SUBORDINATE MORTGAGE FINANCING: THE PERILS OF THE SENIOR LENDER

Despite the risks, senior lenders may find attractive benefits.

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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. A "subordinate" mortgage gives the subordinate lender a claim to the value of the collateral, but only after the senior mortgage has been paid. A subordinate lender takes greater risks in exchange for receiving a higher interest rate. The subordinate mortgage makes the deal work for the borrower, and some lenders find the subordinate risk-reward package more attractive than that offered by a "plain vanilla" first mortgage loan.

As commercial real estate financing continues to explode and values continue to rise, the marketplace can probably expect to see revived interest in subordinate mortgages. Some senior lenders have a sanguine view of subordinate mortgages; they are, after all, subordinate and, therefore, just like more equity. If another lender is willing to accept a subordinate position, it must say something good about the value of the collateral.

This view ignores more than it explains. Subordinate mortgages create a variety of new issues and risks for senior lenders, not all self-evident. Before a senior lender permits its collateral to be encumbered by subordinate financing (a likely next chapter in some parts of the real estate lending boom of the late Nineties), the senior lender must understand the issues and risks of subordinate financing, and how to control them.

Subject to the qualifications discussed in this article, subordinate mortgages can be useful tools in real estate finance. Therefore, their role in the marketplace may grow beyond their present occasional cameo appearances involving underfunded takeout commitments or as security for "break-up fees."

If, however, the senior mortgage is destined for securitization, then any subordinate mortgage at all may be a problem. Because of the issues addressed in this article, rating agencies are typically unwilling to tolerate any subordinate mortgage, even with a draconian intercreditor agreement, at least under today's rating criteria. Therefore, unless and until the rating agencies change their minds about subordinate mortgages, this discussion applies only to senior loans that are made without an eye toward securitization.

Except in rated transactions, subordinate mortgages are not intrinsically unacceptable or bad. They merely create risks that must be understood, evaluated, and mitigated in the context of a particular transaction.

THE RISKS OF SUBORDINATE MORTGAGES AND THEIR MITIGANTS

This section describes each risk that a subordinate mortgage creates for a senior lender and suggests "mitigants," specific steps the senior lender can take to moderate or temper each risk.

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Modifications and Subordination

Under ancient principles of real estate law that modern courts still apply, if a senior lender and the borrower agree to modify a senior mortgage that is "ahead of" a subordinate mortgage, then the modification can turn the senior mortgage into a subordinate mortgage, either in whole or in part. This principle is based on the theory that the modification somehow increased the risk and burden to the holder of the subordinate mortgage. As punishment, the senior mortgage can, in whole or in part, be made subordinate to the formerly subordinate mortgage. This actually happens.

Senior lenders risk loss of priority when they agree to modify the senior loan.

The risk of lost priority forces senior lenders to proceed gingerly in their dealings with borrowers. Anything a senior lender does to modify the senior loan might later be deemed to "increase the burden" on the property. Unless a modification unambiguously reduces the borrower's burden (say, the senior lender agrees to decrease the interest rate), this principle means the senior lender must obtain the consent of the subordinate lender before agreeing to any change in the senior loan.

A variation on this problem arises when the senior loan contemplates that the senior lender will or may advance additional loan proceeds after the closing. Whether the first lender will preserve its lien priority for these future advances (as against subordinate mortgages) usually depends on whether the senior lender's obligation to lend more money was "optional" or somehow "obligatory." The treatment of this issue varies extensively among states.

A similar problem can arise in some multiproperty loans. If the senior lender releases part of its collateral (one site out of ten) because of a paydown of the loan, the release can create similar "subordination" concerns for the senior lender's lien on the remaining collateral. If the paydown was in hindsight deemed to be insufficient, then it increased the allocable effective amount of indebtedness—the "burden" of the loan—on each of the remaining sites, just like an additional advance or a rate increase on a single-property loan.

A senior lender can mitigate these risks by including language in the senior mortgage documents that places subordinate lenders "on notice" of possible future amendments, advances, or inadequate paydowns. As the price of consenting to subordinate financing in the first instance, the senior lender can require the subordinate lender to consent in advance to all these events, perhaps within specified limits, and acknowledge they will not impair the priority of the senior mortgage.

Later, if the borrower wants or needs to modify the loan, any such modification will often be part of a workout that also benefits the subordinate lender. A senior lender willing to agree to such a modification can, as a condition to its agreement, try to obtain:

- The subordinate lender's written approval;
- A recorded modification of the senior mortgage; and
- Updated title insurance to confirm that the change did not cause any subordination of the senior mortgage.

Of course, if the subordinate lender refuses to consent to the loan modification, or if unexpected nonconsensual liens (such as judgments) arise, then the senior lender might not be able to obtain updated title insurance.[1]

Three-Way Negotiations

If a transaction involving a subordinate lender ever goes into default, the subordinate lender needs to be "at the table," as it can often veto any modification of the senior loan. Its consent may be needed for many common elements of a workout: capitalization of interest; conversion of a floating rate to a fixed rate or vice versa; additional advances of the loan to correct problems; a lockbox; changes in management procedures; and other loan modifications.

The subordinate lender may second-guess and complicate discussions. As the price of its consent, the subordinate lender may try to force the senior lender to buy it out, or at least to pay it down.

To mitigate the risk of a "holdup" by the subordinate lender, a senior lender can insist, at the original loan closing, that any subordinate lender pre-approve a wide variety of possible agreements that the senior lender might later make with the borrower, or that the subordinate lender completely waive any right to withhold consent to such agreements. Ultimately, if the subordinate lender creates too much trouble at the

"workout" table, the threat of a foreclosure under the senior mortgage, though drastic, may be a great way to obtain cooperation.

Subordinate lenders may intentionally or unintentionally impair shared collateral.

Protection of Collateral

A subordinate lender can take a number of actions that intentionally or unintentionally impair the shared collateral. Here are six examples:

- The subordinate lender can terminate leases in a foreclosure action;
- It may disapprove a lease that both borrower and senior lender believe is beneficial;
- It may frustrate the borrower's leasing program by refusing to enter into nondisturbance agreements;
- It may attempt to control insurance proceeds or condemnation awards in a manner inconsistent with the senior lender's preferences;
- It can establish but mismanage an escrow account to pay real estate taxes or other basic carrying costs; and
- After a default, it can appoint a receiver that mismanages the building or applies rental income solely to the subordinate mortgage.

To mitigate these risks, the senior lender can limit the rights of the subordinate lender to take any of these actions by including appropriate restrictions in the subordination agreement between the lenders. The senior lender will also want to assure that the subordinate lender cannot "leapfrog" its priority by acquiring any interest in the property that might be superior to the senior mortgage, such as the lien for unpaid real estate taxes. And if the subordinate lender somehow receives a voluntary prepayment on its loan, the senior lender may want that prepayment to be applied instead to the senior loan.

Inconsistent or Confusing Obligations

The subordinate mortgage and the senior mortgage may impose inconsistent obligations on the borrower. Contradictory obligations may divert the borrower's attentions. The subordinate lender may seek to declare a default and to exercise remedies as a result of acts or omissions by the borrower that did not violate the senior mortgage.

To avoid these problems, the senior lender needs to control and understand the terms of the subordinate mortgage. If the senior lender agrees to a subordinate mortgage whose terms are inconsistent with those of the senior mortgage, the senior lender should require the subordinate lender to waive the benefit of those inconsistent requirements wherever appropriate. Although the senior lender cannot always extract such a waiver, it can be alert for covenants that restrict the senior lender's flexibility. For example, the subordinate loan documents might (and commonly do) prohibit the borrower from agreeing to modifications of the senior loan. Any such restriction might vitiate any provisions in the subordination agreement between the two lenders that allow the senior lender to agree to future amendments with the borrower without the subordinate lender's consent.

The Race to the Courthouse

When a borrower defaults, the subordinate lender typically tries to complete its foreclosure before the senior lender can. If the subordinate lender achieves this goal, then when the subordinate lender later negotiates with the senior lender, it does so as the owner of the collateral, a stronger and more stable position than merely holding a defaulted subordinate lien.

A quick transfer of title to the subordinate lender may indirectly benefit the senior lender. The subordinate lender as owner may be more flexible and more willing to invest more money in the property. On the other hand, time pressure on the subordinate lender early in the default process may lead the subordinate lender to act more precipitously in exercising remedies. This may accelerate the inevitable borrower bankruptcy. The sooner the subordinate lender starts foreclosure, the sooner the property may descend into chaos.

The senior lender should consider how to mitigate this risk in negotiating its subordination agreement with the subordinate lender. The senior lender should try to include "standstill" provisions that preclude the subordinate lender from exercising remedies without the senior lender's consent. In effect, a senior lender would prefer to limit the subordinate lender to having only one right: the right to wait for the senior foreclosure sale; to bid at that sale; and to receive any excess proceeds after the senior lender has been paid.

Foreclosure Complexity

Once the senior lender starts to foreclose, a subordinate mortgage will complicate an already com-

plex proceeding. The subordinate lender may be more ready, willing, and able than the borrower to mount an aggressive defense. In a default context, the value of the collateral will typically have declined below the sum of the two loan balances so that all (or most) of the value of the collateral will be consumed by the senior loan. The subordinate lender may therefore assert not only the usual panoply of borrower defenses and counterclaims but a series of related theories from the perspective of a subordinate mortgage, such as the following:

- The senior lender modified its mortgage;
- It did not supervise the senior loan;
- It did not properly assure that senior loan advances were applied to increase the value of the collateral;
- It waived the borrower's obligations in a way that damaged the subordinate lender;
- It failed to disclose information;
- It conspired with the borrower;
- It committed other acts or omissions that amounted to bad faith, irresponsibility, and so on, and it should be punished; or
- When it foreclosed against only part of its collateral, it lost its lien as against the rest of its collateral, perhaps because it bid the full amount of its loan.

> A simple approach allows the subordinate lender to protect its position, but to "put its money where its mouth is."

Theories that a subordinate lender might assert are generally fact-sensitive and hence expensive to deal with, requiring extensive discovery. This is particularly true when the senior loan documents contemplate future advances for borrower activities such as capital improvements, leasing commissions, or, worse, ground-up construction.

When the senior lender is asked to approve the subordinate loan, the senior lender can try to protect itself against the risk that the subordinate lender may complicate a foreclosure. The senior lender can try to obtain prior agreement from the subordinate lender not to raise any defenses, particularly the costly defenses described above. The subordinate lender could also be required to agree that such defenses may be asserted only as affirmative claims in an action separate from the foreclosure.

The senior lender might involve the subordinate lender in loan administration. For example, the subordinate lender could be required to sign off on disbursements, effectively precluding future claims of mismanagement or incompetence. As extra insurance, the senior lender might require the subordinate lender to agree to deliver periodic estoppel certificates. Of course, measures like these place additional administrative burdens on a senior lender.

A Different Approach

A senior lender may wish to propose a simpler approach to the interaction between senior and subordinate loans. Instead of devising elaborate rights, obligations and procedures, and facing the risk of a fight, the two lenders could agree that if the loan goes into default, the subordinate lender will be given two very simple options.

First, the subordinate lender could buy out the senior loan. This would allow the subordinate lender to protect its position if it believed the value of the property supported both the senior loan and at least part of the subordinate loan.

Second, if the subordinate lender did not believe the property value supported both loans, then the subordinate lender would "pass" on its purchase option, but would then be required to abandon its position or assign that position to the senior lender.

This very simple approach would allow the subordinate lender to protect its position, but it would also force the subordinate lender to "put its money where its mouth is," and decide with its own cash whether there is value in its position worth preserving. After a default, this approach would protect the senior lender from the subordinate lender's sniping, attacks, and interference, and eliminate many of the risks of subordinate financing. It might even help restore the pristine and Zen-like simplicity that rating agencies want to see when they examine the capital structure of a mortgage borrower. To the author's knowledge, this solution to subordinate mortgages has not actually been tried.

Marshalling of Assets

In a foreclosure of a senior mortgage that is also secured by other property, a subordinate lender may try to force the senior lender to "marshal the borrower's assets," that is, to proceed against the other security before it proceeds against the security common to the two lenders. Any such campaign by the

subordinate lender creates more factual and procedural issues that produce more delay, expense, and exposure.

To mitigate this risk, the senior lender can insist on the express right to foreclose separately or collectively on any collateral in whatever order it chooses. It can also require the subordinate lender to waive "marshalling."

After a default, the subordinate lender can try to detect "flaws" in the senior mortgage.

Defects in Perfection

When a loan goes into default, the subordinate lender has a significant incentive (and usually the resources) to apply a microscope to the validity and perfection of the senior mortgage (i.e., proper recordation against all appropriate collateral). Any defect in perfection could gratuitously elevate the priority of the subordinate mortgage. The senior lender can, of course, readily prevent the problem by properly perfecting its senior mortgage in the first instance.

When the senior lender is asked to approve subordinate debt, it should try to persuade the subordinate lender to agree that, to the extent the senior mortgage might be improperly perfected, the subordinate lender's position will be held in trust for the senior lender's benefit.

Problems Raised by Borrower's Bankruptcy

After a default, when the borrower files its inevitable bankruptcy proceeding, the subordinate lender becomes a competing creditor and a separate class of debt. The existence of multiple creditors increases the complexity of subsequent events and issues. It eliminates some of the benefits of lending to a single-asset entity.

Worse, the borrower and the subordinate lender might collude to facilitate a "cramdown" of the senior mortgage. Together, they might concoct a plan or reorganization that (in some immaterial way) "impairs" the subordinate mortgage, thus artificially creating a class of impaired creditors to support a "cramdown" of the senior debt.[2]

In bankruptcy, defects in perfection (see above) or in procedural steps that might be appropriate (e.g., filing a proof of claim in some cases) can become crucial issues in the battle among lenders. Both the debtor and subordinate lender will scrutinize the senior lender's position. If the senior lien is not fully perfected or the senior lender missed some procedural step, the borrower and subordinate lender may work together to set aside the security.

Finally, the subordinate lender may be tempted to provide "debtor-in-possession financing" to the borrower, secured by a "super-priority" lien that would come ahead of the senior mortgage.

Again, the senior lender can protect itself by agreement with the subordinate lender. This document can limit and restrict the subordinate lender's rights in a borrower's bankruptcy. It can limit the subordinate lender's right to provide "debtor-in-possession" financing or to interfere with the senior lender's exercise of its rights in the bankruptcy and can try to protect the senior loan against claims that it was not perfected.

Extra Stress on Borrower

The mere existence of a subordinate mortgage increases the burden on a property's cash flow. If cash is already tight, the creation of a subordinate loan may only worsen the property's cash flow difficulties and increase the risk of bankruptcy.

The senior lender might insist that if the property can no longer support debt service payments on the subordinate loan, the subordinate lender will waive or defer them, thus decreasing (or at least postponing) the risk of default.

Subordinate Lender Nonperformance

Although the senior lender may, to mitigate the risks described above, obtain a subordination agreement from the subordinate lender, the latter might simply violate the agreement. Certain violations could leave the senior lender with complicated claims for damages against a virtually judgment-proof subordinate lender. If the subordination agreement does not bind third parties (such as tenants), the senior lender might be left to suffer the consequences of the subordinate lender's nonperformance, with no real remedy.

If the subordinate lender were itself subject to a bankruptcy proceeding during a foreclosure of the senior mortgage, the subordinate lender's bankruptcy proceeding would inhibit and delay the lender's foreclosure effort. Furthermore, in its bankruptcy proceeding, a creative subordinate lender might conceivably try to set aside any subordination agreement that it had made with the senior lender, by somehow characterizing the agreement as an "executory contract" or a "voidable transfer."

As in any creditworthiness issue, the senior lender's best protection is to deal only with a creditworthy subordinate lender. Perhaps it can insist on credit enhancement or security. It might also obtain a lien on the subordinate mortgage itself, but this solution creates its own panoply of issues and concerns. The senior lender can obtain some comfort by controlling what goes into the subordinate mortgage and making sure it cannot be amended or transferred.

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Differing State Laws

The relationship between subordinate and senior lenders, often rocky, has in some states been the subject of legislative "improvement." California, for example, allows certain subordinate lenders to file notices that require the senior lender to give timely notice to the subordinate lender if a senior loan goes into default. Other states may have similar requirements.

Consequently, senior lenders need to understand the peculiarities of laws in states in which they operate, and must evaluate whether they are willing and able to comply with them. If not, they should reconsider whether to make the loan, or try to find some other solution.

Administrative Problems

In addition to statutory requirements for notices, subordinate lenders often ask the senior lender to agree to provide both notices of default and the opportunity to cure any default under the senior mortgage. Any such requirement can be a pitfall for the senior lender—just another opportunity to do something wrong and be punished for it.

To mitigate this risk, senior lenders can refuse to agree to burdensome notices and opportunity to cure. A senior lender can, instead, try to persuade the subordinate lender to rely on its "due process" right to be notified of the foreclosure and to bid at the sale. If these efforts are unavailing but the senior lender nevertheless wants to proceed, the senior lender must train its asset management personnel to remember the special requirements of the subordinate lender.

Problems of General Complexity

The sheer length of the above list of "risk factors" amply demonstrates that the existence of subordinate mortgages will increase the complexity of any transaction as well as its legal and underwriting issues. Along with extra expense and delay, complexity brings the risk of loose ends, gaps, and unexpected factual circumstances that no one thought of during the negotiations and closing.

THE BENEFITS OF SUBORDINATE FINANCING

If a senior lender can mitigate the risks that subordinate financing can create, such financing can also create some significant benefits for a senior lender.

Making the deal possible. Some transactions simply will not work without subordinate financing. In these cases, if the senior lender does not permit subordinate financing, it will not be able to close and "book" the loan. In the long run, of course, a successful closing of a bad deal may be much worse than no closing at all. Losses eventually suffered on the loan may dwarf the fees initially collected by making it.

Curing defaults. If the borrower defaults, the subordinate lender has an incentive to try to protect its position. Thus, although it has no obligation to pay, it becomes a possible substitute source of payment to the senior lender.

Someone to do the dirty work. If both loans are in default at the same time, as is often the case, the senior lender may be not at all reluctant to allow the subordinate lender to take over ownership of the collateral. The senior lender can then sit back while the subordinate lender fights with the borrower. This works best, of course, if the subordinate lender is willing to keep the senior mortgage current.

Underwriting comfort. The fact that a subordinate lender is willing to make its loan reinforces the senior lender's assessment of the value of the collateral. This is true, of course, only to the extent that the subordinate loan is "hard-money" rather than pure "seller paper."

Bidding at the sale. At a foreclosure sale, if the value of the collateral has not declined below the outstanding balance of the senior mortgage, the subordinate lender has an enormous incen-

tive to bid for the property. This bidding may increase the proceeds from the sale and the likelihood that the senior loan, or a meaningful portion of it, will be paid off from the foreclosure. Most subordinate lenders would also have an incentive to attract other bidders to the sale, which would improve the senior lender's expected outcome.

Another investor. If the property needs cash for capital projects beyond the borrower's capabilities or inclinations, the subordinate lender may be willing to provide it.

Exit strategy. The subordinate lender may be the most logical source for take-out financing to repay the senior mortgage when it matures. If the senior loan is not fully amortizing, the existence of the subordinate lender can help the senior lender prevent a problem upon maturity.

CONCLUSION

This article summarizes the problems that subordinate financing can create for a senior lender. The bottom line may be that the rating agencies are right: the only good subordinate mortgage is a subordinate mortgage that encumbers someone else's collateral. In some transactions, however, the potential benefits of subordinate mortgages may lead a senior lender to try to mitigate the risks of subordinate mortgages, and perhaps even go a step further and accommodate concerns that a prospective subordinate lender might raise. ■

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1. A senior lender might have insisted at the original closing that the title company review the subordination agreement and commit to provide this type of insurance for future modifications, without any need for the subordinate lender's consent to any particular modification.

2. The term "cramdown" refers to Bankruptcy Code Section 1129(b)(1), which under certain circumstances allows a debtor to alter or restructure its debts over the objections of its creditors. The requirements are complex, but if at least one class of impaired creditors accepts the plan of reorganization, it might be "crammed down" on objecting creditors.

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