'Mezz' Lending — What Is It, How Does It Work?

Law360, New York (April 23, 2009) -- With banks making fewer senior loans, and the market for traditional second-lien financing all but gone, mezzanine loans have increasingly been used to bridge the financing gap.

Though mezzanine loans originally gained popularity in the real estate context, in the past couple of years companies have turned to mezzanine lenders to provide term loans for acquisitions and other corporate needs, in larger amounts and in greater numbers than ever before.

As with all types of debt financing, mezzanine loans have been negatively impacted by the economy in recent months. Still, as these types of loans continue to be available, they can provide a helpful alternative form of financing.

Basics of Mezz Lending

But let’s start at the beginning. What exactly is a mezzanine or "mezz" loan, and how is it different from other types of loans?

Mezz loans are a distinct type of capital, situated on the middle ground between equity and senior debt. Though structured as a debt investment, mezz loans were traditionally unsecured, and in many ways were expected to look and act a lot like an equity investment. This remains the case for many real estate mezz loans even today.

However, in the corporate lending context, these days mezz lending bears little resemblance to the traditional and has expanded to include everything between senior loans and equity — from unsecured financings that closely resemble preferred stock all the way to second-lien loans that look and act much like senior credit facilities.

Similar to Equity

Because mezz loans started out acting like equity — and in some cases converted what would have been an equity investment into a debt investment — it was intended that the loan would not be paid back for a long time.
Mezz loans generally have longer terms than senior loans, and carry little or no amortization during the life of the loan.

Indeed, to discourage early payment and keep rates of return high for the mezz investors, most mezz loans include prepayment penalties. Many also have "no-call" provisions prohibiting voluntary payment within the first two to three years.

Interest rates on mezz deals are typically high, in keeping with the concept that the return on investment should imitate that of equity (or get reasonably close, considering that the lender also has a right to the return of its principal).

Often, a portion of the interest will be paid “in-kind” meaning that it is not paid in cash but rather is added to the principal amount of the loan.

Over the past several months, interest rates on mezz facilities have increased dramatically due to market conditions. Loans with interest rates above 15 percent (including paid-in-kind interest) are common.

**Similar to Second-Lien Loans**

Over time, the lines between second-lien and mezz loans have become blurred in the corporate lending context. Many corporate mezz loans today are secured by second (or even third or fourth) liens on all of the borrower’s assets — a significant departure from past practice, and a departure from common practice in the real estate lending world.

Mezz lenders see value in obtaining a junior security interest, because they will then have significant additional rights in the event of a bankruptcy of the borrower.

A security interest can give the lender a seat at the negotiating table among the secured creditors, even in cases where there may not be sufficient assets to pay the secured creditors in full.

A junior loan would normally command a higher interest rate than a senior loan, because there is inherent risk whenever another creditor has the first right to be paid.

Perhaps as a holdover from when most mezz deals were unsecured, mezz deals are typically priced higher than traditional second-lien loans would be. This is true even when the mezz lender obtains a second lien and is otherwise in exactly the same position as a second-lien lender.

**Warrants vs. Co-Invest**

Unlike senior or second-lien loans, mezz loans are almost always accompanied by some form of equity interest in the borrower. Historically, this has taken the form of a warrant, which gives the lender the right to acquire stock or other equity interests of the borrower.

The lender usually will not exercise its purchase rights under the warrant until a liquidity event such as an
acquisition of the company occurs, at which point the lender can sell its equity and cash out immediately. Sale of the equity effectively results in an additional return on the mezz lender’s investment.

There are also many mezz deals that include an equity co-investment right instead of warrants. A co-investment right gives the lender the right to invest in the company and receive equity interests, similar to the private equity sponsors or other major investors.

With co-investment rights, the lender must make an additional cash investment above and beyond the loan amount, at the time the loan is made. In exchange, the lender will acquire the stock or membership interests at the closing, at the same price as the other investors.

Most of the terms applicable to the equity interests held by the lender will be the same as those for the other investors, though it is not unusual for the lender’s equity to have restricted voting rights.

**Loan Documents**

Mezz loan documents will generally mirror the senior debt documents in all important respects. To make things easier for the borrower and all of the lenders, exactly the same language is likely to be used for the representations and warranties, events of default, and all of the covenants.

Financial covenants — and sometimes the negative covenant baskets — will generally be set more loosely in the mezz loan documents, so that these provisions will not trigger a default on the mezz debt quite as soon as on the senior.

The senior lender will require this in order to further its position as first in line and protect its ability to take action if the company’s performance slips.

There will often be negotiation as to whether the mezz loan will be able to cross-default to the senior loan, or whether it must cross-accelerate, meaning that the mezz lender cannot declare a default under its loan based solely on a senior loan default unless the senior lender has also actually accelerated its loan.

**Negotiating Intercreditor Agreements**

Because mezz loans usually exist in a capital structure with other indebtedness, there is often a need for an intercreditor agreement. This will be required by the senior lender if the mezz lender has a security interest in the assets of the borrower.

Intercreditor agreements are typically heavily negotiated, as each creditor desires to protect its rights in the event of a default or bankruptcy.

Interest payments, and possibly a few other types of payments, will normally be permitted on the mezz debt as long as the senior debt is not in default.

However, there will usually be a payment blockage period and a remedy standstill period if there is a
default under the senior loan.

The senior lender will require these blockage and standstill periods in order to maintain control of the situation and prevent the mezz lender from effectively jumping ahead in any respect.

Because the senior loan is to be paid first, the senior lender will have the first right to control the disposition of collateral and any other actions that may be taken against the borrower.

Hot topics for negotiation include the duration of the blockage and standstill periods, limitations on amendments that can be made to both sets of loan documents, caps on the amount of senior debt, whether the mezz lender will have an option to purchase the senior debt, and many bankruptcy-related issues.

Very often, the senior lender expects the mezz lender to have a truly “silent second” lien on the assets, and the mezz lender will be asked to waive significant rights with respect to the collateral.

Though mezz loans carry the risk of being lower in the capital structure and subject to subordination, the higher potential returns on this type of debt can make it attractive to lenders.

Corporate borrowers continue to rely on mezz loans to fill the financing gap and get their deals done. There may be fewer deals overall these days, but mezz lending remains an important part of the financing picture.

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