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A rock and a hard place: The rights and remedies of a mezzanine lender

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As the real estate market faces one of the worst economic crises in recent memory, lenders and borrowers alike are scrambling to preserve and maximize the value of their investments. With property values falling and with difficulties in selling, recapitalizing or refinancing many real estate projects, mezzanine lenders must make the hard decision between walking away and foreclosing on its collateral. As tough as that choice might be, if the decision is made to exercise its remedies under the mezzanine loan, mezzanine lenders should be extremely careful in the course of action they take. Although seemingly simple, mezzanine lenders should be wary of the potential pitfalls in exercising their remedies.

Mezzanine loans generally

Mezzanine financing, in the broad sense, refers to non-conventional funding that shares characteristics of both debt and equity. In real estate, certain types of bridge/subordinate debt are generally referred to as mezzanine financing. Until recently, mezzanine loans were often used to bridge the shortfall between (i) the total costs of a project, and (ii) the equity investments raised plus the maximum amount of the mortgage loan for such project. Mezzanine loans were common and useful alternatives where junior liens on the underlying real property were prohibited by the first mortgage lender.

Although mezzanine loans can have different characteristics, uses and structures, the most common structure can be depicted as follows[1]:

For simplicity sake, this article will refer to the above structure and use the defined terms in footnote 1.

Governing law

Unless the mortgage borrower "opts-into" Article 8 of the Uniform Commercial Code (UCC), Article 9 of the UCC would generally govern the pledge, perfection and enforcement of the pledged collateral (which pledged collateral would constitute a general intangible except as described in the footnote below[2]). A prudent mezzanine lender will require mortgage borrower to opt into Article 8, because the mezzanine lender's interests may otherwise be adversely affected by another creditor if the pledged collateral was perfected under Article 9. This is because a security interest in a general intangible can only be perfected by filing a financing statement[3] whereas a security interest in investment property may be perfected by filing a financing statement or taking possession and/or control of the collateral[4]. A security interest perfected by control takes priority over one perfected by possession, which takes priority over one perfected by filing.[5] By requiring mortgage borrower to opt into Article 8 (thereby converting the pledged collateral from a general intangible to an investment property) and by the mezzanine lender taking possession and control of the certificated interest representing the pledged collateral, the mezzanine lender can have priority over another creditor that perfected its security interest with respect to the same collateral by only filing under Article 9.

Pre-foreclosure

Prior to exercising any remedies under its loan documents, the mezzanine lender should carefully review all loan documents to determine the extent of its rights. In addition, an intercreditor agreement typically will have been entered into between the mezzanine lender and the mortgage lender, setting forth the rights and restrictions of each party. Most intercreditor agreements provide the mezzanine lender with the right to cure the mortgage borrower's defaults under its loan documents (thereby preventing the mortgage lender from foreclosing out the mezzanine lender) and also with the right to purchase the mortgage loan at par. The mezzanine lender should carefully review any such intercreditor agreement. In addition to reviewing the relevant documents, the mezzanine lender should do the following:

A. Confirm that the UCC financing statement, pledged certificates (if any) and the UCC title policy are in the files and were all properly completed.
B. Obtain a title date down.
C. Determine whether any third-party consents are required or if there are any third-party restrictions with respect to the mezzanine lender's exercise of remedies.
D. Determine if there are any state specific concerns (e.g., engage local counsel) or any securities law issues.
E. Consider the steps and costs necessary to operate the property after foreclosure.

Foreclosure

If a default[6] occurs under the mezzanine loan documents, there are several statutory remedies provided under the UCC as follows:

1. Public and Private Sales

Whether the pledged collateral constitutes a general intangible or an investment property, the UCC permits both public and private foreclosure sales for each such type of collateral. Of the differences between a public and private sale, the most critical distinction for the mezzanine lender that is attempting to get control of the property is that mezzanine lender may not purchase the collateral at a private sale unless "the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations."[7] Equity interests in limited liability companies and partnerships generally are not traded in the marketplace so most mezzanine lenders are forced to conduct a public sale in order to preserve its right to purchase the collateral. As such, this article will focus mainly on public dispositions.

Unlike real property foreclosures (the process of which are usually outlined in detail under applicable statutes), Article 9 offers less detail on the process of public dispositions. What the UCC does provide is:

(i) That notice must be given to (1) the debtor; (2) any secondary obligor; and (3) certain other lienholders that have or had an interest in the subject collateral[8;]

(ii) the precise form of notice;[9] and

(iii) that the foreclosure sale must be "commercially reasonable"[10].

It is unclear what "commercially reasonable" means exactly. Neither the UCC nor the official comment provides much guidance and there is a dearth of case law on the subject. In the absence of a safe harbor rule or other guiding principles, prudence should dictate the mezzanine lender's foreclosure actions. Below are some matters for the mezzanine lender to consider in light of the "commercially reasonable" requirement:

a. Use the same notice period required for a foreclosure sale of real property in the applicable jurisdiction[11] notwithstanding that the UCC provides for a minimum notice period of 10 days for transactions other than consumer transactions[12].
b. Notify all potentially interested parties in addition to the required notice parties under the UCC.
c. Advertise in as many areas as possible and, to the extent applicable, target specific trade journals.
d. Engage brokers or other third parties who deal in the type of collateral being sold.

Of course, the above described actions often run counter to the goal the mezzanine lender is trying to achieve, such as (x) minimizing potential bidders to ensure that Mezzanine Lender will have the winning bid for the lowest bid price and (y) reducing foreclosure costs and expenses.

However, as various courts and commentators have noted in the past, the purpose of the "commercially reasonable" public sale is to maximize the bid price for the collateral and any actions taken (or not taken) to minimize potential bidders or to reduce foreclosure costs will increase the risk of a future challenge that the public sale was commercially unreasonable. the mezzanine lender should carefully analyze the likelihood of a challenge by a party given the particular facts (i.e., the identity of the potential bidders and whether they have any economic incentive to challenge the subject public sale), which oftentimes is a business evaluation, to determine the right course of action.

2. Collection

Article 9 permits the mezzanine lender to enforce the obligations of an account debtor on the subject collateral and require such account debtor to pay directly to the mezzanine lender[13]. In a typical mezzanine loan transaction, however, this remedy has limited value given that the mezzanine borrower is a single-purpose entity and should have no (or limited) account debtors.

3. Acceptance of collateral in satisfaction of debt

The mezzanine Lender should know that a "deed in lieu" type of remedy is available for a mezzanine loan. The mezzanine lender can accept collateral in full or partial satisfaction of the underlying debt. There are certain statutory conditions that must be met,[14] but an acceptance of collateral in satisfaction of the underlying debt (as compared to a public sale or judicial foreclosure) will save the mezzanine lender significant costs and, if done properly, will have less uncertainty (unlike a public sale) regarding any future challenges to the enforcement of such remedy.

4. Judicial foreclosure

Finally, judicial enforcement is available to the mezzanine lender. Although any judicial process will be more expensive than a non-judicial remedy, there may be certain circumstances under which a judicial foreclosure is necessary or desirable and such remedy is an option for the mezzanine lender to consider.

Summary

These are difficult times for most lenders and, perhaps, dire times for mezzanine lenders. As described in this article, it is critical for mezzanine lenders to understand the various practical limitations and underlying uncertainty when attempting to foreclose on its collateral. Although it may feel like being stuck between a rock and a hard place, a mezzanine lender can maximize the value of its investment by carefully navigating through the foreclosure waters.

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Footnotes

1--As shown in the example above, the investor(s) of the "property" sets up an entity to hold title to the "property." Such entity (mortgage borrower) obtains a loan from the mortgage lender (mortgage lender), which loan is secured by a mortgage, deed of trust or similar instrument. The investor(s) also creates an entity (mezzanine borrower) that owns all of the equity interests in mortgage borrower. The mezzanine borrower obtains a mezzanine loan from the mezzanine lender (mezzanine lender), which mezzanine loan is secured by a pledge of all of the mezzanine borrower's interests in the mortgage borrower (such collateral, the pledged collateral).

2--Pledged collateral constitutes a "general intangible" under Article 9 unless (i) the equity interests are publicly traded, (ii) the parties "opt in" to Article 8, or (iii) the pledged entity is a registered investment company. ("General intangibles" are defined as "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property..." UCC §9-102(a)(42)). An equity interest in a limited liability company or a partnership would be an "investment property" (and be excluded from the definition of "general intangibles") if such interest met one of the three listed exceptions.

3--See UCC §9-310(a).

4--See UCC §9-312(a), UCC §9-313(a) and UCC §9-314(a).

5--See UCC §9-328.

6--"Default" is not defined under the UCC and the UCC does not provide much guidance on whether a default must be material in order for the mezzanine lender to exercise its remedies. This article will not focus on this issue, but mezzanine lenders should, on a case by case basis, evaluate the default and determine if the exercise of its remedies is the proper course of action.

7--See UCC §9-610(c)(2).

8--See UCC §9-611(c).

9--See UCC §9-613.

10--See UCC §9-610.

11--See also UCC §9-611(e) which provides for a 20-day safe harbor rule.

12--See UCC §9-612.

13--See UCC §9-607.

14--See UCC §9-620, UCC §9-621 and UCC §9-622.

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