



Negotiating Mezzanine Finance

In project and asset finance transactions, it is common for there to be more than one financier. This is particularly so where the amount of money the borrower is proposing to bring to the transaction does not satisfy the first ranking financier's credit or risk requirements. A commercial bank may, for example, only be willing to advance up to 60% of the total funds required to complete an acquisition/project, while the borrower can only access 20% of the total funds required as equity. The borrower must then look to other sources of funding the shortfall between the equity and the bank debt.

There are many ways in which funding for the shortfall can be provided – for example, as additional equity invested by a third party, as preferred equity or as second-ranking debt, often referred to as a mezzanine loan.

In this note we highlight some issues commonly faced by mezzanine financiers that should be kept in mind when negotiating the terms of the mezzanine finance with the borrower and the senior financier.

General structure of mezzanine finance

Mezzanine financiers are in a more vulnerable position than the senior financier due to the second-ranking position of the mezzanine debt. That is, in a traditional financing structure with a senior and mezzanine financier, the senior financier will be able to receive all amounts owing to it in full before the mezzanine financier is entitled to be repaid and the senior financier will also be entitled to control all enforcement action.

Commercial terms, interest rates and fees

One of the reasons why mezzanine financiers are willing to take the additional risk referred to above is that mezzanine financiers are usually able to require a higher interest rate and other fees than the senior financier on the mezzanine debt.

While the higher interest rate and fees are most often justifiable by the additional level of risk the mezzanine financier takes, it is important to ensure that the interest rate, default rate and fees do not become void as a penalty or unenforceable as unconscionable terms. There have been several recent cases on what constitutes a penalty, and while it is difficult to provide a definite answer on when an interest rate or fee may fall foul of these decisions, a lawyer will be able to provide you with a view on the risk of a specific transaction, after considering all the circumstances of the transaction as a whole.

There are two main approaches to the commercial terms of the mezzanine finance agreement. Either the terms are drafted to mirror the senior finance agreement or the mezzanine finance agreement contains less detailed representations, covenants, undertakings and default provisions than the senior financier will require. There will be many considerations to take into account when determining how to structure the document, including whether it is likely that the mezzanine debt will remain outstanding for a long period after the senior financier has been repaid. Regardless of the approach taken, it is important to ensure that there are "cross-default provisions" in the mezzanine finance agreement so that a default by the borrower under the senior finance agreement will also trigger a default under the mezzanine finance agreement.

Security and priority

Although the senior financier will have securities ranking in priority to the mezzanine financier, the mezzanine financier will require the borrower to provide the mezzanine financier second-ranking securities. Often these mirror the first ranking securities, and typically consist of a mortgage over any land and a general security deed over the borrower and any guarantors.

In addition to the security, the first ranking financier will usually insist on the financiers entering into an intercreditor deed or a deed of priority and subordination. Generally, there are two main purposes with this document:

- **Priority:** regardless of time of registration of the securities or anything else affecting priority, the senior financier's securities and rights will rank in priority to the mezzanine financier until the senior debt is fully repaid.



Banking & Finance Factsheet

- **Subordination:** the mezzanine financier's rights are subordinated to the senior financier, which usually means that the mezzanine financier cannot demand payment, accept payment or otherwise have the mezzanine debt repaid until the senior financier is repaid.

The intercreditor deed can be a complex document, and is often one of the most difficult documents to negotiate. This is particularly so where the mezzanine financier requires certain concessions from the senior financier. Some of the more usual (and useful) concessions that a mezzanine financier will request are set out below:

- **Limits on the first ranking debt (priority debt limit):** while it is usually accepted that all amounts to be advanced under the senior facility as at the date of the intercreditor deed will rank ahead of the mezzanine financier, the mezzanine financier may ask for a restriction on further advances or increases to the facility limit so that if the senior financier wishes to provide further advances to the borrower, these rank behind the mezzanine financier.
- **Restrictions on the type of fees that can be charged:** usually, in addition to the specific priority amount, the senior financier will also have priority for all interest, cost, expenses and fees related to the senior facility. It is important that the definitions of interest, cost, expenses and fees are carefully reviewed to ensure these cannot be used to potentially circumvent the priority debt limit (if there is one).
- **Standstill period:** often, in a situation where the borrower has defaulted, the senior creditor will require a mezzanine financier to 'sit tight' for an indefinite time without any right to enforce or accelerate its debt. A mezzanine financier may want to limit this to a certain time period. If, at the expiry of that period, the senior financier has still not taken any enforcement action, then the mezzanine financier will be free to take enforcement action. It needs to be kept in mind that the mezzanine financier will still need to account to the senior financier for all amounts recovered (up to the priority limit), but it allows the mezzanine financier to at least commence the process of enforcement and realisation.
- **Cure and takeout rights:** it may be in the mezzanine financier's interests (to preserve its position) to be able to step in and cure a default, or actually acquire the senior debt and security, before the senior financier has the right to enforce its security.

It is crucial, especially to a mezzanine creditor, to get the terms of the intercreditor deed right as these terms will determine when the mezzanine financier is able to enforce its rights and recover its debt.

Sometimes, either because of the first ranking financier's requirements or for reasons of practicality it is not possible to have two sets of securities registered and the senior financier and mezzanine financier may decide to set up a security trust structure, where a security trustee will hold the security for both the senior financier and mezzanine financier. While this can be a complex document and may often take some time to negotiate, it can also be an efficient way of governing the relationship between two financiers (and will also often contain the agreed intercreditor principles). Depending on the transaction, the security trustee can be either a professional trustee company (who will charge a fee) or a special purpose vehicle set up by the parties (and usually controlled by the senior financier).

Other times, the senior financier will refuse to allow any second-ranking securities to be registered. This puts the mezzanine financier in a vulnerable position, and while there may be certain ways of protecting the mezzanine financier's interest, it is a situation that should be avoided if at all possible.

In Queensland, unless a certificate of title has been issued for a property, it is generally not necessary from a registration perspective to have the senior financier's consent to register a second-ranking mortgage over land. This means that, technically, it is possible for a mezzanine financier to register its mortgage without entering into an intercreditor agreement with the senior financier. However, it is still recommended that consent is sought. If not, the borrower will most likely be in breach of its obligations under the senior finance documents when granting the mezzanine securities, which may entitle the senior financier to effectively sell the mortgaged property without any further consent or approval from the mezzanine financier.



Additional guarantees

A mezzanine financier may, due to the additional risk taken, be able to successfully negotiate additional guarantees from directors/shareholders or other members of the borrower group in addition to those given to the senior financier. This is not common, and often it will result in the senior financier requiring the same guarantees – however, it does occur. Often the terms of the intercreditor deed will still restrict the ability of the mezzanine financier to call on these guarantees, so it will be important to ensure that this is considered when negotiating the intercreditor deed.

Other issues

In addition to the above, there are a range of issues to consider and potential provisions to include in the mezzanine finance agreement or intercreditor deed depending on the nature of the particular transaction. There may be other relationships that should also be documented (for example with construction companies or joint venturers). These issues can only be properly considered once all of the surrounding details are known.

In order for the mezzanine financier to be in the best possible position, we recommend seeking legal advice early, preferably at the structuring stage, as this will allow the mezzanine financier's legal advisors to suggest appropriate structures and highlight some important points for negotiation early on.

Are Watne

Senior Associate | Banking & Finance

P: +61 7 3024 0407

E: a.watne@hopgoodganim.com.au