"What Is Mezzanine Financing and Why Might It Be Useful?"

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Traditionally real estate financing has occurred when one or more lenders are given one or more mortgages on real estate (the “Mortgaged Property”) owned by a borrower (the “Mortgage Borrower”) as collateral for one or more loans. While many real estate loan transactions involve only a senior mortgagee (the “First Mortgagee”), it 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 (the “Second Mortgagee”). In underwriting their loans, lenders often rely upon a loan-to-value ratio, pursuant to which a First Mortgagee would limit its loan proceeds to a given percentage of the appraised value of the Mortgaged Property such as 70%. The Mortgaged Borrower may be able to raise additional funds by securing a Second Mortgagee willing to loan additional amounts at a higher interest rate. When a Mortgage Borrower encumbers its property with two or more mortgages the question arises as to whether the Mortgaged Borrower is over-leveraged and unable to support the combined debt burdening the Mortgaged Property.

"Mezzanine Financing" has evolved as many First Mortgagees have tried to navigate the many delays and difficulties of foreclosing on properties that have become over-leveraged and encumbered by a second mortgage. For example in situations where a mortgaged property may have declined in value, many Second Mortgagees often have the financial ability and incentive to delay and obstruct a first mortgage foreclosure. As the role of securitized loans has increased, rating agencies have also been particularly dubious about the risks posed by subordinate mortgages. Mezzanine Financing alleviates these concerns by providing non-mortgage subordinate financing thereby creating higher loan proceeds without subjecting a First Mortgagee to all of the undesirable features of second mortgage financing.

Mezzanine Financing generally utilizes a collateral assignment of the ownership interest in the Mortgage Borrower. The "Mezzanine Borrower" would own a 99% membership interest in the Mortgage Borrower (the “property-owning LLC”). As collateral for the Mezzanine Financing, the Mezzanine Borrower would pledge its membership interest in the Mortgage Borrower. Accordingly, the Mezzanine Lender would have a claim against the equity interest in the Mortgage Borrower, but would have no direct claim against the Mortgaged Property and no right to make a claim against the Mortgaged Property in the context of a first mortgage foreclosure.

From the borrower's perspective, the use of mezzanine financing enables it to obtain flexible loan structuring and higher loan proceeds that can be closed simultaneously with (or following) mortgage financing. Unfortunately, mezzanine loans are often underwritten at higher interest rates than traditional mortgage loans since a mezzanine lender will not be secured by any real property collateral. Mezzanine financing can also complicate mortgage loan negotiations since mezzanine loan obligations are typically repaid only with excess cash flow after payment of debt service, insurance, taxes, operating and capital expenses, resulting in the need for lenders to negotiate an intercreditor agreement to alleviate any conflicting interests.