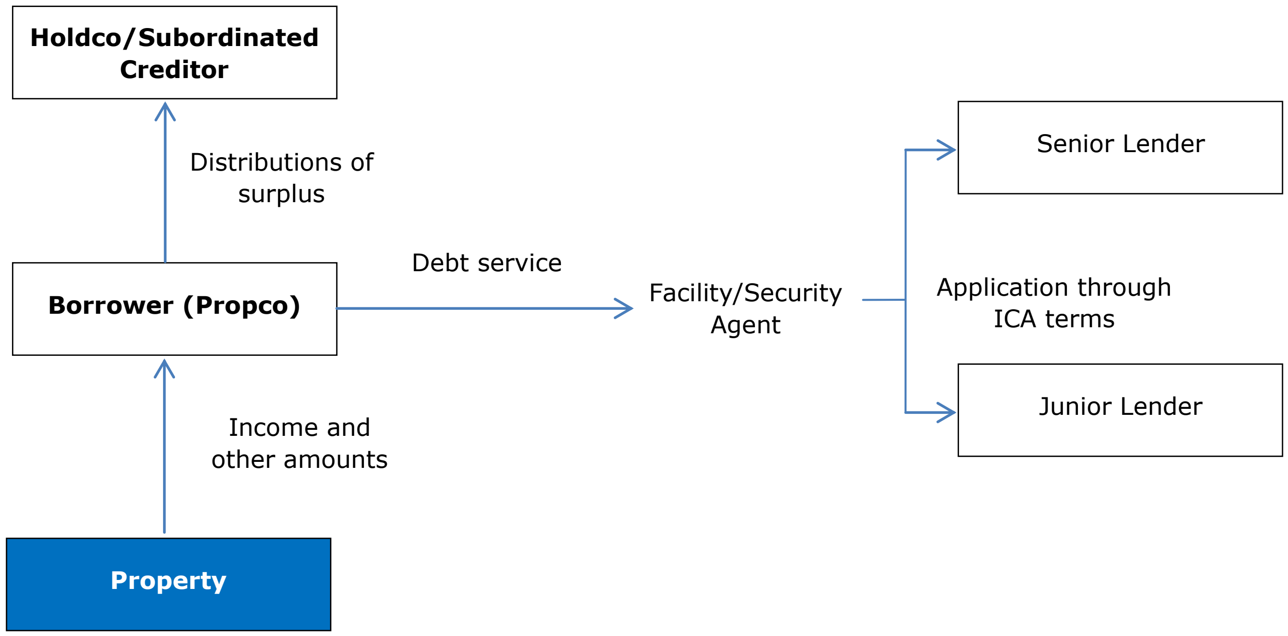
(f) Where tranching of loans and the pricing thereof is transparent to the borrower (such as in a structural subordination model) the service of the various tranches will be dealt with through account waterfalls that are visible to the borrower. In a structural subordination model, once senior interest and (on some transactions) any required amortisation is paid to the senior lender, the surplus can be used to service the mezzanine debt through the repayment of intercompany loans to the mezzanine borrower who will then satisfy its own obligations to the mezzanine lender under the mezzanine loan documents. Please see figure 2 below.

Figure 2: Simplified structural subordination payment diagram



(g) In a whole loan model, there is one principal amount outstanding (in respect of the whole loan) and the borrower is required to pay interest at one unified rate. The principal payment mechanics and the margin are then regulated behind the scenes between the junior lender and the senior lender. Please see figure 3 below.

Figure 3: Whole loan intercreditor payment diagram



(h) Once the borrower has satisfied its payment obligations under the whole loan there will be no obligation to make any further payments.

(i) This may have consequences, particularly for junior lenders, as this two stage process of payments can create payment imbalances which are likely to reduce the amount that the junior lender can expect as its allocation of interest and/or its ultimate recovery owing to shortages of available funds.

4.2 **Payment imbalances**

(a) Payment imbalances are likely to occur when:

(i) the proportion of senior debt to junior debt is lower than at origination of the whole loan; and/or

(ii) the total amount owed by the borrower to the lenders is different to the total amount expected by the lenders collectively.

(b) This might occur:

(i) through amortisation obligations;

(ii) on the disposal of a property or other mandatory prepayment events (for example, hedging prepayment proceeds); and

(iii) on the occurrence of certain cash sweep events,

where the whole loan provides for pro rata application to all lenders but the undisclosed intercreditor agreement provides that amounts should be applied other than pro rata.

(c) This might also occur where the intercreditor agreement provides:

(i) that interest due to the junior lenders may in certain circumstances be diverted to amortise the senior loan. The effect being akin to capitalising the junior interest;

(ii) that interest due to the junior lenders may in certain circumstances be escrowed pending the expiry of a stablisation period;

(iii) that partial payments, rather than being applied pro rata to lenders to which the same rate is due (and hence a uniform default rate applying), are applied in accordance with a waterfall that prioritises a tranche with a lower interest rate and leaves a more expensive loan in default;

(iv) for a concept of cure loans, such that non-payment of a part of the loan, is cured by the junior lender so increasing the junior loan proportions; or

(v) for payment of prepayment fees or other indemnity payments to be applied to reduce the senior debt disproportionately ahead of payments to the junior lender.

(d) When this happens:

(i) the rate of interest that the borrower pays ceases to match the blended rate that is expected by the lenders (resulting in a "behind the scenes" interest shortfall); and

(ii) the borrower may not be under an obligation to pay the full amount of the junior loan outstanding, for example where junior interest has capitalised (resulting in a "behind the scenes" principal shortfall).

(e) Unless the consequences of such an interest shortfall and principal shortfall are addressed in the intercreditor agreement the result will be that the junior lender will not have received the payment for which it has bargained (and would therefore expect to be compensated by an ability to charge default interest) yet there may be no payment default in the underlying facility agreement.[4]

(f) The junior lender will not have a cause of action against the borrower as from the borrower's perspective it has paid all that is required under the whole loan agreement.

(g) As is demonstrated by the worked example below at figure 4 this would not be the case if the parties applied a structural subordination approach where shortfalls which affect the mezzanine lender can be recovered as a result of the direct arrangements between the borrowing group and the mezzanine lender in the mezzanine loan documents, or applied a disclosed intercreditor approach where no misalignment should result.

[4] Note that this assumes that the default interest provisions in the whole loan agreement follows the principles set out in the LMA REF recommended form facility agreement, such that default interest is only payable on an unpaid sum where a payment default has occurred. We note that certain lenders have different requirements as to default interest such as default interest being payable on the whole outstanding amount on the occurrence of any event of default.

Figure 4: simplified worked example of payment imbalance under a whole loan arrangement and comparison with structural subordination arrangement

Position at origination							
	Whole Loan	**Senior Loan**	**Junior Loan**		**Aggregate senior and mezzanine loan**	**Senior Loan**	**Mezzanine Loan**
Amount	£100	£80	£20	Amount	£100	£80	£20
Interest rate	6%	5%	10%	Interest rate	6%	5%	10%
Interest amount payable	£6	£4	£2	Interest amount payable	£6	£4	£2
Scenario One: Position following prepayment of £20 where loan is performing, interest serviced on both senior and junior loans and pro rata application of principal amounts							
	Whole Loan	**Senior Loan**	**Junior Loan**		**Aggregate senior and mezzanine loan**	**Senior Loan**	**Mezzanine Loan**
Amount	£100	£80	£20	Amount	£100	£80	£20
Interest rate	6%	5%	10%	Interest rate	6%	5%	10%
Interest amount paid	£6	£4	£2	Interest amount paid	£6	£4	£2
Principal application	£20	£16	£4	Principal application	£20	£16	£4
New balance	£80	£64	£16	New balance	£80	£64	£16
Interest amount payable	£4.80	£3.20	£1.60	Interest amount payable	£4.80	£3.20	£1.60
Difference from expectations		£0	£0	Difference from expectations		£0	£0
Scenario Two: Position following prepayment of £20 where loan is in distress, junior interest allocated to prepay senior principal and sequential application of principal amounts assuming 2% default interest above the 10%							
	Whole Loan	**Senior Loan**	**Junior Loan**		**Aggregate senior and mezzanine loan**	**Senior Loan**	**Mezzanine Loan**
Amount	£100	£80	£20	Amount	£100	£80	£20
Interest rate	6%	5%	10%	Interest rate	6%	5%	10%
Interest amount paid	£6	£4	£0	Interest amount paid	£6	£4	£0
Principal application	£20	£22	£0	Principal application	£20	£22	£0
New balance	£80	£58	£20 plus £2 unpaid interest	New balance	£80	£58	£20 plus £2 unpaid interest
Interest amount payable	**£4.80**	£2.90	£2+£0.24 =£2.24	Interest amount payable	**£5.14**	£2.90	£2+£0.24 =£2.24
Difference from expectations		£0	**-£0.34**	Difference from expectations		£0	**£0.00**

4.3 **Methods available to remedy payment imbalances**

(a) Use of a dynamic junior interest rate

A number of participants have addressed payment imbalances by implementing a dynamic junior interest rate whereby the senior loan is entitled to a particular fixed rate while the junior loan rate is expressed to be the balance of remaining available funds paid by the borrower on the particular interest payment date.

While this largely (although not completely) deals with the payment imbalance from a technical perspective, it does not address the central issue for the junior lender, that amounts that it was expecting to receive at the time it acquired the junior loan can be reduced as a result of the payment imbalance.

(b) Embed the tranching of the loans in the credit agreement

It is possible to address the payment imbalances by tranching the whole loan in the loan documentation rather than behind the scenes, such as in a disclosed A/B structure. However this may not be appropriate, for example where the originator requires flexibility as to the proportion of senior debt as against junior debt without involvement of the borrower (including likely disclosure of potentially sensitive information).

(c) Require the borrower to enter into the intercreditor agreement and provide an indemnity for shortages in available funds

It could be possible to require the borrower to enter into any intercreditor arrangements so that it can indemnify the relevant lender in respect of any losses as a result of any payment imbalances. Whether the borrower is prepared to agree to provide such an indemnity is for commercial negotiation. Moreover, similar issues as to timing and dislosure as referred to above could also apply here.

(d) Use of Default Interest and/or or prepayment fee.

Where the switch to a non pro rata application of pre-payments only occurs after some sort of trigger linked to an event of default, and the underlying whole loan agreement provides that default interest is payable upon the occurence of an event of default and in relation to the entire loan (rather than solely in relation to payment defaults and in relation to the unpaid amount), the intercreditor agreement might provide that some or all of the default interest is applied in a way that can balance out certain of the payment imbalances. Such a measure may not address fully the payment imbalances discussed above but it could provide the junior lender with some comfort that additional payment obligations are being created for its benefit to mitigate shortfalls that it may suffer.

Similarly, any prepayment fees may be shared disproportionately, with a high proportion being allocated to the junior lender to recoup some of its return.

5. DIFFERENTIATION OF EVENTS OF DEFAULT (SENIOR AND JUNIOR) AND RESULTING TRIGGERS

5.1 As with structural subordination arrangements the payment rules regulating payments to senior and junior lenders will become more favourable to the senior lender (for example, a switch to sequential principal application and the implementation of cash sweeps and cash traps) on the occurrence of a particular trigger which indicates that the loan is experiencing a certain degree of distress.

5.2 In many cases the trigger to a more senior lender friendly regime will occur on the occurrence of a material event of default[5]. The LMA REF ICA and the 2012 CREFC Guidelines suggest that such trigger should take effect only on the occurrence of a material event of default *in respect of the senior loan* and this is not difficult to legislate for in a structural subordination arrangement given that the senior loan and the mezzanine loan are documented separately.

5.3 The position is different for whole loan arrangements where the whole loan facility agreement provides only for one event of default in respect of the whole loan. The parties will therefore agree to differentiate in the intercreditor agreement between what constitutes a whole loan material event of default and what constitutes a material event of default which affects the senior loan only.

5.4 This is particularly relevant when constructing the financial covenants with senior ICR and LTV triggers likely to be required.

5.5 It is also important with regards to establishing whether and when the junior acquisition right might be triggered.

5 Commonly non-payment, financial covenant breach or insolvency/insolvency proceedings.

6. ACQUISITION RIGHTS

6.1 Acquisition rights - the position in a structural subordination arrangement

(a) One of the main benefits for mezzanine lenders in using the structural subordination model is their ability to exercise acquisition rights to step in and take control of the mezzanine borrower potentially while the senior loan continues to perform.

(b) If constructed carefully, in certain circumstances the exercise of such rights on the occurrence of a mezzanine event of default but before the occurrence of a senior event of default (or where a senior event of default has occurred but appropriate remedy periods have been effectively provided for) may allow the mezzanine lender (or its permitted transferees) time to remedy any underlying problems with the property or conduct negotiations with the senior lender in any restructuring, without interference from the borrowing group.

(c) Participants in whole loan arrangements also look to structure similar rights in favour of the junior lender but there are a number of challenges that need to be addressed to provide for such rights being effective or to be exercisable independently from any co-operation of the senior lender at the time of the relevant default.

6.2 Acquisition rights - the problems in replicating the position in a structural subordination arrangement in a whole loan arrangement

(a) Availability of junior only security

(i) Senior lenders often require share security in respect of the shares in the borrower to supplement the asset level enforcement options that they control in the form of mortgages over the property.

(ii) This means that in structures where only the propco and holdco provide security, and the senior lender requires control of the share security in the borrower, the availability of junior only share security is limited.

(iii) The proposed transaction structure referred to at paragraph 2 above contemplates the equity sponsor providing a further layer of share security which, if acceptable to the borrowing group, could be used as security to be enjoyed by the junior lender only.

(iv) Further, in some jurisdictions, a second share pledge over the propco shares may be possible, though a sponsor may query why this is needed, when it has no visibility on the behind the scenes tranching.

(b) Mechanical problems and avoiding cross default

(i) In order to ensure that the full range of enforcement options are available to the junior lender in being able to unilaterally exercise its step in or acquisition rights it will (in some jurisdictions) need to crystalise the payment obligations that are owed to it at the time of enforcement.

(ii) Crystallising the payment obligations that are owed at enforcement will typically require acceleration of the junior loan. In a whole loan scenario, acceleration will be effected by the facility agent acting on the instructions of the majority lenders of the whole loan and it will be the whole loan (or any part of it) that is accelerated.

(iii) An acceleration of the whole loan will result in the whole of the debt including the senior loan being immediately due and payable, triggering a payment default on the senior loan. Even partial acceleration in an amount that is equal only to the junior loan may cause an insolvency event in respect of the borrower which, in turn, will trigger a senior event of default. Hence cross default from junior to senior loan may be hard to avoid, and the consequences will need to be dealt with in the intercreditor agreement.

(iv) Moreover, depending on the jurisdiction of the borrower, the occurrence of an insolvency event is likely to require the directors of the borrower to consider taking measures to seek insolvency protection. Indeed, in certain jurisdictions, it would be a criminal officence not to take such steps other than in limited circumstances.

(v) Hence, without additional thought, the ability of a junior lender to unilaterally exercise any junior security rights in a whole loan arrangement may be limited.

6.3 **Potential solutions to the problem**

(a) Permitting "soft" enforcement as opposed to "hard" enforcement

(i) We consider "hard" enforcement to be the acceleration of all or part of the whole loan and appointment of a receiver or administrator to sell the assets of holdco and/or the borrower.

(ii) We consider "soft" enforcement to be the undertaking of less invasive enforcement action such as utilising the security trustee's contractual rights that should be present in the relevant security documents without accelerating all or any part of the whole loan to either:

(A) compel and control shareholder resolutions in respect of the holdco or the borrower; or

(B) require the replacement of all or some of the directors of holdco or the borrower to ensure that a preferred restructuring route (such as a disposal programme) is followed.

(iii) Depending on the jurisdiction in which the borrower operates and the drafting of the relevant security documents, it might be possible for a junior lender to effect a soft enforcement without an acceleration of the whole loan. However, it should be noted that this route is not available in all jurisdictions and that shadow directorship issues will need to be considered. Further, it is only beneficial in order to influence a restructuring as opposed to realising value through a full enforcement process.

(b) Ability to accelerate the loan in part and hardwiring standstill mechanics and waiver of certain insolvency events of default into the intercreditor agreement at its inception

(i) It may be possible for the parties to hardwire into the intercreditor agreement the form of enforcement action that could be taken independently by the junior lender. However, for such hardwiring to be effective the intercreditor agreement would need to go into some detail as to the method of acceleration, the form of any approriate standstill arrangement and pre-agreed waivers of any relevant events of default. Of course, one might not have the foresight to cover every possible event.

(ii) While we are of the view that such a hardwiring is possible in certain circumstances it will be important for parties to obtain advice from local counsel in respect of the insolvency laws of the jurisdiction of the borrower and holdco.

(iii) Additional devices such as parallel debt or guarantee structures could also be considered, again depending on the jurisdiction of the borrower and holdco.

(c) Corporate solutions

Where junior only security is not available at all it may be that a junior lender will be able to replicate certain elements of a junior only security package by the application of certain corporate finance techniques such as receipt of a share warrant or golden share or have the power to appoint a director to the board of the borrower who would posess blocking or controlling rights in certain circumstances. Given that share security is "illiquid", these corporate finance solutions may also be used on transactions where a secured junior lender is seeking a very high level of control from a corporate perspective in a default scenario. Of course, being a director or shareholder brings with it additional legal obligations and duties, and it is likely that corporate finance solutions will be of most interest in the very highly leveraged and/or asset intense transactions, such as certain development financings or to alternative lenders.

7. TAX CONSIDERATIONS

7.1 Where the borrower is privy to the tranching arrangements, then the borrower is aware of how much it is paying to each lender and no unusual tax issues should arise. However, where the tranching is behind the scenes, the borrower does not know how much of each payment is, ultimately, paid to the junior lender or the senior lender.

7.2 According to the loan documentation, the lenders share all amounts pro rata. There are a number of structural variants which could be used to deliver the intended sharing of the borrower facing economics between the senior lenders and junior lenders. These include use of debt-on-debt hybrids, credit default swaps or mutual payment arrangements, which are beyond the scope of this paper. However this section will consider the assignment method and the contractual method, as the two most basic alternatives:

(a) the senior lender would assign its rights to receive some of the interest from the borrower (i.e. that part in excess of the underlying senior rate) to the junior lender (the junior interest top up). As such, all such amounts would be held on trust to be paid to the junior lender (**Transfer Structure**); or

(b) there is no assignment, rather, there is a separate back-to-back contractual obligation to make a payment of an amount equal to the junior interest top up from the senior lender to the junior lender (**Contractual Structure**).

7.3 The two structures may have different tax consequences. The key issues are set out below but the issues and analysis will vary, based mainly upon where the borrower and the junior lender are incorporated and tax resident.

7.4 **Withholding tax:**

(a) Some jurisdictions (including the US, UK and Ireland) impose withholding tax on payments of interest albeit that the vast majority of lenders in the market are able to avail themselves of a withholding tax exemption.

(b) Because the borrower does not know how much interest ultimately is paid to a particular lender, filling out the usual paperwork required to obtain the relevant withholding tax exemptions may not be straightforward. That may be more of an issue under the Transfer Structure since in case the beneficial ownership of the interest is not as per the face of the loan agreement. Moreover, if withholding did ever apply (e.g. due to a change in law) then, under the Transfer Structure, either:

(i) the borrower would need to understand how much interest had been assigned so it could withhold the correct amount of tax; or

(ii) in theory it might be possible for the agent to agree to withhold in place of the borrower (the **agency withholding approach**). The advantage of that approach is that the borrower would not then need to be privy to the economics between the lenders. The downside of this agency withholding approach is that (a) tax clearance may be required in the borrower's revenue jurisdiction in order for the agent to perform the withholding in place of the borrower; (b) the agent then has all the practical issues involved in actually calculating the withholding, filing any necessary paperwork and paying that to the local revenue authorities; and (c) the borrower may seek indemnity protection from the agent to the extent that the agent fails to withhold correctly. In practice, our experience is that agents would rarely agree to the agency withholding approach.

(c) Under the Contractual Structure, the idea is that the senior and junior lenders remain beneficially entitled to the underlying interest payments set out on the face of the loan agreement. Thus, the borrower should only need to withhold on the amounts it actually pays to the lender causing the withholding issue. The payment of an amount equal to the junior interest top up by the senior lender to the junior lender would not usually constitute an interest payment as a matter of English law, unless in some way the senior lender receives part of the interest it is due to be paid, as paying agent for the junior lender or to hold on trust for the junior lender. The intercreditor agreement may however need to consider the position on a change of law on this point, and whether the senior lender would in certain circumstances where withholding applied, be obliged to gross up.

7.5 **Vat:**

It is unlikely that either the Transfer Structure or the Contractual Structure would have material unexpected VAT costs. That said, the analysis for the Contractual Structure is not entirely straightforward. Ultimately however, we would expect most revenue authorities to consider that the payments under the Contractual Structure would attract a VAT exemption, but advice should be sought.

8. CREDIT RISK CONSIDERATIONS

The Transfer Structure is, on the face of it, more robust than the Contractual Structure in terms of protecting the junior and senior lenders from the insolvency of each other. If using the Contractual Structure, then whether the position of one or both parties can be improved upon the insolvency of the other (without prejudicing the tax position) will depend on the local insolvency and tax law in the jurisdictions where the relevant entities are located.

9. SECURITISATION CONSIDERATIONS

9.1 Under the Capital Requirements Regulation (EU Regulation 575/2013) (the **CRR**), European banks and investment firms may only invest in securitisations if the originator, sponsor or original lender has disclosed that it will retain a material net economic interest of at least five per cent. in such securitisation. Similar rules apply to alternative investment funds under the AIFMD and insurance firms under Solvency II. Other than in certain limited circumstances CMBS transactions are likely to be considered as a securitisation for the purposes of the CRR.

9.2 In a typical commercial real estate loan structure, retention of all or part of the junior loan (B loan) by the originator or original lender of at least an amount that is equal to 5 per cent. of the securitised amount would be a valid retention option. There are other alternatives for compliance with retention requirements; for example, holding 5 per cent. of all classes of the CMBS notes (the vertical slice).

9.3 There has been some discussion in the market as to whether care should be taken when tranching a whole loan prior to a CMBS exit. If a CRE loan is contractually tranched into senior and junior loans (A and B loans) prior to being securitised (for instance, to facilitate the earlier syndication of the junior loan (B loan)) there is an argument that the resulting tranched loan itself could constitute a "securitisation" under the CRR definition. This could be problematic because the subsequent tranching of the senior loan (A loan) into CMBS notes could be considered a "re-securitisation", which would attract punitive additional risk weighting for institutional CMBS noteholders.

9.4 Certain market participants have been operating under the assumption that tranching of a CRE loan into a senior and a junior loan (an A loan and a B loan) is unlikely to be characterised as a securitisation (which would mean that there is no risk of the actual CMBS issuance being characterised as a re-securitisation). Some market participants have received some general guidance on an informal basis from certain regulators on this conclusion. However, there remains some doubt surrounding this question in the absence of a clarification on the definition of securitisation in the CRR or the Regulatory Technical Standards (EU Regulation 625/2014).