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From virtually the beginning of the market dislocation that began in 2007, institutional lenders have sought to clean up their balance sheets, raise cash, and reduce their exposure to real estate by disposing of their loan holdings in the secondary debt market. Although transactional activity slowed nearly to a halt in the fourth quarter of 2008 and has yet to regain much velocity, many originators and holders of real estate debt remain liquidity-constrained. As a result, this market should eventually become active again, particularly if valuation and pricing stability returns to the market.

Purchasers of interests in existing real estate loans have historically been most concerned with property performance and the financial stability of the borrower. Those risks still exist, and in fact are likely getting worse, but they are usually reflected in the pricing of an investment. The ability of other lenders in a given capital structure to perform has, however, generally been taken for granted, especially when those lender counterparties were well-known institutions. But now consider a few scenarios:

- A construction loan made by a commercial bank and secured by a mixed-use development was syndicated into multiple *pari passu* notes. One of the note holders, a fund managed by an institutional advisory firm, defaulted on its obligation to make its share of a loan advance to which the borrower was entitled. As a result, the borrower was unable to pay a number of contractors, causing significant delay in completion of the project.
- Pursuant to a participation agreement governing loan participations sold in a fully funded acquisition loan, the originating lender collected monthly debt service payments from the borrower and disbursed the proceeds to the participants. The originating lender subsequently sought bankruptcy protection. Debt service payments made by the borrower following the originating lender's filing were not disbursed to the participants, but instead were treated as assets of the originating lender's estate pending completion of the bankruptcy proceeding.
- At the time it originated an acquisition loan secured by a fully leased office building in which a number of leases were expected to expire, the originating lender structured the loan as a senior first-mortgage loan and a junior mezzanine loan. The mezzanine loan was subsequently sold to an investor. Under the terms of the senior loan, the borrower funded amounts monthly into reserves to pay for future leasing costs.

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The senior lender collected these funds and maintained the reserves, but commingled the funds with other reserve funds held in connection with other loans to other borrowers. Citing liquidity problems, the senior lender refused to disburse funds from the reserves when requested by the borrower, who then requested that the mezzanine lender fund the leasing costs. The mezzanine lender was unwilling to fund, as it had no contractual obligation to the borrower and the inter-creditor agreement between the originating senior lender and the mezzanine lender did not contain any provisions with respect to such senior lender defaults.

These examples make it clear that investors in real estate debt are facing a new reality. They must focus not only on the viability of the real estate project and the financial stability of the borrower, but also on the creditworthiness, liquidity, and stability of the holders of other interests in the debt capital structure, including senior and junior loan holders, co-lenders, and holders of participation interests. For purposes of this article, we will refer to such other loan interest holders generally as "counterparties."

Investor concerns about counterparty default risk are amplified by the multi-layered and complex capital structures that were created during the real estate boom years and the variety of different institutions often present in an existing loan structure, such as foreign and domestic commercial banks, investment banks, life insurance companies, institutionally managed commingled real estate or private equity funds and hedge funds. As highlighted by the examples above, much of the risk investors face relates, directly or indirectly, to the obligations of lenders with respect to future fundings or disbursements from reserves, although there are a host of other scenarios that can cause investor anxiety. Fortunately, a large proportion of real estate debt currently outstanding is fully funded. In these transactions, the risk of future funding defaults does not really exist, except perhaps in connection with releases of funds from reserves and escrows during the term or upon maturity or refinancing. At the same time, however, a significant number of real estate loans contain some form of future advance feature. In the current climate many of the parties obligated to make these advances face real challenges to their liquidity and, perhaps, even their long-term viability, making the risks inherent in these types of transactions, and steps that can be taken to mitigate them, worthy of further discussion. In the real estate recession of the early 1990s, this risk typically existed to a much lesser extent, if at all. Loans were generally made by commercial banks and held on their balance sheets or syndicated to other banks. And while the savings and loan industry suffered from liquidity and solvency issues, most of the players in the commercial real estate debt market remained sound. In today's environment, however, many holders of debt interests may be less well capitalized, or less liquid, than their borrowers.

As a starting point, investors should understand the rights, obligations, and remedies under the loan documents, including documents governing the counterparty relationship (such as co-lender, inter-creditor, or participation agreements) and appreciate the counterparty risks that may exist in each investment opportunity. The interests most commonly available on the secondary debt market that involve counterparty risk generally fall into one of three categories: participations, co-lender structures, and senior/mezzanine loans. In the case of participation interests, the seller is often the originator of the underlying loan, who retains a senior interest and the role of "agent" or "lead lender" and is typically the only party with direct contractual privity with, and primary obligations to, the borrower. Participants acquire individual interests that are fully derivative of the originating lender's interest and that are governed by a participation agreement. Alternatively, in the case of co-lender arrangements, while there is often an originating or agent lender, the co-lenders are usually direct parties to the credit agreement with the borrower. The relative rights and obligations of the co-lenders amongst themselves are governed by specific provisions in the credit agreement or in a separate co-lender agreement. In the mezzanine loan structure, each of the loans—first mortgage and perhaps numerous layers of mezzanine debt—is a separate transaction between the lender and a borrower, with separate loan documents. The borrowers under each such loan are usually controlled by a common parent or sponsor, and each loan is secured by its own collateral. The relationship between the senior first mortgage and the mezzanine loans is governed by one or more inter-creditor agreements.

As mentioned above, the risk that gives both borrowers and lender counterparties the greatest anxiety is that a lender will fail to fund agreed-upon future loan advances when requested by the borrower. The exposure

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of an investor in a debt structure in which one or more counterparties has such an obligation may vary depending upon how the interests in the loan are structured. If the loan has been structured as a participation, the primary future funding obligations generally remain exclusively with the lead lender, and the future funding obligations of the participant lenders are governed by a participation agreement. If the borrower requests a future advance under the loan, the lead lender notifies the participant lenders of such request and, pursuant to the participation agreement, each participant lender, as well as the lead lender, is obligated to fund its share of the requested advance. If a participant lender fails to fund a future advance, such failure generally does not relieve the lead lender of its obligation to the borrower for the full amount of the requested funding, although the lead lender generally can avail itself of remedies in the participation agreement against the defaulting participant. At a minimum, a lead lender that funds on behalf of a defaulting participant should be able to offset amounts to which the defaulting participant would be entitled out of repayment proceeds, although the lead lender would initially be out-of-pocket in funding the amounts the defaulting participant failed to fund. Additionally, the participation agreement may require the non-defaulting participants to fund, on a pro rata basis, the shortfall caused by a defaulting participant lender. In such case, remedies may also be available to the non-defaulting participants in the applicable participation agreement, such as dilution of the defaulting participant's interest to reflect the amounts funded by the other participants or the defaulting participant's loss of voting or approval rights on major decisions, such as whether to foreclose on or work out a distressed loan.

Even if the non-defaulting lenders are not contractually required to fund the defaulting lender's share of the future advance, non-defaulting lenders should consider that the failure by a participant to fund its share of an advance may result in borrower defaults under the underlying loan, as the borrower is likely relying on the future advance to complete construction or to lease, manage, and operate the underlying real estate asset, and could give rise to a claim by the borrower for damages against the lead lender. Although the sole contractual privity in participated loans is between the lead lender and the borrower, an aggrieved borrower may seek to include the participants in its cause of action. The lead lender and the participants can protect themselves against the risk of borrower claims through sufficient indemnity provisions pursuant to which a defaulting participant indemnifies the lead lender and the other participants from any loss or liability caused by its failure to fund. The value of such an indemnity, of course, depends on the creditworthiness of the indemnitor.

Many of these same issues exist in the context of a co-lender structure, except that no single co-lender is solely or primarily responsible to the borrower; typically each co-lender is directly responsible to the borrower only for its respective share of the future funding obligations. As a practical matter, the other co-lenders have an incentive to fund the non-funded amount so that the borrower can meet the obligations to which the funds were allocated, although the non-defaulting co-lenders generally are not obligated under the co-lender agreement to fund such shortfalls.

In the case of an investment in a structurally subordinated interest, such as a mezzanine loan, where the investor acquires a separate, stand-alone loan, the rights and obligations of senior and junior lenders are generally governed by one or more inter-creditor agreements. However, while participation and co-lender agreements have historically addressed the implications of a default by another lender, most inter-creditor agreements have focused only on rights and remedies available to the senior or junior lenders following a borrower default. Consistent with the example above, most inter-creditor agreements in force today do not include rights or remedies in favor of the junior or mezzanine loan holder following a senior lender default. In fact, most "standard" inter-creditor agreements state that neither the senior nor mezzanine lender owe any particular duty of care to the other in the administration of their respective loans, which would make it difficult for a mezzanine lender to succeed in a claim for damages against the senior lender following a default by the senior lender in its obligations to the borrower. Instead, the junior loan holder will likely have to stand by while the dispute between the senior lender and the borrower is resolved, unless the junior lender can exercise a negotiated right to purchase the senior loan at par and assume the obligations of the defaulting lender. Neither of these options are optimal or particularly attractive.

Given the increased complexity of loan structures and documents entered into during the real estate boom, it is not surprising that lenders are now discovering that

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many scenarios involving lender defaults were not adequately addressed in the applicable agreements, if at all. While we discussed generally how counterparty defaults might be treated under typical documents, in considering a new investment prospective investors should consider whether the documents they are buying into (the participation agreement, the co-lender agreement, or the inter-creditor agreement, as applicable) provide adequate protective measures in the case of a counterparty lender default. While it would be nice to obtain one or more of the most obvious credit support mechanisms, such as letters of credit, guaranties, or an escrow of funds, these options are inconsistent with a seller's goal to reduce exposure in a given loan and thus will likely be resisted by the seller. Some other rights or remedies that a prospective investor could seek to obtain (in addition to those that may already exist in existing "standard" documents) include:

- A right in favor of the investor to cure a defaulting lender's breach coupled with a priority security in the underlying collateral to secure the amount funded to cure the breach. This approach would be most useful in a first mortgage loan/mezzanine loan structure where the senior lender retains future funding or reserve disbursement obligations. Ideally, the mezzanine loan holder would record a mortgage for a nominal amount at the time it acquires its interest and the inter-creditor agreement would provide that amounts funded by the mezzanine loan holder to cure senior lender defaults could be secured by such mortgage and have priority over amounts otherwise owed to the senior interest holder.
- A security interest in a selling counterparty's loan interest in favor of an investor to collateralize the counterparty's ongoing obligations, which would be perfected through the applicable provisions of the UCC. This option would only be available in transactions where a selling lender retains interests in the overall debt structure and would protect the investor only against the risk of the selling lender's default. The investor acquiring an interest would become a secured creditor of the selling lender, with the resulting priority of claim in a possible future bankruptcy of the selling lender. This option may be more easily obtained by a mezzanine loan holder to secure amounts funded to cure a senior lender's default than by an investor to obtain a security interest in the underlying collateral.
- Automatic, self-operative subordination of a defaulting lender's entire lien on the underlying collateral and right to repayment from the underlying loan. While mezzanine loan holders are structurally subordinated from the outset, holders of co-lender and participation interests often hold their interests on a *pari passu* basis with the other co-lenders or participants, as applicable. Having the full amount of its investment put at risk would create a meaningful disincentive to a counterparty considering whether to default with respect to future funding obligations, particularly in the case of a construction loan that is near maturity and repayment via permanent refinancing.
- A right to buy out or force a sale of a defaulting counterparty's interest at a significant discount to par, similar to the remedy often seen in commingled real estate or private equity funds for an investor's failure to fund a capital call. While appealing on its face, in the current economic climate, it may be difficult to find a party willing to take over the defaulted counterparty's interest (especially if it would require assuming ongoing funding obligations) unless the discount is significant.
- A requirement that the interests of lead lenders in participation or co-lender structures be held by single-purpose entities established in a manner to protect against consolidation into a parent bankruptcy. While this structure would not protect against future funding defaults, since the single-purpose subsidiary will remain dependent upon its parent for capital, it would help protect against many of the risks associated with lead lender bankruptcies in participations and co-lender structures. For example, in transactions sponsored by Lehman Brothers, if the lead lender's interests had been held through a single-purpose subsidiary, upon the bankruptcy filing of the parent, the subsidiary would likely have remained outside of the bankruptcy. Payments made by the underlying borrower would thus not become part of the parent's bankruptcy estate.
- A right to restrict transfers by a counterparty lender of its interest in the loan, or at least its future funding obligations, only to parties approved by the other counterparties.

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Investors should keep in mind that taking advantage of these remedies may require a coordinated effort among the non-defaulting counterparty lenders. Given the diversity of holders of real estate debt interests, the interests of counterparty lenders may not always be aligned and agreement on an approach may be difficult to reach. In addition, the effectiveness of some of these protective measures may be hindered if the counterparty default occurred in the context of a bankruptcy filing by such defaulting counterparty lender.

The bankruptcy of a counterparty lender in a real estate debt structure elevates many of the issues discussed relating to default risk to an entirely new level. Counterparties to transactions in which the affiliates of Lehman Brothers held an interest can attest to the difficulties they have faced since that company sought bankruptcy protection. Given that many of these issues are being litigated for the first time, it is difficult for investors to adequately protect themselves against a counterparty's bankruptcy. The enforceability of many of the rights and remedies found in current versions of participation, co-lender, or inter-creditor agreements, let alone the more enhanced rights proposed above, is being litigated presently. A thorough discussion of the bankruptcy law issues is, however, beyond the scope of this article.

It is difficult to predict how long the current instability in the market will last, and with it the risk of counterparty default. Evaluating a counterparty today is difficult given how quickly liquidity and credit can deteriorate in the current capital markets, and it can be very risky to rely on a counterparty's credit, even in the case of the most "brand name" counterparties. Furthermore, as we have discussed, counterparty lender defaults are a relatively new concern, and the existing loan documents inherited in a loan purchase may not provide adequate protections. As many of these provisions are considered and resolved by courts, more guidance will become available for loan purchasers. In the meantime, prospective investors should carefully consider and appreciate the risks and uncertainty involved and factor such risks into the valuation process of a secondary debt purchase.

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