

2024 Mortgage Lending Institute
September 12-13, 2024
University of Texas

Intercreditor Agreements

*Avoiding Lender-on-Lender Violence
In the Closing Process*

Kevin A. Sullivan
Winstead PC
ksullivan@winstead.com
(214) 745-5292

2728 N. Harwood
Suite 500
Dallas, Texas 75201

600 W. 5th Street
Suite 900
Austin, Texas 78701

INTRODUCTION

With the increased prevalence of mezzanine financing as a part of the necessary capital for real estate projects, a different three-way dynamic emerges among the senior lender, mezzanine lender and property owner. The Intercreditor Agreement, as the primary document between the two lenders, is an important part of that new dynamic and one that can create issues and frustrations for each of the three parties. A fight between the lenders over the Intercreditor Agreement can, at best, delay and, at worst, derail a real estate financing transaction.

This paper attempts to give some insight into the perspectives and objectives of each of the senior lender, mezzanine lender and project owner. A discussion of certain of the most common issues frequently negotiated in an Intercreditor Agreement is also included. The hope is that with a better understanding of each party's perspective, "lender-on-lender violence" can be avoided and your financing transaction can close expeditiously.

MEZZANINE FINANCING

I. **Increasing Importance of Mezzanine Financing into the Overall Capital Stack for Real Estate Projects.**

The word "mezzanine" means middle or in-between (derived from the Italian word *mezza*). Most of us first encountered this word in reference to a kind of intermediate floor in a shopping mall or office building typically overlooking a main lobby floor. In keeping with that terminology, a Mezzanine Loan with respect to real estate financing is an intermediate source of capital positioned between the traditional equity and first lien debt. It is a higher risk/higher rate form of financing than the first lien mortgage debt.

A variety of factors have contributed to the increasing significance of mezzanine financing into the overall capital stack. Those factors include:

- Some pullback by traditional lenders in providing first lien financing
- A reduction in proceeds available from those lenders who are willing to provide first lien financing
- An increased number of providers willing to provide mezzanine debt
- An increasing institutionalization of the process of providing mezzanine debt and the relationship of that debt with the senior financing
- An increase in the comfort of property owners in including mezzanine financing as a part of the overall capital sources for their projects

Mezzanine financing is used in all sorts of real estate projects and financing structures including construction lending and CMBS.

II. **Some Defined Terms Useful in Discussing Mezzanine Financing.**

"Capital Stack" – the collective sources of funds required with respect to a Project which may typically consist of the Senior Loan, a Mezzanine Loan and equity (whether preferred or common).

"Intercreditor Agreement" - the, typically, private agreement between the lenders in a Senior Loan-Mezzanine Loan structure.

"Mezzanine Borrower" – the owner of, typically, the entire equity interests in Project Owner and the obligor under the Mezzanine Loan.

"Mezzanine Loan" – subordinate financing provided as a part of the Capital Stack to, typically, the owner of the entire equity interest in the Project Owner.

"Project" – the real estate project which is the subject of the financing transaction (whether the real estate asset is under construction or completed and operating).

"Project Owner" – the entity (typically a limited liability company or limited partnership) which owns the Project and serves as the borrower of the Senior Loan. This entity may also be referred to as "Senior Borrower" or "Mortgage Borrower".

"Senior Loan" – the financing (whether in the nature of construction, permanent or other financing) provided by the most senior source in the Capital Stack and being typically secured by a first lien deed of trust or mortgage lien against the Project.

III. **Basic Structures of Mezzanine Financing.** A very simple example of a mezzanine financing structure is attached to this paper as Annex One. This fairly simple example is used for purposes of this paper inasmuch as it facilitates discussion of the basic concepts that come up with respect to an Intercreditor Agreement. These structures can be much more complex including multiple tiers of mezzanine financing and multiple tiers of equity (all with competing interests and objectives).

- A Mezzanine Loan is typically provided to the sole owner of the Project Owner with the anticipation that such Mezzanine Borrower will then contribute those funds into the Project Owner as a capital contribution;
- The Mezzanine Loan is secured by the equity ownership in the Project Owner. The Mezzanine Loan is not secured by the Project, the Project Owner is not an obligor with respect to the Mezzanine Loan and the Mezzanine Borrower is not an obligor with respect to the Senior Loan;
- Inasmuch as the Mezzanine Loan is subordinate in interest and right to the Senior Loan, the Mezzanine Loan typically is viewed as a riskier credit and thus bears a higher rate of interest than the Senior Loan;
- The Mezzanine Loan typically will use loan documents similar to that of a Senior Lender (e.g., Promissory Note, Loan Agreement, Guaranties, etc.) but with the

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First appeared as part of the conference materials for the
58th Annual William W. Gibson, Jr. Mortgage Lending Institute session
"Intercreditor Agreements - Avoiding Lender-on-Lender Violence in the Closing Process"