MEZZANINE AND MORTGAGE LENDERS BRING KNIVES TO A GUNFIGHT: SURVIVING THE TRANCHE WARFARE WITH RUSTY INTERCREDITOR AGREEMENTS

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In the U.S. commercial real estate market, the various lenders in a multi-tranche debt structure negotiate and enter into intercreditor agreements that prescribe each lender's respective rights and remedies. Until the recent subprime mortgage crisis, these intercreditor agreements had become largely streamlined but had not been tested in courts. As the crisis produced a great number of borrower defaults, foreclosures, bankruptcies, and out-of-court workouts, "tranche warfare" broke out among senior and junior lenders who pursued aggressive legal battles to protect their financial interests in shrinking borrower assets. When such intercreditor disputes wound up in litigation, courts interpreted intercreditor provisions in novel and unexpected ways that, moreover, were contrary to what the lenders had assumed to have accomplished in their agreements. The consequence of these decisions was to shatter reliance upon previously familiar intercreditor provisions. This Note focuses on the mezzanine and mortgage lender aspect of the tranche warfare, and proposes drafting changes and additions to intercreditor agreements—such as standstills, covenants not to sue, and releases of claims—that can help to

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reduce the prevailing uncertainty in the industry following recent court decisions and that will better capture the lending parties' intentions in future transactions.

I. INTRODUCTION

In the wake of the subprime mortgage crisis in *residential* housing, the U.S. *commercial* real estate market is grappling with a multitude of foreclosures, bankruptcies, and workouts of varying magnitude and publicity.[1] In addition to the usual

[1] *See generally Further Slide Seen in N.Y. Commercial Real Estate*, N.Y. TIMES DEALBOOK (Jan. 08, 2010, 5:57 AM), http://dealbook.nytimes.com/2010/01/08/further-slide-seen-in-ny-commercial-real-estate/ ("[M]ore than 180 major buildings [in Manhattan] totaling $12.5 billion in value . . . are in trouble, meaning in many cases they face foreclosure or bankruptcy, or have had problems making mortgage payments."); Sibley Fleming & Matt Hudgins, *Lenders Face Costly Problem*, NAT'L REAL EST. INVESTOR, Jan. 1, 2010, *available at* http://nreionline.com/finance/investors/real_estate_lenders_face_costly/index.html (stating that the volume of under-water mortgages will be as high as 49% among mortgage loans maturing in 2011 and 63% in 2012, and citing a Cohen Financial executive for the

borrower-lender proceedings, lenders that own senior and junior interests in multi-tranche debt structures are pursuing vigorous legal battles and negotiations among themselves, in hopes of outdoing fellow lenders and recouping their investments in the borrowers' dwindling collateral—a phenomenon that came to be known as "tranche warfare."[2]

During the market's prosperous years, lenders originated multiple loans of differing seniority on a single project—the so-called "slicing and dicing"—and entered into intercreditor agreements *inter se* in order to delineate each lender's legal rights and remedies.[3] Over time, these agreements were standardized to meet rating agency requirements for commercial mortgage-backed securities, but had "never been tested [in court] before this current meltdown."[4] Once the crisis hit, several borrower-owners of deeply depreciated investment properties defaulted.[5] Consequently, the

proposition that "[lenders] will have to either sell those loans at a discount or foreclose and get rid of the property.").

[2] *See, e.g.*, Mark Marasciullo, *How the Actions of the Fed are Creating Tranche Warfare in Commercial Real Estate*, BUS. INSIDER, Oct. 14, 2010, *available at* http://www.businessinsider.com/tranche-warfare-commercial-real-estate-2010-10 (explaining that following the commercial real estate market crash, lenders at various tranches, i.e., "slice[s] of debt capital structure," are "warring among themselves" to defend their interests); *see also* Elliot Brown, *'Tranche Warfare' Finally Breaks Out at Stuy Town as Billionaire Hedge Funder Goes to Court*, THE COM. OBSERVER (Feb. 24, 2010, 8:54 PM), http://www.commercialobserver.com/2010/02/tranche-warfare-finally-breaks-out-at-stuy-town-as-billionaire-hedge-funder-goes-to-court/ (providing an account of the Stuyvesant Town tranche warfare taking place between junior and senior lenders with conflicting interests, which led to junior lenders suing to halt senior lenders' foreclosure action).

[3] *See* Marasciullo, *supra* note 2.

[4] Lingling Wei & Alex Frangos, *Hancock at Center of 'Tranche Warfare'*, WALL ST. J., Jan. 21, 2009, *available at* http://www.grubbellis-ny.com/2009Articles/1-21-08/WSJ%20-%20Hancock%20at%20Center%20of%20_Tranche%20Warfare_.pdf (statement of John Zizzo, real estate attorney at Cadwalader, Wickersham & Taft LLP).

[5] *See, e.g.*, Alan Rappeport, *US Commercial Mortgage Rate at 3.4%*, FIN. TIMES, Dec. 1, 2009, *available at* http://www.ft.com/cms/s/0/285da848-de1b-11de-b8e2-00144feabdc0.html#axzz1CMBKGOBw (citing Real Estate Econometrics for data showing that commercial real estate default rate

quarreling lenders of high-profile, multi-billion dollar real estate projects sought judicial determination of their rights in the context of looming foreclosures, bankruptcies, or disputed workouts. Problematically, courts interpreted parties' intercreditor provisions in unexpected ways—contrary to the real estate finance industry's assumptions and practices—and thus reassigned lenders' priority positions. These tranche warfare decisions served as a rude awakening for lenders and undermined their reliance upon familiar intercreditor provisions, and have impelled them to renegotiate their respective rights in multi-tranche debt structures.[6]

Tranche warfare is a relatively new phenomenon that is still unfolding. As a result, there is a dearth of scholarship and caselaw on the subject, and in particular, with regard to the intercreditor relationship aspect.[7] Understanding how intercreditor agreements will and should be remodeled, in light of the lessons learned from tranche wars, will contribute to a better understanding of what to expect in the post-crisis commercial real estate market.[8]

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continued to rise from 2.88% to 3.4%, a record high in sixteen years, in the third quarter of 2009 while commercial real estate values fell by 37% since the past year); Sam Chandan, *Mixed News for Commercial Mortgages*, THE COM. OBSERVER (June 3, 2010, 3:55 PM), http://www.commercialobserver.com/2010/06/mixed-news-for-commercial-mortgages/ (observing that the default rate for commercial mortgages increased from 3.8% in the last quarter of 2009 to 4.2%—a new high—in the first quarter of 2010, and are expected to continue to rise).

[6] *See, e.g.*, Mitchell Berg & Salvatore Gogliormella, *Rights and Restrictions in Intercreditor Agreements*, 244 N.Y. L.J. 5, 5 (2010) (urging "lenders at all levels of the capital structure to be mindful of the limitations and protections contained in intercreditor agreements.").

[7] There are works focusing on the future of mezzanine finance, non-recourse carve-out guarantees, or bankruptcy-remoteness, for instance. However, none focuses specifically on the intercreditor agreement aspect. This Note aims to contribute to this particular dimension of the existing and growing scholarship.

[8] *See* Steven Horowitz, *Current Issues for Mezzanine Finance, Preferred Equity & Secondary Financing*, CR048 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 1 (2010) [hereinafter Horowitz, *Current Issues for Mezzanine Finance*] (explaining that "[c]ertainly changes to loan origination driven by

This Note focuses on the mezzanine-mortgage lender aspect of the ongoing tranche wars and proposes reactive changes to intercreditor agreements in order to meet lenders' evolving demands and expectations. Part II provides background on today's evolving tranche wars through a brief account of why multi-tranche lending that incorporates mezzanine financing became desirable, and how rights and remedies were initially allocated—or assumed to be allocated—between different tranches. Beginning with a brief overview of the tranche wars, Part III continues with a closer analysis of two prominent cases, which aptly capture the relevant dimensions of tranche warfare. First, this Note will examine the tranche war among the mezzanine and mortgage investors of the troubled Stuyvesant Town-Peter Cooper Village residential complex ("*Stuyvesant Town*")[9] and second, the tranche war that took place between multiple tranches involved in the Extended Stay Inc. chain of hotels' bankruptcy proceedings ("*Extended Stay*").[10] This Note identifies intercreditor agreement provisions that became problematic in those cases and compares those provisions to their counterparts in the Commercial Real Estate Finance Council's widely used standard form intercreditor agreement ("Model Intercreditor Agreement")[11] as a baseline for

case law, legislation, etc., will impact subordinate financing . . . identity of mezzanine lender pool may change.").

[9] Bank of Am., N.A. v. PSW NYC LLC, No. 651293/10, 2010 WL 4243437 (N.Y. Sup. Ct. Sept. 16, 2010).

[10] *In re* Extended Stay Inc., 435 B.R. 139 (Bankr. S.D.N.Y. 2010). There are numerous comparable tranche warfare cases. *See, e.g.*, Wei & Frangos, *supra* note 4 (providing an account of the scramble between mezzanine and mortgage lenders to gain control of the Hancock Tower following a borrower default); *How Mezz Lenders Battled over NY Workout*, COM. MORTGAGE ALERT, Nov. 5, 2010, at 1, 7 (commenting on the unexpected outcomes for the quarreling mezzanine lenders of W New York Hotel as a result of various lawsuits and intercreditor deals). However, this Note focuses on *Stuyvesant Town* and *Extended Stay* to allow for an in-depth analysis of key intercreditor issues that arose in these prominent cases, and will be influential to other cases.

[11] CRE Finance Council, Standard Loan Document, Intercreditor Agreement, *available at* http://www.crefc.org/Industry_Standards/Standard_Loan_Documents/Standard_Loan_Documents/ (follow "Intercreditor

analyzing the outcomes they produced in court. Part IV forecasts how the events discussed in Part III may impact the future drafting of intercreditor agreements, and makes specific suggestions for improvement.[12]

II. THE EVOLUTION OF MULTI-TRANCHE LENDING WITH MEZZANINE LOANS

The traditional form of real estate financing consisted of a mortgagee, or mortgagees, originating a mortgage loan to a property-owning borrower, and taking a security interest in the borrower's real property to secure the payment obligation.[13] In the booming commercial real estate market of the early 1980s, it became common for mortgage borrowers to seek, and for lenders to extend, additional, subordinate financing on an already-mortgaged property.[14] Initially, additional financing took the form of a second mortgage on the first mortgagee's collateral. The second mortgage was subordinated to the first, so that the junior

Agreement" hyperlink) [hereinafter Model Intercreditor Agreement]. *See also* Derek Cottier, *Commonly Negotiated Issues in Intercreditor Agreements*, 575 PRAC. L. INST. 281, 315 (2010) (describing the Commercial Mortgage Securities Association's (which became the Commercial Real Estate Finance Council) 2002 model intercreditor agreement as "the most broadly used form of [i]ntercreditor [a]greement between a senior lender and a mezzanine lender" and adopting it as a basis for the author's discussion of commonly negotiated intercreditor provisions).

[12] This Note identifies intercreditor provisions that failed or did not work as expected, which are likely to be *corrected*, that is, negotiated differently in the future. The Note, while suggesting possible changes, does not purport to predict the exact shape of future provisions because that outcome will largely depend on investors' and lenders' appetites for risk, post-crisis market demand, and the lenders' relative leverage in bargaining in each transaction.

[13] RESTATEMENT (THIRD) OF PROP.: MORTGS. § 1.1 (1997).

[14] *See, e.g.*, Joshua Stein, *Subordinate Mortgage Financing: The Perils of the Senior Lender*, 27 REAL EST. REV. 3, 3 (1997) ("Subordinate mortgages were once a somewhat common way to bridge the gap between a low loan-to-value first mortgage and the amount of equity a borrower was willing or able to invest.").

mortgagee could not stake any claim on the shared collateral until after the senior mortgagee was paid in full.[15]

Second mortgages carried significant benefits, which mezzanine loans have inherited and preserved. Subordinate financing permitted the borrower to realize pecuniary gains from its appreciating property in the form of higher loan proceeds.[16] In some cases, the entire transaction was contingent upon obtaining subordinate financing; other times, borrowers turned to second mortgagees to raise cash for capital projects that the borrower and the senior mortgagee were unable or unwilling to finance.[17] From the first mortgagee's perspective, the second mortgagee provided a potential additional source of repayment for the first loan because the latter had the incentive and right—although not the obligation—to cure the borrower's default on the first mortgage.[18] Moreover, a second lender's willingness to extend a loan to the project gave the senior lender underwriting comfort and reaffirmed its own assessment of the collateral.[19] From a macro perspective, second mortgages enabled a new category of investors to enter the commercial real estate market to extend subordinate loans at higher interest rates and higher risks than traditional mortgage investors.

Notwithstanding their benefits, subordinate mortgages also entailed risks that made first mortgagees reluctant to permit borrowers to obtain them, and ultimately led to their near-extinction in the commercial real estate finance space.[20]

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[15] *Id.*

[16] Steven Horowitz & Lisa Morrow, *Mezzanine Financing*, *in* REAL ESTATE FINANCING DOCUMENTATION: STRATEGIES FOR CHANGING TIMES (2004), *available at* SJ005 ALI-ABA 541, 544 (Westlaw) ("[I]t had been fairly common until recent years for the Mortgage Borrower to obtain higher loan proceeds by also granting a second mortgage on its property to a subordinate lender.").

[17] Stein, *supra* note 14, at 8.

[18] *Id.*

[19] *Id.*

[20] *See, e.g.*, Steven Alden, *Protecting the First Mortgagee*, REAL PROP. L. SEC. NEWSL. (N.Y. St. B.A., New York, N.Y.), Jan. 1988, at 1 ("Despite the secondary priority accorded to a subsequent mortgage, first

Most importantly, subordinate mortgagees impeded the senior mortgagee's exercise of its foreclosure remedy. Second mortgagees had the willingness and wherewithal to delay or obstruct a first mortgage foreclosure by raising various defenses, counterclaims, and other legal theories,[21] whereas the borrower may be unable or unwilling to do so.[22] The shared collateral structure posed further risks, such as imposing inconsistent obligations on the borrower, overextending the borrower's cash flow, junior lender holdups during workout negotiations, and complications related to borrower bankruptcy and to the securitization of the first mortgage.[23]

Seasoned mortgagees could anticipate and mitigate some of these risks through intercreditor agreements.[24] However, even in the presence of stringent agreements, senior mortgagees were frustrated with costly and time-consuming nuisances from second mortgagees when the latter tried to exert control over the borrower or to foreclose upon defaulted

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mortgagees are reluctant to allow borrowers the right to further encumber the property being used as collateral for the first mortgage."); Andrew Berman, *"Once a Mortgage, Always a Mortgage"—The Use (and Misuse) of Mezzanine Loans and Preferred Equity* Investments, 11 STAN. J.L. BUS. & FIN. 76, 90 (2005) ("[I]n the last ten years real estate finance has fundamentally changed, and property owners now increasingly avoid (or are prohibited from incurring) junior mortgage debt."); Horowitz & Morrow, *supra* note 16, at 544–45 (explaining that subordinate mortgages became less common as first mortgage lenders became "sensitized to the pitfalls and increased difficulties of foreclosing on properties which are also subject to a second mortgage").

[21] In the event of a default, it is likely that the collateral's value has declined below what it was at loan origination. Consequently, the sale price obtained at the foreclosure sale will not be adequate to service first the senior mortgage in full, and then the subordinate mortgage in full. Subordinate mortgagees faced with this risk of investment loss had the incentive to delay or hinder the first mortgage foreclosure. *See* Stein, *supra* note 14, at 5–6.

[22] Alden, *supra* note 20, at 1; Stein, *supra* note 14, at 5–6.

[23] Stein, *supra* note 14, at 4–7.

[24] *See generally* Stein, *supra* note 14 (suggesting ways for senior lenders to mitigate certain pitfalls of subordinate mortgages).

properties.[25] With the outbreak of the late 1980s' savings-and-loan crisis and ensuing surge in borrower defaults, the pitfalls of second mortgages became too burdensome on senior mortgagees, who gradually refused to permit them altogether and thereby rendered them obsolete.[26]

As the market recovered, mezzanine lending emerged as a new mode of subordinate financing to replace second mortgages.[27] The innovation of mezzanine loans is structural subordination—the mezzanine collateral consists of the mezzanine borrower's pledge of its equity interest in the mortgage borrower.[28] Therefore, unlike a second mortgagee, the mezzanine lender's equity collateral is separate from the mortgagee's collateral. The common capital structure consists of a mortgage borrower, which is a bankruptcy-remote special-purpose entity ("SPE") established for the sole purpose of holding the mortgaged property, and a mezzanine borrower, which is the next higher subsidiary entity (also an SPE) above the mortgage borrower in the organizational structure.[29] The mezzanine borrower is a parent company and equity owner of the mortgage borrower.[30] If the mezzanine loan goes into default, the mezzanine lender can foreclose on the equity of the mezzanine borrower and thus gain control of the mezzanine borrower.[31] Subsequently, the mezzanine lender can take control of the mortgage borrower, and by virtue of its ownership of the mezzanine borrower, it can indirectly take control of the mortgaged property.

Mezzanine loans appeared to offer the ideal solution for all parties, free from the pitfalls of second mortgages. First

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[25] Alden, *supra* note 20, at 1.

[26] *See* Paul Rubin, *Strategic Thinking for the Mezzanine Lender*, AM. BANKR. INST. J., Oct. 2009, at 42.

[27] *Id.*

[28] STUART M. SAFT, COMMERCIAL REAL ESTATE TRANSACTIONS § 9:10 (3d ed. 2010); Marcia Goldstein, Jae Kim, Sara Coelho & Gabriel Morgan, *Issues Raised by Complex, Multi-Tranche Financial Structures in Bankruptcy*, 585 PRAC. L. INST. 309, 315 (2011).

[29] Rubin, *supra* note 26, at 42; Goldstein et al., *supra* note 28, at 315.

[30] Goldstein et al., *supra* note 28 at 315.

[31] *Id.*

and foremost, the mortgage lender felt that its interests would be more adequately protected with mezzanine lenders, which cannot stake a direct, secondary claim on the mortgage collateral or borrower, and thus have no direct right to intervene in a mortgage foreclosure.[32] Moreover, from the mortgagee's perspective, mezzanine loans capture the abovementioned benefits of second mortgages, such as underwriting comfort and a potential secondary source of payment in the event of a borrower default, since the mezzanine lender would likely have the incentive to cure borrower defaults to protect its own interest.[33] The borrower, for its part, reaps all of the financial benefits of subordinate financing that second mortgages offer.[34] The mezzanine lender—despite conceding to a disadvantaged position in the intercreditor arrangement—enjoys financial rewards for taking on a higher risk by charging high interest rates.[35]

The mezzanine and mortgage lender enter into an intercreditor agreement, which covers the fundamental aspects of the mezzanine lender-mortgagee relationship. This agreement generally formalizes the subordination structure and restricts the mezzanine lender's exercise of certain remedies.[36] Typical provisions dictate, among other things, what constitutes permitted mezzanine loan collateral, each party's rights to modify its respective loan documents, available remedies in the event of a default on either loan, rights of the mezzanine lender to cure defaults on the first mortgage loan, and rights of the mezzanine

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[32] *See* SAFT, *supra* note 28, § 9:10.

[33] *See supra* notes 18–19 and accompanying text.

[34] Mark Fawer & Michael Waters, *Mezzanine Loans and the Intercreditor Agreement: Not Etched in Stone*, REAL EST. FIN. J. (Spring, 2007), *available at* http://www.dicksteinshapiro.com/files/Publication/427b6314-e547-40de-9e31-5e0e18a69c7a/Presentation/PublicationAttachment/f0db8de8-3e64-44dd-ab40-aa956023f0a9/Mezzanine%20Loans%20and%20the%20Intercreditor%20Agreement.pdf, at 79–80.

[35] *See* Rubin, *supra* note 26, at 42; Fawer & Waters, *supra* note 34, at 79.

[36] Fawer & Waters, *supra* note 34, at 79.

lender to purchase the first mortgage loan.[37] Other key provisions, which in turn became key problem provisions during the tranche wars, include general subordination terms, permitted transfers of the mezzanine loan, conditions to taking title to the pledged equity interests, and provisions related to borrower bankruptcies.[38]

In the early days, continuous tensions between the mezzanine lender who seeks to secure certain rights from the mortgagee and the mortgagee who tries to limit the mezzanine lender's interference with its control over the mortgage borrower and collateral "made the negotiation of an intercreditor agreement one of the most difficult aspects of mezzanine loan financing."[39] The later introduction and extensive adoption of the Model Intercreditor Agreement simplified and streamlined this process by providing a starting point for parties who then modified model provisions to meet the requirements of a given multi-tranche transaction.[40]

However, as the following discussion demonstrates,[41] mezzanine loans' promising features—expressed in largely standardized intercreditor agreements—proved less than perfect during the tranche wars. Once courts reinterpreted certain commonly used intercreditor provisions, mezzanine loans, in the way that they had been negotiated, turned out to be vulnerable to the traditional unpleasant aspects of second mortgages, such as complications over the

[37] Model Intercreditor Agreement, *supra* note 11.

[38] *Id.*

[39] David Forti & Timothy Stafford, *Mezzanine Debt: Suggested Standard Form of Intercreditor Agreement*, CMBS WORLD, Spring, 2002, at 26, 89, *available at* http://www.crefc.org/assetlibrary/34b53eb2e9dc441ebd d7c70dc7a0bc88/9ead4f926c924374844f117ac46e51ef2.pdf (explaining that in the early 2000s, the difficulties, "time, expense and uncertainty associated with negotiating mezzanine loan intercreditor agreements" resulted in a push from various players in the market "to develop a standard form of intercreditor agreement to use as a baseline.") Forti & Stafford subsequently authored the widely used *Model Intercreditor Agreement*. *See supra* note 11.

[40] *See* Cottier, *supra* note 11.

[41] *See* discussion *infra* Part III.

mortgagee's control over the mortgage borrower and collateral and undesirable restrictions on both lenders' exercise of their rights and remedies.

III. THE OUTBREAK OF TRANCHE WARS AND RESULTANT COURT RULINGS ON INTERCREDITOR AGREEMENTS: THE STUYVESANT TOWN AND EXTENDED STAY EXAMPLES

During the subprime mortgage crisis, numerous commercial real estate borrowers holding both mortgage and mezzanine debt were unable to pay their debt service and defaulted on their loans.[42] It became readily apparent that the underlying collateral no longer carried enough value to pay off all tranches in the event of a foreclosure.[43] Accordingly, over the last few years, tranche wars began as creditors sought to recover as much as possible from the borrowers' dwindling assets.[44] As the wars progressed, heated cases involving billions of dollars in defaulted debt wound up in litigation for equitable declarations and determination of the parties' disputed rights.[45] The ensuing

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[42] *See supra* note 1 and accompanying text.

[43] "The current economic environment has been particularly difficult for subordinate debt holders: mezzanine lenders, B piece holders, private equity. Decreased asset value may preclude these holders from receiving any recovery at all." Horowitz, *Current Issues for Mezzanine Finance*, *supra* note 8.

[44] *See* Marascuillo, *supra* note 3.

[45] *See, e.g.*, *In re* Extended Stay Inc., 435 B.R. 139 (Bankr. S.D.N.Y. 2010); Bank of Am., N.A. v. PSW NYC LLC, No. 651293/10, 2010 WL 4243437 (N.Y. Sup. Ct. Sept. 16, 2010). *See also* Steven Davidoff, *The Battle for Stuyvesant Town*, N.Y. TIMES DEALBOOK (Sept. 7, 2010, 5:00 PM), http://dealbook.nytimes.com/2010/09/07/the-battle-for-stuyvesant-town/ (noting that the judge's reading of one disputed clause in the intercreditor agreement will determine the mezzanine and senior lenders' claims over Stuyvesant Town-Peter Cooper Village); *Extended Stay Lenders Say Firms Engineered Bankruptcy*, N.Y. TIMES DEALBOOK (June 25, 2009, 7:23 AM), http://dealbook.nytimes.com/2009/06/25/extended-stay-lenders-say-pe-firms-engineered-bankruptcy/ [hereinafter *Engineered Bankruptcy*] (recounting the pending lawsuit that two mezzanine lenders

court decisions gave investors and lenders at mezzanine and mortgage tranches substantially different rights and remedies than they had bargained for in their intercreditor agreements, as the following subsections A and B demonstrate.

A. An Analysis of the *Stuyvesant Town* Case

In the first exemplary case, *Stuyvesant Town*, the non-party borrower owned the Stuyvesant Town-Peter Cooper Village residential complex on Manhattan's east side. The property had a purchase price of $5.4 billion and a reported appraisal value of less than $2 billion at the time of the 2010 foreclosure proceedings.[46] The borrower defaulted on both its mortgage and mezzanine loans totaling $3 billion and $1.4 billion, respectively.[47] The senior lenders "accelerated" the senior loan shortly after the default, rendering the full outstanding balance of the multi-billion dollar loan plus interest immediately due,[48] and also initiated the process of foreclosing upon the property.[49] Given the drastically depreciated value of the property, the proceeds of a mortgage foreclosure could not pay off the senior lenders in full, thus rendering the equity collateral worthless and imposing a complete loss on the mezzanine lenders.[50] Confronted with this bleak prospect, the mezzanine lenders rushed to exercise their own contractual remedies and to foreclose upon their security interest in the borrower's equity, which would give them control of the Stuyvesant Town-Peter Cooper Village property.[51] As new equity holders, the mezzanine lenders could push the property into bankruptcy, which would result

brought against senior lenders, certain senior mezzanine lenders, and the borrower, alleging a multi-way conspiracy to engineer a bankruptcy to wipe out the plaintiffs).

[46] Horowitz, *Current Issues for Mezzanine Finance*, *supra* note 8, at 2.

[47] *PSW NYC LLC*, 2010 WL 4243437, at *1. *See also Current Issues for Mezzanine Finance*, *supra* note 8, at 2.

[48] *PSW NYC LLC*, 2010 WL 4243437, at *3.

[49] Davidoff, *supra* note 45.

[50] *Id.*

[51] *Id.*

in a stay on all claims against the collateral and enable the mezzanine lenders to formulate a bankruptcy plan most favorable to their interests.[52]

In response to this threat, the senior lenders brought an action against the mezzanine lenders. The senior lender plaintiffs requested (1) a declaration and enforcement of their rights under the intercreditor agreement; and (2) injunctive relief to prevent the mezzanine lenders from exercising their equity collateral foreclosure remedy.[53] The senior lenders advanced the theory that the mezzanine lenders' attempts to seize the equity collateral violated Section 6(d) of the intercreditor agreement. The senior lenders interpreted the agreement to require the mezzanine lenders, or other purchasers of the equity collateral at an auction, "to cure all Senior Loan defaults prior to acquiring the [e]quity [c]ollateral."[54] The mezzanine lender defendants responded with several counter-arguments, the weightiest of which was that Section 6(d) no longer held applicable because it pertained to the acceleration of the senior debt, which already occurred.[55]

The issue turned on the court's interpretation of Section 6 entitled "Foreclosure of Separate Collateral" in the intercreditor agreement, which provides in relevant part as follows:

> To the extent that any Qualified Transferee acquires the Equity Collateral pledged to a Junior Lender

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[52] Davidoff, *supra* note 45. *See generally* Steven Horowitz, *Key Considerations for Distressed Investing*, 574 PRAC. L. INST. 275 [hereinafter Horowitz, *Key Considerations*] (noting the possibility that following a mezzanine foreclosure, "the mezzanine lender (now owner of the property) decides to move the foreclosed company" as an important risk or opportunity for prospective investors in distressed real estate debt instruments).

[53] *PSW NYC LLC*, 2010 WL 4243437, at *1.

[54] *Id.* at *4.

[55] *Id. See also* David McLaughlin & Oshrat Carmiel, *Pershing, Winthrop Seek Stuyvesant Foreclosure Halt*, BLOOMBERG BUS. WK., (Sept. 20, 2010, 12:19 PM), http://www.bloomberg.com/news/2010-09-20/pershing-winthrop-ask-to-delay-foreclosure-of-manhattan-s-stuyvesant-town.html.

> pursuant to the Junior Loan Documents in accordance with the provisions and conditions of this Agreement . . . , such *Qualified Transferee shall acquire the same subject to (i) the Senior Loan and the terms, conditions and provisions of the Senior Loan Documents . . . for the balance of the term thereof, which shall not be accelerated by Senior Lender . . . solely due to such acquisition* and shall remain in full force and effect; *provided, however, that* (A) such Qualified Transferee shall cause, *within ten (10) days after the transfer*, (1) Borrower and (2) the applicable Senior Junior Borrowers, in each case to reaffirm in writing, subject to such exculpatory provisions as shall be set forth in the Senior Loan Documents and the related Senior Junior Loan Documents, as applicable, all of the terms, conditions and provisions of the Senior Loan Documents and the related Senior Junior Loan Documents, as applicable, on Borrower's or the applicable Senior Junior Borrower's, as applicable, part to be performed and *(B) all defaults under (1) the Senior Loan[,] . . . which remain uncured or unwaived as of the date of such acquisition have been cured by such Qualified Transferee.*[56]

The material terms of Section 6(d) of this intercreditor agreement—save for a few differences in phrasing—mirror those in the Model Intercreditor Agreement.[57] This suggests that such a version of an equity collateral foreclosure provision was common in the industry, although apparently it had not been tested in court before the *Stuyvesant Town* case.

During the court proceedings, outside commentators and practitioners generally maintained that the mezzanine lenders had the better argument in interpreting Section 6(d),[58] which closely followed the way lenders had been

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[56] *PSW NYC LLC*, 2010 WL 4243437, at *2 (emphasis added).

[57] Model Intercreditor Agreement, *supra* note 11.

[58] *See, e.g.*, Davidoff, *supra* note 45 ("[I]f you read the agreement, [the mezzanine lender plaintiffs] appear to have the better [argument] . . . . [whereas] the senior lenders are trying to sow ambiguity, arguing for

negotiating and interpreting equity collateral foreclosure provisions in intercreditor agreements all along. Moreover, the literal text appears to better support the mezzanine lenders' and the majority's expectations. In plain English terms, Section 6(d) states that the mortgage lender will not accelerate its loan solely because a Qualified Transferee acquires the Equity Collateral, a mezzanine foreclosure event, unless the Qualified Transferee fails to reaffirm specified loan documents or fails to cure the default on the senior loan within ten days after such acquisition.[59] Similarly, the mezzanine lender defendants argued that Section 6(d) is "designed to prevent the Senior Lenders from accelerating the Senior Loans [solely] due to a transfer of the Equity Collateral," more specifically, they argued that the "provided, however, that" language introduces subsections (A) and (B) as requirements for the preceding subsection (i) wherein the senior lender pledges not to accelerate the senior loan, not as pre-conditions for acquiring the equity collateral.[60] Therefore, the mezzanine lenders argued, since the senior lenders had already accelerated the loan, this section was irrelevant.[61]

The mezzanine lenders buttressed their position with a number of other well-grounded arguments. For example, they asserted that because subsection 6(d)(4) grants a Qualified Transferee a ten-day grace period *after* the transfer of collateral to reaffirm its obligations under the Senior Loan Documents,[62] Section 6(d) cannot be a precondition to the UCC sale of the equity collateral.[63]

example about the meaning of the semicolon in this clause and piecing together other clauses and their affect on this one.").

[59] *See* Davidoff, supra note 45; *NY Court Ruling Binds Mezzanine Lender's Ability to Foreclose on Collateral Following Acceleration of Mortgage Loan*, REAL EST. ALERT (Akin, Gump, Strauss, Hauer & Feld LLP, New York, N.Y.), Sept. 29, 2010, at 2–3 [hereinafter *Consequences of the Stuyvesant Town Ruling*].

[60] *PSW NYC LLC*, 2010 WL 4243437, at *6.

[61] *Id.*

[62] *Id.* at *2.

[63] *Id.* at *7.

Second, the mezzanine lenders pointed to the most fundamental premise of multi-tranche lending with mortgage loans—the existence of separate collateral to secure the mortgage and mezzanine loans—to support their alleged right to foreclose on their separate equity collateral, in which the plaintiffs had no real interest. Defendants noted that their foreclosure would not impact the plaintiffs' ability to proceed with the senior loan foreclosure.[64]

In addition, the mezzanine lenders urged the court to interpret Section 6(a), which lists seven conditions to be satisfied before a junior lender can foreclose on its equity collateral,[65] to recognize mezzanine lenders' rights to foreclose upon fulfilling those conditions. They rightly noted that curing the senior loan is not one of the enumerated preconditions for foreclosure, although the parties could have easily added it there, if having that precondition were their intention during the bargaining process.[66]

Even though almost all intercreditor agreements subordinate and substantially curtail the rights of mezzanine lenders vis-à-vis their senior counterparts, as the *Stuyvesant Town* defendants argued, mezzanine lenders expectably do not wish to be left without any meaningful remedies with regard to their high risk loans.[67] Subject to fulfilling certain familiar conditions in the intercreditor

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[64] *Consequences of the Stuyvesant Town Ruling*, *supra* note 59, at 3.

[65] Bank of Am., N.A. v. PSW NYC LLC, No. 651293/10, 2010 WL 4243437, exhibit A at 52 (N.Y. Sup. Ct. Sept. 16, 2010), *available at* https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=4NpRAMSzDUDwYiV6vfcIhg==&system=prod [hereinafter Stuyvesant Town Intercreditor Agreement]. "No Junior Lender nor any Loan Pledgee with respect to a Junior Loan shall complete a foreclosure or otherwise realize upon any of its Equity Collateral . . . *unless*" the enumerated requirements such as a qualified transferee, a qualified manager, a new non-consolidation opinion etc. are satisfied. *Id.* at 52–53 (emphasis added). Subsection 5(a) of the Model Intercreditor Agreement closely resembles Subsection 6(a) of Stuyvesant Town Intercreditor Agreement in all material aspects. Model Intercreditor Agreement, *supra* note 11, at 13–14; Stuyvesant Town Intercreditor Agreement, *supra*, at 52–53.

[66] *PSW NYC LLC*, 2010 WL 4243437, at *7.

[67] McLaughlin & Carmiel, *supra* note 55.

agreement, like the Section 6(a) requirements that only a qualified transferee take title to the equity collateral and that a qualified manager manage the property after the change in control,[68] "[m]ezzanine lenders have an expectation that they can foreclose on their separate collateral without being required to fully pay off the related mortgage loan."[69] Thus, the mezzanine lender-defendants were not outliers in the commercial real estate finance world, when they declared "ludicrous" the plaintiffs' interpretation of Section 6(d), requiring them to pay off the handsome $3.67 billion sum due on the senior loan[70] as a pre-condition to exercising any mezzanine foreclosure remedy.[71]

Contrary to the expectations and speculations of the real estate finance community,[72] and arguably to the plain language of the agreement,[73] the court wholly dismissed the mezzanine lenders' interpretation of the intercreditor agreement and upheld the senior lenders' theory of the case. Judge Lowe held, "the [i]ntercreditor [a]greement is unambiguous. Its plain language obligates [mezzanine lenders] to cure all Senior Loan defaults if [they] acquire[] the Equity Collateral, which includes the $3.6 billion

[68] Stuyvesant Town Intercreditor Agreement, *supra* note 65 and accompanying text.

[69] McLaughlin & Carmiel, *supra* note 55; *see* Berg & Gogliormella, *supra* note 6 ("[A] mezzanine lender is typically permitted to foreclose or otherwise realize upon the equity collateral for its loan . . . without obtaining the consent of the mortgage lender . . . if certain conditions are satisfied, including that the transferee of title to such collateral be a qualified transferee and that the property will be managed by a qualified manager following the change in ownership.").

[70] Davidoff, *supra* note 45.

[71] *PSW NYC LLC*, 2010 WL 4243437, at *4, *6; *see* Berg & Gogliormella, *supra* note 6.

[72] *See, e.g.*, Davidoff, *supra* note 45 ("Although it is not free from doubt, it appears that the better reading is the funds' [i.e., mezzanine lenders'] and that this reading is unambiguous."); *Consequences of the Stuyvesant Town Ruling*, *supra* note 59, at 3 (stating the authors' opinion that "Judge Lowe's reading of the intercreditor agreement is not correct and that PSW [the mezzanine lender] had the better of the argument").

[73] *See* discussion *supra* Part III.A.

Indebtedness resulting from the Default."[74] As such, the court's ruling on the separate collateral foreclosure issue practically extinguished the mezzanine lenders' interest in the Stuyvesant Town-Peter Cooper Village project. Furthermore, the Court of Appeals swiftly denied the mezzanine lenders' motion for appeal to vacate the lower court's order and to get an injunction to halt the senior lenders' imminent foreclosure.[75] Those decisions opened the door for the mortgage lenders to dictate the future of Stuyvesant Town-Peter Cooper Village—free from subordinate lender meddling.[76]

However, momentarily leaving aside the *Stuyvesant Town* mezzanine lenders' legal misadventures,[77] the decision also shattered the expectations and assumptions of a much wider array of players in the commercial real estate market, who had long been using similar provisions that they expected to be interpreted more or less in the manner the defendant mezzanine lenders had argued.[78] *Stuyvesant Town* yielded a peculiar consequence for future multi-tranche lending arrangements, as "a mezzanine lender's ability to foreclose on collateral now seems contingent on whether the underlying mortgage loan has been accelerated."[79]

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[74] *PSW NYC LLC*, 2010 WL 4243437, at *5.

[75] Maria Woehr, *Pershing Loses Stuyvesant Town Appeal*, THE STREET (Sept. 28, 2010, 05:02 PM), http://www.thestreet.com/story/10873848/1/pershing-loses-stuyvesant-appeal.html?cm_ven=GOOGLEN.

[76] McLaughlin & Carmiel, *supra* note 55.

[77] Although the court cleared the way for the mortgage foreclosure to proceed, in the end, the foreclosure sale was cancelled after the servicer for the mortgage lenders purchased the troubled mezzanine lenders' interest in the property. *Update 2-Stuyvesant Town bondholders buy loans from Ackman*, REUTERS (Oct. 26, 2010, 6:17 PM), http://www.reuters.com/article/idUSN2616694220101026. Hence, it would appear that following a series of legal defeats, the mezzanine lenders ultimately got their happy ending by recovering their distressed investment capital.

[78] *See* Berg & Gogliormella, *supra* note 6; Davidoff, *supra* note 45.

[79] *Consequences of the Stuyvesant Town Ruling*, *supra* note 59, at 1, 3 ("Judge Lowe's decision . . . will force a mezzanine lender to exercise its rights under its mezzanine loans sooner rather than later because the

Although this Note's focus is not on identifying the reasons for the unexpected decisions, a cursory glance at this question helps to contextualize the landmark decisions and to extrapolate more accurate improvements. The commercial real estate community has speculated that the *Stuyvesant Town* ruling was guided by the judge's policy concerns in protecting the fate of the highly publicized Stuyvesant Town-Peter Cooper Village, which provides large-scale rent-stabilized, affordable housing in Manhattan.[80] Although the mezzanine lenders did not announce a plan to foreclose on the equity collateral and then to place the property into bankruptcy, various parties, including the court and senior lenders, assumed such a plan to be underway.[81] The court found that prospect to be detrimental to the stability and wellbeing of Stuyvesant Town-Peter Cooper Village and its

longer the mezzanine lender waits, the greater the likelihood that a significant monetary default might exist under the mortgage loan. If such a default occurs, the mezzanine lender might not be in a position to exercise remedies under its mezzanine loan because it will not want, or have the ability, to cure the monetary defaults under the senior loan.").

[80] *See id.* at 3 (contending that the court's decision was probably influenced by the fact that the senior lenders were in ongoing negotiations with the borrower-owner "for an orderly transition of management of the properties," whereas if mezzanine lenders foreclosed on the equity and subsequently put the property into bankruptcy, this outcome would "have a significant chance of throwing the property into disarray").

[81] The senior lender plaintiffs asserted an additional cause of action, in anticipation of such a scheme, to declare that Section 11(d)(ii) of the intercreditor agreement prohibits the defendants "from orchestrating a Borrower's bankruptcy unless the Senior Loan is paid off in full." This issue became moot in light of the Court's ruling on Section 6(d), requiring defendants to pay off the senior loan as a requisite to foreclosing on the equity collateral. Bank of Am., N.A. v. PSW NYC LLC, No. 651293/10, 2010 WL 4243437, at *9 (N.Y. Sup. Ct. Sept. 16, 2010). *See Consequences of the Stuyvesant Town Ruling*, *supra* note 59, at 3 ("[The] ruling may very well have been influenced by . . . [its] recognition that, if . . . [defendants] were to have successfully foreclosed on the equity collateral, . . . [defendants] would have been able subsequently to file the fee owner for bankruptcy. Judge Lowe's creative reading of the intercreditor agreement may have been intended to preclude this result.").

25,000 occupants,[82] and thus likely sought to prevent such a plan with its decision.[83] The court's discussion of the balance of equities reveals this underlying reasoning, holding that the public interest served by "maintaining stability in . . . 'the largest residential property in Manhattan and home to a significant portion of the city's moderate income housing'" outweighs the harm to the mezzanine lenders in binding them to the court's unfavorable interpretation of the intercreditor agreement.[84] Therefore, in the future, the judiciary's policy concerns may produce unexpected outcomes even when interpreting clearly bargained-for and articulated intercreditor agreements.

B. An Analysis of the *Extended Stay* Case

Whereas mezzanine lenders in the *Stuyvesant Town* case discovered that the intercreditor agreement afforded them even more limited protection and rights than they had bargained for, the *Extended Stay* case disappointed senior lenders and certain senior junior lenders. There, as the parties' claims were being adjudicated, senior lenders found out that despite the intercreditor agreement that appeared to unequivocally support their superiority, junior lenders could interfere with, sabotage, or at the very least delay the remedies they sought to exercise.

Extended Stay Inc., which operates a large chain of mid-priced hotels across the United States, was purchased for $8 billion in 2007,[85] using extremely high financial leverage of $7.4 billion, comprising $4.1 billion and $3.3 billion in senior mortgage and junior mezzanine debt, respectively.[86] The "slicing and dicing" went further in this case; the mezzanine tranche was sliced into ten alphabetized tranches, labeled A

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[82] Charles Bagli, *In Latest Battle for Control of Stuyvesant Town, the Tenants Are Wooed*, N.Y. TIMES, Sept. 2, 2010, *available at* http://www.nytimes.com/2010/09/03/nyregion/03stuytown.html.

[83] *See* notes 81–82.

[84] *PSW NYC LLC*, 2010 WL 4243437, at *12.

[85] *Engineered Bankruptcy*, *supra* note 45.

[86] *In re* Extended Stay Inc., 435 B.R. 139, 144 (Bankr. S.D.N.Y. 2010).

through J, with descending levels of priority and rights.[87] The original mortgage lenders held some of the senior mezzanine tranches, and securitized and sold off others.[88] Shortly after the financing, the global subprime mortgage crisis rapidly unfolded, and the borrower-hotel group ran into financial hardship like many of its peers.[89] Consequently, the borrower and senior mortgage lenders, as well as a few of senior and fulcrum[90] mezzanine lenders, began negotiating an informal, out-of-court financial workout,[91] which gradually wound up in a conditional conveyance-in-lieu agreement between the borrower and a senior mezzanine lender, Mezzanine B Lender.[92]

Line Trust, a Mezzanine G lender[93] that was likely out-of-the-money in the capital structure and not a party to the workout negotiations, commenced an action to halt the potential workout.[94] Line Trust colorfully alleged that the senior mortgage lenders and senior mezzanine lenders in

[87] As between mezzanine lenders, Mezzanine A is the most senior and the other nine tranches are subordinated to it, with Mezzanine J being the most junior tranche. *In re* Extended Stay Inc., 418 B.R. 49, exhibit A at 11 (Bankr. S.D.N.Y. 2009) [hereinafter Extended Stay Intercreditor Agreement].

[88] *See* Complaint at 13–18, Line Trust Corp. v. Wachovia Bank N.A., 2009 WL 1560033 (N.Y. Sup. Ct. June 3, 2009) (No. 601713/09).

[89] *See, e.g.*, *How Mezz Lenders Battled over NY Workout*, *supra* note 10, at 1, 7 (discussing how the W New York Hotel, faced with treble drops in occupancy rates, room rates, and cash flow during the recession could barely pay its mortgage debt service and defaulted on its mezzanine debt, leading to a tranche war).

[90] Fulcrum interest is "the most junior interest [in a multi-tranche debt structure] that is 'in the money.'" Memorandum from Christopher Malloy & Jennifer Geier, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates (May 19, 2010) (on file with author) [hereinafter Skadden Memorandum].

[91] Michael Canning, Joseph Forte, Marcia Goldstein & Hon. Arthur Gonzales, *Real Estate Restructurings: Issues Raised by Complex, Multi-Tranche Structures*, 573 AM. BANKR. INST. 1, 8 (2010).

[92] *See* discussion *infra* pp. 23–24.

[93] Complaint at 13, *Line Trust Corp.*, 2009 WL 1560033 (No. 601713/09).

[94] *Id.*

tranches A through E,[95] "in cahoots with the defendant borrowers, hatched a Machiavellian scheme to wipe out entirely the Plaintiffs and holders of other junior mezzanine loans."[96] More specifically, this junior lender alleged that the defendant lenders had colluded with the defendant borrower to have the latter stop paying operating expenses for sixty days, thereby engineering an event of default under the Mezzanine B loan agreement.[97] Such a default would allow Mezzanine B Lender to exercise its remedies and to realize upon the equity collateral.[98]

The *Extended Stay* intercreditor agreement, signed between all lenders, follows the *Model Intercreditor Agreement* with regard to the equity collateral enforcement action and right to cure provisions.[99] Pursuant to Section 12(b)(i) of the *Extended Stay* intercreditor agreement, a Junior Lender[100] may exercise its enforcement remedies over the equity collateral, provided that:

> [p]rior to . . . commencing any Equity Collateral Enforcement Action by reason of an Event of Default under the applicable Junior Loan Documents, the Junior Lender holding the Junior Loan that is

[95] *Id.* at 6.

[96] *Id.*

[97] The borrower's nonpayment negated the borrower's required SPE status, which constituted a breach of Section 4.1.30(a)(iv) of the Mezzanine B Loan Agreement and therefore an event of default under that loan agreement. *Id.* at 13.

[98] *Id.* at 2, 14.

[99] *See* Model Intercreditor Agreement, *supra* note 11, at 17–18, 20 (Sections on Equity Collateral Enforcement Action and Rights of Cure, respectively). Because the Model Intercreditor Agreement contemplates one mortgagee and one mezzanine lender as its parties, it requires the mezzanine lender to provide notice of default to the mortgagee, and the mezzanine lender has the right to cure defaults on the mortgage loan. However, those provisions are parallel to the intercreditor provisions in *Extended Stay*, which comprises ten mezzanine tranches of differing seniority.

[100] "Junior Lender" means, *inter alia*, all of the mezzanine lenders, collectively or individually. Extended Stay Intercreditor Agreement, *supra* note 87, at 11.

> subject to an Event of Default shall provide written notice of the default which would permit such Junior Lender to . . . commence an Equity Collateral Enforcement Action to the applicable Subordinate Junior Lenders . . . . If the default identified in the Junior Loan Default Notice is a monetary default relating to (1) any scheduled payment of principal or interest or (2) the payment of any other liquidated sum of money, the Subordinate Junior Lenders shall have until ten (10) Business Days after the later of (a) the receipt (or deemed receipt) by the applicable Subordinate Junior Lenders of the Junior Loan Default or (b) expiration of the applicable Senior Junior Borrower's Notice to cure such monetary default.[101]

Defendant Mezzanine B Lender, at least facially, fulfilled the requirements of this intercreditor provision down to the letter. Mezzanine B Lender sent the plaintiff and other mezzanine lenders a notice of default, stating that the fact that borrower's operating expenses had not been paid when they came due and had been outstanding for more than sixty days negated the SPE status of the borrower, which, in turn, constituted a breach and an event of default under the Mezzanine B loan agreement.[102] The Mezzanine B Lender provided each subordinate mezzanine lender with ten days from the receipt of the notice to cure the default by paying the approximately $3.5 million overdue expenses,[103] and informed them that if the event of default was not cured by the deadline, "Mezzanine B Lender reserves all rights to . . . take any Equity Collateral Enforcement Action."[104] None of the mezzanine lenders, including Line Trust, exercised the right to cure the Mezzanine B Loan default.

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[101] *Id.* § 12(b)(i).

[102] Complaint at 13–14, Line Trust Corp. v. Wachovia Bank N.A., 2009 WL 1560033 (N.Y. Sup. Ct. June 3, 2009) (No. 601713/09).

[103] Lingling Wei et al., *Hotel Creditors May Have an Extended Stay*, WALL ST. J., June 4, 2009, at C3.

[104] Complaint at 14, *Line Trust Corp.*, 2009 WL 1560033 (No. 601713/09).

After the monetary cure period expired, Mezzanine B Lender notified Line Trust and other junior mezzanine lenders that it had entered into a conditional conveyance-in-lieu agreement with the Mezzanine B borrower, wherein that borrower would convey the collateral pledged under Mezzanine B loan to the Mezzanine B Lender.[105] Defendant Mezzanine B lender plainly and accurately stated that its proposed action met the requirements of Section 12(b)(i) of the intercreditor agreement,[106] as well as the rest of the agreement, which enumerates "an assignment in lieu of foreclosure" as a permissible equity collateral enforcement action to realize upon the equity collateral.[107]

The looming conveyance-in-lieu action, which would wipe out all mezzanine lenders junior to Mezzanine B, alarmed Line Trust, who rushed to court to halt this action within two days of receiving notice.[108] Interestingly, in this case the junior lender-plaintiff did not challenge the substance of the senior tranches' rights and remedies in the intercreditor agreement, but rather presented reasons why the senior lenders should not be permitted to exercise those intercreditor rights. Line Trust conceded that the defendant lenders would be entitled to a conveyance-in-lieu enforcement action under the intercreditor agreement and did not contest that they had fulfilled the agreement's various requirements, such as providing notice of default and granting a right to cure.[109] Instead, Line Trust accused the defendant lenders and borrower of orchestrating a collusive borrower default to open the way for a conveyance-in-lieu in order to extinguish subordinate mezzanine loan interests—including Line Trust's—or failing that, to allow defendant lenders to obtain full payment pursuant to Section 10(b)[110] of

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[105] *Id.* at 17–18.

[106] *See supra* note 103 and accompanying text.

[107] Extended Stay Intercreditor Agreement, *supra* note 87, at 9.

[108] *See* Complaint at 18, *Line Trust Corp.*, 2009 WL 1560033 (No. 601713/09).

[109] *See id.* at 13–14, 16.

[110] Section 10(b) provides, in pertinent part, "If . . . there shall have occurred and be continuing an Event of Default under the Senior Junior

the intercreditor agreement, while cutting off distribution of funds to the plaintiff and other subordinate lenders.[111] Line Trust asserted that the defendants' "trumped up default" amounted to a breach of the covenant of good faith and fair dealing implicit in the intercreditor agreement, and therefore asked the court, *inter alia,* to enjoin the defendants' conveyance plan, to declare that no default had occurred under the Mezzanine B Loan, and to grant the plaintiff monetary damages for the alleged breach of contract.[112]

Line Trust surmised that the sixty-days-overdue operating expenses could only be a product of collusion among the defendants because all of the mezzanine lenders were current on their interest payments, which were to be paid *after* the operating expenses were paid, pursuant to the cash management agreements.[113] Thus, under the ordinary "waterfall" of debt service payments in order priority, the operating expenses should have been paid ahead of the mezzanine debt service.[114] Plaintiff further asserted that even if the nonpayment had occurred non-collusively, it would not have constituted an event of default because under Line Trust's interpretation of the relevant loan documents, the overdue operating expenses were below the two-percent threshold under the Special Purpose Entity covenant.[115] Accordingly, the covenant would not have been breached even if those expenses had been overdue for sixty days.[116]

Loan Documents, after giving effect to Subordinate Junior Lender's cure rights pursuant to Section 12, the Senior Junior Lender holding the applicable Senior Junior Loan shall be entitled to receive payment and performance in full of all amounts due or to become due to such Senior Junior Lender before any applicable Subordinate Junior Lender is entitled to receive any payment." Extended Stay Intercreditor Agreement, *supra* note 87, at 55.

[111] Complaint at 18, *Line Trust Corp.*, 2009 WL 1560033 (No. 601713/09).

[112] *Id.* at 22–23, 26–27.

[113] *Id.* at 17–18.

[114] *Id.*

[115] *Id.*

[116] *Id.* at 15–16.

However, Line Trust's interpretation does not find support in the original text of the covenant, which plainly establishes a sixty-day grace period for liabilities related to operating expenses amounting up to two percent of the outstanding loan:

> [[A] Party required to be a Special Purpose Entity] will incur, create or assume no Indebtedness other than . . . (d) in the case of Borrower, Property Owner and Operating Lessee collectively, liabilities incurred in the ordinary course of business relating to the ownership and operation of the Properties . . . and the routine administration of Borrower, in amounts not to exceed in the aggregate two (2.0%) percent of the outstanding principal amount of the Loan (. . . provided that when aggregated with the amount of liabilities that are specific to any other Individual Properties, shall in no event exceed two percent (2.0%) of the outstanding principal amount of the Loan) *which liabilities are not more than sixty (60) days past the date incurred.*[117]

Judge Lowe, who also presided over the *Stuyvesant Town* case, issued an order requiring the defendants to show cause and a temporary restraining order instructing the Extended Stay loans' administrative agent to distribute funds to the various tranches as if an event of default had not occurred.[118] It is unclear how successful or substantive Line Trust's claims of a multi-party "Machiavellian scheme" or its interpretation of the event of default would have been because the defendant senior and senior junior mezzanine lenders did not fight back in the state court action. The defendants probably did not contest the action because they worried that this action would delay, if not thwart, their proposed workout, while Extended Stay's assets were rapidly eroding and loans at all tranches were due to expire—albeit with extension options—in less than two weeks.[119]

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[117] *Id.* at 16 (emphasis added).

[118] *See* Line Trust Corp. v. Wachovia Bank, N.A., No. 601713/09, 2009 WL 1560033, at *1–2 (N.Y. Sup. Ct. June 3, 2009).

[119] *See* Wei, *supra* note 103, at C3.

Accordingly, Line Trust succeeded in thwarting the multi-lender restructuring plan, and consequently Extended Stay Inc. filed for voluntary Chapter 11 bankruptcy protection shortly thereafter, [120] which led to the voluntary dismissal of the state court action.[121]

Perhaps emboldened by the state court saga, Line Trust brought a new action during the bankruptcy hearings. This time, Line Trust alleged that certain senior lenders had conspired with the borrower and persuaded it to file voluntary Chapter 11 reorganization bankruptcy by offering to indemnify the borrower's principal for its personal liability that would arise from a voluntary bankruptcy filing—one of the contractual carve-outs from the otherwise non-recourse mortgage and mezzanine loans.[122] According to Line Trust, the senior lenders would now be able to exert substantive control over the bankruptcy plan in order to advance their own financial stakes and to extinguish the junior lenders' interests.[123]

Line Trust's complaint asserted, *inter alia*, that the senior lenders had devised "a comprehensive scheme designed to induce Mr. Lichtenstein to do that which the senior lender defendants themselves promised all other lenders, under the express terms of the intercreditor agreement, they would never do—cause the borrowers to file for bankruptcy protection."[124] However, Line Trust's assertion does not follow from the express terms of the *Extended Stay* intercreditor agreement, which wholly incorporated the relevant Model Intercreditor Agreement provision on creditor obligations in the context of borrower bankruptcy

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[120] *In re* Extended Stay Inc., 435 B.R. 139, 144–45 (Bankr. S.D.N.Y. 2010).

[121] Stipulation of Discontinuance, Line Trust Corp. v. Wachovia Bank N.A., 2009 WL 1560033 (N.Y. Sup. Ct. June 19, 2009) (No. 601713/09).

[122] *See* Skadden Memorandum, *supra* note 90, at 8–9.

[123] *Id.*

[124] *Engineered Bankruptcy*, *supra* note 45. Appellant David Lichtenstein and his portfolio company, Appellant Lightstone Holdings, led an investor consortium that acquired Extended Stay in June 2007. *Id.* at 143–44.

scenarios. The *Extended Stay* intercreditor agreement provides:

> For as long as the Senior Loan shall remain outstanding, none of the Junior Lenders shall solicit, direct or cause Borrower or any other entity which Controls Borrower . . . [ ] or any other Person to: . . . institute proceedings to have Borrower or any SPE Constituent Entity adjudicated a bankrupt or insolvent; [or] . . . consent to, or acquiesce in, the institution of bankruptcy or insolvency proceedings against Borrower or any SPE Constituent Entity; . . . [or] file a petition or consent to the filing of a petition seeking reorganization, arrangement, adjustment, winding-up, dissolution, composition, liquidation or other relief by or on behalf of Borrower or any SPE Constituent Entity.[125]

Under this provision, junior lenders explicitly pledge not to, *inter alia*, consent to, acquiesce in, or cause the institution of bankruptcy proceedings—voluntary or involuntary—against the borrower. Thus, the provision is a pledge from Extended Stay Inc.'s subordinate junior mezzanine lenders to its senior junior lenders not to instigate borrower bankruptcy.[126] However, there is no corresponding *upstream* intercreditor provision requiring senior lenders to pledge the same to their junior counterparts—contrary to Line Trust's assertion that senior mortgage and senior mezzanine lenders expressly agreed not to cause the borrower's bankruptcy.[127] Since the *Extended Stay* intercreditor agreement and the Model Intercreditor Agreement are nearly identical on this issue, it is unclear where Line Trust found support for its claim for reciprocity in senior and subordinate lenders' obligations with respect to borrower bankruptcy, which, as shown above, is not

[125] Extended Stay Intercreditor Agreement, *supra* note 87, at 59–60; *accord* Model Intercreditor Agreement, *supra* note 11, at 19.

[126] Extended Stay Intercreditor Agreement, *supra* note 87, at 59–60.

[127] *See* Extended Stay Intercreditor Agreement, *supra* note 87; Model Intercreditor Agreement, *supra* note 11.

supported by the express terms of the intercreditor agreement.[128]

Around the same time as Line Trust's proceeding, a myriad of similarly disadvantaged or out-of-the-money junior lenders brought legal action against the better-off, more senior lenders. For example, Five Mile Capital, a junior certificate holder, sued two senior lenders for alleged breach of the Trust Servicing Agreement for engaging in pre-petition negotiations with the debtor-borrowers.[129] Another mezzanine debt holder, Bank of America, brought an action against both a senior lender and the debtor-borrower's principal, Mr. Lichtenstein, to enforce the non-recourse carve-out guarantees, which would have been triggered when the borrower filed for voluntary bankruptcy, a so-called "bad boy act."[130]

Extended Stay managed to muddle through various intercreditor claims and emerged from Chapter 11 bankruptcy after the bankruptcy court approved the debtors' plan of reorganization to sell one hundred percent of the company to an investor consortium for $3.93 billion—less than half the original purchase price—thereby leaving junior lenders seriously impaired.[131] Mezzanine lenders Bank of America and Line Trust's adversary proceedings against the borrower's principal and lenders at various tranches still await decision at state court, where they had been

[128] *See* Extended Stay Intercreditor Agreement, *supra* note 87; *Skadden Memorandum, supra* note 90; *Engineered Bankruptcy, supra* note 45.

[129] *In re* Extended Stay Inc., 435 B.R. 139, 146 (Bankr. S.D.N.Y. 2010).

[130] *Id.*

[131] Order Pursuant to § 105(a) of the Bankruptcy Code and Bankruptcy Rule 9019 for Approval of Settlement, *In re* Extended Stay Inc., 418 B.R. 49 (Bankr. Ct. S.D.N.Y Sept. 27 2009) (No. 09-13764); *see* Nadja Brandt, *Extended Stay Exits Bankruptcy Amid Sale of Company*, BLOOMBERG (Oct. 8, 2010, 5:40 PM), http://www.bloomberg.com/news/2010-10-08/extended-stay-exits-bankruptcy-amid-sale-of-company-update1-.html.

remanded.[132] However, for the purposes of this Note, the larger framework of the *Extended Stay* tranche warfare that produced the knotty intercreditor lawsuits is far more instructive than the actual outcomes of the claims on guarantor indemnity, fraudulent concealment, breach of fiduciary duty and so on.[133]

As authors Malloy and Geier argue, it is very likely that Line Trust and its impaired creditor peers resorted to litigation with various insubstantial claims "to thwart the interests of the senior lenders (or threaten to take such action) in hopes of either forestalling a foreclosure or restructuring that would wipe out the junior debt or perhaps extracting concessions to permit them to realize value on an investment that would otherwise be under water."[134] For example, Line Trust's initial state court order succeeded as a nuisance tactic to hold up the workout plan between the defaulting borrower, senior lenders, and fulcrum mezzanine lenders.[135] As a result, the borrower went into bankruptcy—a generally disfavored, costly, time-consuming, and uncertain course of action for creditors. Subsequently, Line Trust and its peers employed comparable tactics during the bankruptcy proceedings, perhaps hoping for similar achievements. Although, in the end, the plan—which wrote off approximately $5 billion in debt—did not protect junior lenders' interests, objections and adversary proceedings—such as those brought by Line Trust—played a prominent role in tabling the first three plans, which would have similarly disadvantaged them or left them out-of-the-money.[136]

The intercreditor agreement in the *Extended Stay* case, besides the insertion of additional, replicated provisions to

[132] Bank of Am. N.A. v. Lichtenstein, No. 601853/09 (N.Y. Sup. Ct. Jan. 10, 2011); Line Trust Corp. v. Lichtenstein, No. 601951/09 (N.Y. Sup. Ct. Oct. 27, 2010).

[133] In re *Extended Stay Inc.*, 435 B.R. at 144–50; Skadden Memorandum, *supra* note 90, at 8–9.

[134] Skadden Memorandum, *supra* note 90, at 8–9.

[135] In re *Extended Stay Inc.*, 435 B.R. at 144–45.

[136] *Id.* at 145.

account for the large number of mezzanine lenders at different tranches, closely resembles the Model Intercreditor Agreement and embodies its material terms, e.g., the general subordination of the junior loan to the senior loan, enforcement actions, and bankruptcy provisions.[137] The intercreditor agreement included the common bankruptcy provision wherein a junior lender agrees not take any action during the borrower's bankruptcy proceedings without the prior consent of the senior lender—except as required to protect its interest in the separate collateral—and grants the senior lender an irrevocable proxy to vote the junior lender's claims during such bankruptcy proceeding.[138] However, this provision was of little avail to senior lenders. This outcome may have been implicitly guided by the prominent *In re 203 North LaSalle St. Partnership* decision, which held that the lenders' intercreditor agreement, while generally enforceable in the event of the borrower's bankruptcy,[139] was unenforceable to the extent that it permitted the senior lender to exercise the junior lender's voting rights under the Bankruptcy Code.[140] Other decisions like *In re Aerosol Packaging, LLC*[141] directly challenged *203 North LaSalle St. Partnership* and held that the lenders' intercreditor agreement was fully enforceable, including the voting rights provision, under Section 501 of the Bankruptcy Code. However, this question has not yet been resolved at a higher court level, and *203 North LaSalle St.* remains widely

[137] *Compare* Extended Stay Intercreditor Agreement, *supra* note 87, at 46–48, 53–54, 69–73, *with* Model Intercreditor Agreement, *supra* note 11, at 13–14, 16–17, 22.

[138] Extended Stay Intercreditor Agreement, *supra* note 88, at 59; *accord* Model Intercreditor Agreement, *supra* note 11, at 19–20.

[139] Section 510(a) of the Bankruptcy Code provides that a subordination agreement is enforceable in bankruptcy "to the same extent that such agreement is enforceable under applicable nonbankruptcy law." *In re* 203 North LaSalle St. P'ship, 246 B.R. 325, 327 (Bankr. N.D. Ill. 2000).

[140] *Id.* at 330–32.

[141] 362 B.R. 43, 47 (N.D. Ga. 2006).

influential, likely playing a part in the *Extended Stay* intercreditor proceedings.[142]

The proliferation of tranche warfare lawsuits and ongoing junior lender nuisances news stories demonstrate that conventional provisions in intercreditor agreements do not shield the senior lenders from debilitating junior lender interference with their rights and remedies. For example, Line Trust was able to thwart senior lenders' restructuring workout plan by narrating an alleged conspiracy in state court—without ever contesting the breadth of the senior tranches' rights in the intercreditor agreement. It is not evident from today's commercial real estate finance practice what, if any, enforceable intercreditor provisions are being introduced to prevent impaired junior lenders from harming senior lenders' interests and frustrating the latter's remedies. In any event, perhaps added restrictions on the already-limited rights and protections of mezzanine lenders would not be entirely desirable.

IV. THE POSSIBLE IMPACT OF THE TRANCHE WAR DECISIONS ON FUTURE INTERCREDITOR AGREEMENTS AND SUGGESTIONS FOR IMPROVEMENT

The mezzanine-mortgage tranche wars were brought before courts and have dismantled a number of intercreditor agreement provisions. Amid the tranche battlefields, the current real estate finance landscape features little mezzanine lending—even compared to diminished mortgage lending.[143] The absence of mezzanine financing can be partially attributed to the crash and slow recovery of over-leveraged investment properties, which can no longer support high levels of multi-tranche debt. But more importantly, the prevailing uncertainty and turbulence following recent decisions has resulted in trench warfare

[142] *See* David Kuney et al., *Real Estate: Homebuilders, Commercial and Hotels*, *in* AM. BANKR. INST., 2008 BANKR. VIEWS FROM THE BENCH 95 (Sept. 12, 2008).

[143] Horowitz, *Current Issues for Mezzanine Finance*, *supra* note 8, at 1.

between the mezzanine and mortgage lenders, who cautiously wait for the other's move whilst trying to weather the crisis.

On a brighter note, this status quo presents distinct opportunities for improvement. Courts have ruled one way or another on key aspects of the creditors' respective rights, thereby delineating the intercreditor relationship beyond the mere expectations, understandings, and assumptions of the parties, which had been largely untested in court until now. The judicial guidance will enable a better-informed and readjusted drafting of intercreditor agreements. From a practical perspective, demand and other characteristics of the post-crisis commercial real estate market—as well as the creditors' relative bargaining powers in each case—will determine the future forms of intercreditor agreements. Moreover, as discussed above in the *Stuyvesant Town* context, the public policy concerns of courts may add another layer of uncertainty to the interpretation and enforcement of intercreditor provisions.[144] With those limitations in mind, the following discussion suggests possible modifications and additions to intercreditor agreements, towards a gradual resolution of tranche warfare and a healthy revival of the commercial real estate market.

A. Possible Mortgage Lender-Friendly Modifications to Intercreditor Agreements

In order to avoid a repetition of *Extended Stay*-type tranche warfare and costly junior lender nuisances, mortgage lenders would ideally have mezzanine lenders pledge not to interfere when the mortgagee is dealing with the borrower. Considering the continuing legacy of *In re 203 North LaSalle St. Partnership*,[145] intercreditor agreements that add restrictions on junior lender rights and remedies in the bankruptcy context offer a dubious solution. Therefore, mortgagees would be better advised to modify intercreditor

[144] *See* discussion *supra* Part III.A. and notes 81–82.

[145] *See* discussion *supra* Part IV and notes 144, 146 and accompanying text.

agreements to grant them more free rein when negotiating a restructuring workout or implementing other remedies *before* the situation escalates to an undesirable bankruptcy proceeding.

The typical mezzanine-mortgage lender intercreditor subordination provision provides, "Mezzanine Lender hereby subordinates and makes junior the Mezzanine Loan, the Mezzanine Loan Documents and . . . all rights, remedies, terms and covenants contained therein" to the senior loan and its rights and remedies.[146] However, as decisions like *Extended Stay* demonstrate, those general subordination terms alone do not sufficiently restrict the junior lenders from exercising their remedies and this, in turn, hinders the mortgagee from receiving the full benefits of its contractual seniority.[147] The changes and additions suggested in this subsection would be quite restrictive on mezzanine lenders, who already have limited rights vis-à-vis the senior tranches, and whether or not they can be obtained would depend on the market and the parties' bargaining powers. However, if a senior lender succeeds in the bargaining process, standstill agreements, as well as covenants not to sue and releases of claims, can achieve more senior lender freedom to transact with the borrower.

Senior lenders can supplement intercreditor agreements with standstill agreements of varying strictness. These agreements are common in the context of first and second mortgages, wherein the second mortgagee agrees—within limits—that in the event of an uncured senior mortgage loan default, it will not foreclose on or take other enforcement action against the lenders' shared collateral until the first mortgagee initiates its own enforcement action.[148] Permissible enforcement actions typically include "any foreclosure proceeding, the exercise of any power of sale, the

[146] Model Intercreditor Agreement, *supra* note 11, at 16.

[147] *See* discussion *supra* Part III.B.

[148] Form 8-3 Inter-Creditor Agreement Among Multiple Lenders, *in* PRAC. L. INST., CONDO. & COOP. DESKBOOK 8–12 (Nov. 1, 2009); *see* Joshua Stein, *Model Subordination Agreement between Mortgagees*, 457 PRAC. L. INST. 225, 236–37, 267–68 (2000); Alden, *supra* note 20, at 3.

taking of a deed or assignment in lieu of foreclosure, the obtaining of a receiver, the taking of any other enforcement or remedial action against the [shared] Senior Collateral or any part thereof."[149] This seemingly draconian standstill provision has mitigating features for junior lenders. First, once the senior lender initiates enforcement action, there is nothing to bar the junior lender from pursuing its own enforcement action.[150] Second, the standstill agreement becomes null and void if the senior lender fails to take enforcement action within a pre-determined, limited time period following the expiration of the junior lender cure period.[151] After the standstill agreement is nullified in this manner, the junior lender—as well as senior lender—is free to exercise its rights and remedies under the loan documents, upon prior notice to the senior lender.[152]

The standstill agreement will function as a heavy-handed extension of common intercreditor payment subordination clauses, in which the mezzanine lender pledges not to receive any payments from the borrower unless all senior debt obligations are current (i.e., during the ordinary flow of events and in the event of a mortgage loan default).[153] The mezzanine-mortgage lender standstill agreement will provide that in case of a senior event of default, the mezzanine lender will not take enforcement action on the equity collateral—for a limited period of time—until the mortgage lender takes enforcement action on the senior collateral. Once again, the mezzanine lenders would be free to exercise their remedies once the time period runs out or once the mortgagee initiates its remedy.

In effect, the standstill agreement will allow the mortgage lender to avoid the proverbial "race to the courthouse" in the event that both loans are in default. It will also give the mortgage lender room to breathe for a limited time, so that it

[149] Form 8-3, *supra* note 148, at 8.

[150] *Id.*

[151] *Id.* at 12.

[152] *Id.* at 13.

[153] *See* Model Intercreditor Agreement, *supra* note 11, at 17.

can gauge the situation, negotiate with the borrower, and select what remedy to pursue, be it a foreclosure, deed-in-lieu-of-foreclosure, or restructuring. As a result, mortgage lenders will be one step closer to avoiding mezzanine lender interference, which could thwart their restructuring plan and produce injurious outcomes like borrower bankruptcy, as was the case in *Extended Stay*.

Mezzanine lenders would be prudent to offset a standstill agreement with an intercreditor provision stating that an event of default under the mezzanine loan, by itself, will not constitute an event of default under the senior loan.[154] Without such a counter-provision, mezzanine lenders would potentially have no opportunity to exercise any collateral remedies because the senior lender could immediately declare a default under its loan by virtue of the mezzanine default, and thus bind the mezzanine lender to a standstill agreement. Especially in light of the *Stuyvesant Town* decision, in the event of a default under the mezzanine loan, mezzanine lenders will want to exercise their equity collateral remedies as soon as possible (i.e. before a monetary default occurs on the mortgage loan, in which case they would be faced with having to pay off the entire outstanding mortgage debt before being able to enforce any remedy).[155] Therefore, the risk of having every mezzanine default trigger a mortgage default could be ruinous for mezzanine lenders.[156] As discussed below, it would be sensible for mezzanine lenders explicitly to opt out of a *Stuyvesant Town* outcome in the intercreditor agreement. Nonetheless, the counter-provision mentioned above offers added protection.

Covenants not to sue, or releases of claims, present another way for senior lenders to limit mezzanine lender interference with their control over the borrower and with

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[154] *See, e.g.*, Form 8-3, *supra* note 148, at 21.

[155] *See* Bagli, *supra* note 82; text accompanying note 79.

[156] It is often the case that if the mezzanine loan is in default, the mortgage loan will be, too, because the borrower has not met any of its debt obligations. This speaks to the riskiness of mezzanine lending; however, even the most intrepid mezzanine lender will demand at least some viable rights and remedies over its investment.

the potential workout process. A covenant not to sue is typically a pledge not to sue covenantee(s) for a presently existing cause of action, as well as for claims and rights that may arise from it.[157] In a release of claims, which is conceptually similar,[158] the releasor immediately discharges its presently existing and related future rights and claims against the releasee.[159] Generally, both agreements cover claims that either exist at the time of the agreement or may later arise from such present claims. In some cases, the agreements state that the "release and covenant not to sue shall not apply to any claims arising after the date of this [a]greement with respect to acts, occurrences, or events after the date of this [a]greement."[160]

A mezzanine lender's covenant not to sue or release, pledging not to bring *any* type of legal action against the senior lender in relation to the latter's enforcement actions would sweep more broadly than a standstill agreement, which essentially provides the mortgagee a head-start, free from mezzanine lender interference, to take enforcement action on its loan. However, it may be problematic to enforce a junior lender's global release or covenant not to sue a senior lender in relation to or on account of the senior lender's *unknown* role in a *possible* future financial workout or other remedy. As a matter of public policy, as well as state law in some jurisdictions,[161] courts will be reluctant to

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[157] *See, e.g.*, 5 WILLISTON ON CONTRACTS 4TH FORMS § 73F:2 (4th ed. 2010); 3 WEST'S PENNSYLVANIA FORMS, CIVIL PROCEDURE § 67:8 (2010).

[158] A release is generally "a present abandonment or relinquishment of a right or claim" whereas a covenant not to sue is "an agreement not to enforce an existing cause of action" against covenantee(s), and the claim survives against third parties. *In re* Bazaar World Corp., 167 B.R. 985, 988 (Bankr. N.D. Ga. 1994)). *See also* JOHN J. DVORSKE ET AL., N.Y. JUR. 2D COMPROMISE, ACCORD, AND RELEASE § 97 (2011).

[159] *See* 9 STUART M. SAFT, COMMERCIAL REAL ESTATE FORMS 3D § 25:36 (2011).

[160] *Id.* § 21:15.

[161] *See, e.g.*, CAL. CIV. CODE § 1542 (2005) ("A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.").

enforce such an agreement, which is premised upon broad future contingencies rather than existing, known claims (the agreement indiscriminately divests the mezzanine lender of all legal remedies to enforce its potential, unknown rights and claims).

One way to increase the likelihood of enforcement would be to limit the scope of the covenant or release. For example, parties could agree upon a time limit on the covenant—like standstill agreements do—whereby covenantor agrees not to sue the senior lender in the context of the latter's negotiations with the borrower for a workout or other enforcement action for a stated time period.[162] Under this type of agreement, the senior lender will have the freedom to negotiate with and assert some control over the borrower without junior lender meddling. Alternatively or additionally, parties can negotiate and limit the breadth of the future claims to be released, as a threshold to weed out the sort of potentially frivolous litigation that mushroomed during *Extended Stay*. Although the released claims will still remain largely unknown, an agreement drafted in this way curtails, instead of eliminates, the junior lender covenantor's legal remedies.

Alternatively, parties can explicitly contract out of state law provisions or public policy trends against enforcing covenants not to sue and releases for claims that are unknown at the time of executing the agreement. For example, a model form release from a debtor to a lender, whose affiliated entity is taking title at a deed-in-lieu-of-foreclosure transaction, provides:

> Debtor hereby agrees, represents, and warrants that it realizes and acknowledges that factual matters now unknown to it may have given or may hereafter give rise to causes of action, claims . . . [etc.] that are presently unknown, unanticipated, and unsuspected, and it further agrees, represents, and warrants that this Release has been negotiated and agreed upon in light of that realization, and that it nevertheless

[162] *See supra* Section IV.A.

> hereby intends to release, discharge, and acquit the parties set forth hereinabove from any such unknown causes of action . . . [etc.] that are in any way related to the [s]ubject [m]atter.[163]

This provision strengthens the likelihood that courts will enforce the release or covenant not to sue in order to give effect to the contracting parties' intents. If the parties add a covenant not to sue or a release, or a combination of the two, to the intercreditor agreement, it is important to ensure the existence and adequacy of consideration for those agreements to prevent a finding of unenforceability or fraudulent conveyance.[164] Money is a common form of consideration in this context; however, the senior lender's agreement to extend financing and/or to permit the borrower to have mezzanine financing can also function as consideration.[165]

At a minimum, well-drafted standstill agreements, covenants not to sue, and releases can bestow upon senior lenders limited-time free rein to negotiate with the borrower and to begin an enforcement action. Blanket versions of these agreements that essentially extinguish the mezzanine lender's rights and remedies, albeit voluntarily, may run into enforceability problems for public policy reasons. However, recent decisions indicate that once a mezzanine lender signs onto such a restrictive agreement, courts will uphold the agreement as a private contract between sophisticated parties. For example, the *Stuyvesant Town* court crowned its decision to effectively eradicate the mezzanine lenders' investment interest by remarking that "subordinated loans are inherently more risky than their senior counterparts—a

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[163] 3 ALEXANDER E. HAMILTON, MILLER & STARR CALIFORNIA REAL ESTATE FORMS § 3:67 (2011). In this case, the debtor acknowledged and waived all rights and benefits that the California Civil Code, which deems unenforceable releases for unknown claims, may confer upon it in the future. *Id.*

[164] *See id. See also* 3B NICHOLS CYCLOPEDIA OF LEGAL FORMS § 51:58 (2011).

[165] *See* HAMILTON, *supra* note 163, § 3:67; 3B NICHOLS, *supra* note 164, § 51:58.

reality of which [the Junior Lender], as a sophisticated party, was no doubt aware when it acquired the mezzanine loan here."[166] Moreover, similar contractual provisions, such as a waiver of foreclosure defenses, wherein "[t]o the maximum extent permitted by applicable law, [m]ortgagor hereby waives all rights, remedies, claims and defenses" in a mortgage foreclosure,[167] are commonplace and upheld. Therefore, if the mortgage lenders enjoy the bargaining leverage to have mezzanine lenders agree to such restrictive provisions, courts will likely not take issue with them, within reason.

B. Possible Mezzanine Lender-Friendly Modifications to Intercreditor Agreements

In the grand overhaul of intercreditor agreements, mezzanine lenders will react to potentially unfavorable restrictions like standstill agreements, covenants not to sue, or releases that mortgagees may introduce in order to curtail mezzanine lender interference. This prospect makes it all the more urgent for mezzanine lenders to clarify and secure what limited rights and remedies they will retain. Generally, mezzanine lenders, having witnessed decisions like *Stuyvesant Town*, will be extra-cautious in drafting intercreditor agreements to ensure that the remedies and rights for which they thought they bargained are indeed enforceable. Given the high-risk nature of mezzanine loans, the absence of any viable remedies will be a deal breaker for at least some mezzanine lenders.

As a starting point, it will be essential for mezzanine lenders to explicitly contract out of detrimental provisions like Section 6(d) of the *Stuyvesant Town* intercreditor

[166] Bank of Am., N.A. v. PSW NYC LLC, No. 651293/10, 2010 WL 4243437 (N.Y. Sup. Ct. Sept. 16, 2010) (quoting Highland Park CDO I Grantor Trust, Series A v. Wells Fargo Bank, N.A., No. 08 Civ. 5723(NRB), 2009 WL 1834596 (S.D.N.Y. June 16, 2009)).

[167] *See* 10 ALAN S. GUTTERMAN, BUSINESS TRANSACTIONS SOLUTIONS § 55:123 (2011).

agreement,[168] which practically stripped away the mezzanine lender's rights by requiring it to pay off the exorbitant $3.67 billion due on the mortgage loan as a prerequisite to exercise its equity collateral foreclosure remedy.[169] Somewhat less urgently, mezzanine lenders will want to reconsider the rights of the mezzanine lender to cure defaults on the first mortgage loan and the rights of the mezzanine lender to purchase the first mortgage loan. Both remedies present alternative routes for a mezzanine lender, who has highly restrictive foreclosure rights over the equity collateral, to thwart a potentially lethal mortgage foreclosure and to protect its investment. However, it is worth noting that given the magnitude of some mortgage loans in the tranche warfare cases—more than $3 billion in *Stuyvesant Town* and more than $4 billion in *Extended Stay*—these rights may not have practical value for many mezzanine lenders. This circumstance may lead to a rearrangement in the mezzanine lender pool, introducing wealthy hedge funds and other institutional investors who are willing to invest in risky in-the-money and fulcrum mezzanine loans. That possibility aside, realistically, many mezzanine lenders will lack the liquidity or financing available to make such purchases. Moreover, per the *Stuyvesant Town* decision, the mezzanine lender would be compelled to purchase the entire mortgage loan *at par*, although the property's present value may have dropped in half, hardly a financial remedy from a subordinate lender's point of view.

On the other hand, the motivation for this provision is that the impaired but optimistic mezzanine lender, who is out of the money in the current capital structure, may nonetheless want to take control of the project. Namely the mezzanine lender, who anticipates that the property is actually worth more than the appraisal amount or that it will drastically appreciate, may wish to exercise its rights to cure a senior loan default or to buy out the mortgagee in

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[168] *PSW NYC LLC*, 2010 WL 4243437, at *2,

[169] *Consequences of the Stuyvesant Town Ruling*, *supra* note 59, at 1, 3.

order to make the senior lenders whole and to retain its interest in the property.[170] Additionally, as mentioned above, hedge funds and other institutional investors, who are confident in their predictions of what mezzanine lenders are in-the-money and which ones are fulcrum lenders, may be willing to step in and cure or buy the mortgage loans. Therefore, the right to cure and the right to purchase the mortgage loan are still valuable intercreditor provisions that mezzanine lenders should preserve. Moreover, given the likelihood that senior lenders will negotiate to limit mezzanine lenders' overall rights and remedies, it is important for mezzanine lenders to guard these rights, which present alternative remedies.

V. CONCLUSION

Machiavelli advised his Prince, "Before all else, be armed." Today, tranche warfare lenders from all ranks are marching into legal battles of immense financial consequence, poorly armed with deficient intercreditor agreements. Recent decisions exposed the significant discrepancies between the parties' understandings and expectations of their intercreditor agreements and what the courts enforced, which pushed mezzanine and mortgage lenders to redefine their relationship. Moving forward, "it is important for lenders at all levels of the capital structure to be mindful of the limitations and protections contained in intercreditor agreements."[171]

As more case law and scholarship on the key issues emerge, the tranche warfare phenomenon can be expected to not only change the mere wording of future intercreditor agreements, but also investors' and lenders' perceptions of their and others' roles, rights, and remedies in multi-tranche commercial real estate finance. In response to post-crisis market forces—coupled with ever-present pressures to structure effective and efficient transactions—the United States commercial real estate market may experience macro-

[170] *See* Horowitz, *Key Considerations*, *supra* note 52.

[171] Berg & Gogliormella, *supra* note 6, at 5.

level changes like the obliteration of certain financial products, the inception of new ones, or, for instance, an altogether change in the identities of certain lender pools.

The possible changes to the intercreditor agreement suggested in Part IV are intended to initiate a discussion about how to draft intercreditor agreements to better serve the needs and expectations of co-existing mortgage and mezzanine lenders. At present, there remain too many unknowns—both in the recovering real estate finance market and in the courts that have before them tranche warfare cases that could become game changers. As a result, it is difficult, if not futile, to speculate on how the future commercial real estate finance landscape will pan out for mortgage and mezzanine lenders. It is, however, much safer to hypothesize that the perpetual demand for efficient negotiations and innovative deal-making will bring about new dynamics in this intercreditor relationship, as lenders prepare for the next high in the reasonably dependable real estate boom-and-bust cycle.