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It is a common mistake to think that, as soon as a loan becomes "seriously distressed", the rights and ability of junior lenders to have a say in the workout process vanishes

Junior lenders can play hardball with special servicers

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In reality, and contrary to popular belief or what some more senior lenders may try to portray, junior lenders remain a powerful voice in most commercial loans, regardless of how poorly it is performing.

As the organisation that is normally "caught in the crossfire", the special servicer knows how important it is for junior lenders to understand their consent and consultation rights, particularly when a default has occurred.

Furthermore, from our perspective, it is often very desirable to have as much interaction as possible with the junior lenders as, without wishing to state the obvious, they have the most to lose. More importantly, the corollary is that they have the most to gain from a successful work out.

At outset, it is worth stating where, in my opinion, the misconception about junior lenders losing their rights comes from. A junior lender can lose their consultation and consent rights if, based on a current appraisal of the mortgaged property, the amount of value left in the relevant lender's tranche of the loan drops below, typically, 25% of the principal amount.

This concept is known as a control appraisal event. Although a 75% fall in the value of a junior tranche sounds large, it has happened far more than anticipated when many of these loans were originally made.

Fire the servicer

The first important point for junior lenders is that they may have the right to replace the special servicer to the A/B loan with one of their choice, although this will not impact the value of the assets or subsequent loss of rights.

That said, the second important point is that the servicer's authority to manage a loan is also balanced by various consultation or consent rights held, for the most part, by the junior lenders.

"Consultation rights" require a servicer to update those holding those rights with regards to certain planned actions or strategies and consider their suggestions prior to moving forward.

Such actions include: consenting to material alterations; approving the borrower's business plan; granting consent with respect to general leasing matters or changes in property managers; and releasing escrows held in connection with the loan.

The third point is that "consent rights", where they exist, will require the servicer to obtain specific approval of the junior lender prior to taking certain actions, such as: extending the loan maturity; modifying the monetary terms of the loan; changing the loan structure from debt to equity; releasing or substituting any collateral in the loan; permitting the borrower to take on additional subordinated debt; accelerating after a default has occurred; and commencing foreclosures against the property.

If the servicer receives a request from a borrower it will usually perform several tasks, including evaluation of the loan's performance and establishing whether the junior lender needs to be updated before going to a credit committee to seek request approval before sending the request to lenders.

In the event that the servicer does not receive a timely response, or in cases of urgent need, the servicer may take immediate action if necessary to protect the interests of the lenders.

However, in the event of the junior lender rejecting the servicer's request, the servicer is commonly prohibited from taking the requested action. If the junior lenders reject the request, the servicer is typically required to propose an alternative course of action for the junior lenders to approve.

This, too, can be rejected. However, loan agreements normally stipulate that the junior lender must agree a course of action within a time frame – typically 60 to 90 days – or allow the servicer to proceed without obtaining further consent from the junior lender.

Juniors take control

How can it work in practice? Earlier this year, Hatfield Philips concluded the £61m sale of three shopping centres in Shrewsbury. The shopping centres were security for a £82m A/B loan, originally provided by Lehman Brothers in September 2006. A valuation in June 2009 put the market value of the portfolio at £47m – a 60% decrease in value.

This decrease resulted in the B note holder being control-valued out of the loan and the "controlling class" status transferring to the most junior class of notes within the securitisation.

A final point is that all independent servicers should ensure that all loans are reviewed on a case-by-case basis to ensure consistency and independence of action in the interest of all parties before making any such material decision. In an A/B loan an independent servicer must be willing to apply the servicing standard and disregard conflicts to service the loan in the best interest of all lenders, and not favour any individual lenders.

Although this can be challenging, a junior lender should take comfort in the fact that it should be treated fairly and within the constraints of the contracts and, if that is not the case, invoke its rights and "fire the servicer".

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