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Foreclosing on a Mezzanine Loan under UCC Article 9: A Guide to Remedies and Strategies

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As structured real estate finance has matured over the past several years, the requirements of the rating agencies (principally motivated by bankruptcy concerns) and the realities of the secondary market have greatly increased the use of mezzanine loans, which have largely replaced second mortgages in real estate finance. In the simplest mezzanine loan structure, the mezzanine lender makes a loan to the immediate parent entity of the mortgage borrower (and such parent entity typically contributes the proceeds to the mortgage borrower). The repayment obligation of the mezzanine borrower is typically secured by a perfected security interest in the equity interests owned by such parent in the mortgage borrower under Article 9 of the Uniform Commercial Code (“UCC”). Further, the lender will want to qualify as a “protected purchaser” under Article 8 of the UCC in order to cut off all adverse claims in the pledged equity collateral.¹ This evolution has continued to the point where more sophisticated real estate financings are structured with multiple tiers of mezzanine loans held by disparate lenders with preferences for different risk positions in the capital structure, with each tier sometimes carved into separate *pari passu* notes, or into an A/B or A/B/C note structure that creates subordination within a mezzanine loan tier. This article will focus on the remedies of a mezzanine lender under Article 9.

As real estate markets head into a downturn, mezzanine lenders, in prior loss position relative to mortgage lenders, will increasingly find themselves with borrowers in distress or

¹ Article 9 governs the perfection of security interests, and Article 9 refers a secured party to Article 8 in order to determine how perfection is accomplished for both certificated and uncertificated securities where the pledged entity has opted into Article 8.

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default. Undoubtedly, a mezzanine lender will be constrained to act by virtue of intercreditor arrangements with the mortgage lender and any senior mezzanine lenders; but after navigating those constraints, a mezzanine lender may have to contemplate enforcement of its remedies against its collateral. Article 9 allows enforcement of a mezzanine lender's remedies through a foreclosure of the equity interest regardless of whether the lender's security interest is in (1) investment property, as either non-certificated or certificated securities, perfected by filing, possession or control under Article 9 or (2) a 'general intangible' perfected only by filing under Article 9.² This article will explore the remedies and strategies available to a mezzanine lender under Article 9 of the UCC after a debtor default.

Before entering into substantive discussions with the debtor, a mezzanine lender should obtain a 'pre-negotiation' or "standstill" agreement to protect against potential reliance claims the debtor might interpose should the work-out negotiations or other discussions fail and foreclosure is the only course of action. While it may seem mundane, it is important for the mezzanine lender to inventory correctly and locate all of the relevant transaction documents, including UCC insurance policies, so that the same are available at the relevant time. It is not unusual that the professionals being called upon to restructure a transaction or carry out the exercise of remedies

² Most often, a limited liability company interest or a partnership interest will be a general intangible under Article 9 and not a security under Article 8 and, therefore, not investment property under Article 9. Official Comment 4 to Section 8-103 provides that (i) Section 8-103 (c) states the general rule that limited liability company interests and partnership interests are not securities unless they are in fact dealt in or traded on securities exchanges or in securities markets, and (ii) the issuer may expressly "opt in" by specifying that the interests or shares are securities governed by Article 8. "Opting in" may be accomplished by providing minimal language in the operating agreement or partnership agreement to the effect that the equity interests are governed by Article 8 of the applicable state's UCC. Subsequent perfection of a security interest in an Article 8 security as investment property under Article 9 may be achieved either through the filing of a financing statement, possession of a certificated security, or control of either an uncertificated security (through a control agreement among the issuer, secured party and debtor whereby the issuer agrees to accept instructions concerning the disposition of the equity from the secured party without further instruction from the debtor) or a certificated security by possession coupled with necessary endorsement. Furthermore, "[a]s an investment property, a security interest perfected by control or possession would in most cases take priority over an interest that had been perfected previously only by filing, even if the subsequent party had actual knowledge." (See James D. Prendergast and Keith Pearson, "How to Perfect Equity Collateral Under Article 8," 20 No. 6 Practical Real Estate Lawyer 33 (2004)). Because in a perfection contest, a security interest in investment property perfected by control trumps a conflicting security interest perfected by a method other than control (i.e., filing), mezzanine lenders have increasingly required equity collateral (1) to be a security under Article 8 and therefore investment property under Article 9 rather than a general intangible under Article 9, and (2) require that the security be in the form of a certificated security rather than a non-certificated security because of the material foreclosure leverage to the secured party holding certificated securities. A secured party has greater leverage when it already possesses the partnership or membership interests as certificated securities with endorsements, and does not have to go through a potential additional step of suing to compel a recalcitrant issuer to transfer certificated securities, as to which the security interest has been perfected by a contractual agreement, to the purchaser subsequent to the foreclosure sale. There are few if any drawbacks from the secured party's standpoint to having the debtor opt into Article 8. Limited liability companies and partnerships with multiple members may not want to opt in due to administrative complexities.

had no involvement with the original financing. If the debtor “opted into” Article 8, it is important to locate the share certificate or understand the control agreement. A mezzanine lender exercising remedies must also be cognizant of any transfer taxes that may arise on account of a transfer in foreclosure (or in lieu thereof). Reviewing the relevant transaction documents may also disclose curable problems, such as the failure to obtain a necessary endorsement to a certificated security, that might be remedied while the parties are still talking.

In planning post-default strategies, the secured party and its counsel must understand the nature of the debtor’s problems that led to the default, as well as the secured party’s endgame. The endgame may depend on whether the secured party is a ‘loan to own’ investor, institutional or otherwise, who acquired the mezzanine debt (perhaps after default) to acquire control over the real estate, or an institutional lender that may not have the interest or the capacity to own and manage the real estate and whose primary goal is to recoup as much of its investment as the asset will bear.

No step is more critical than to understand the impact that a foreclosure transfer will have on the various rights and interests underlying the mezzanine loan collateral, including the mortgage loan and any senior mezzanine loans, ground leases or material contracts pertaining to the underlying property. Any intercreditor agreements between the mortgage lender and the mezzanine lender (or among or between mezzanine lenders) will provide the most significant input into the timing and nature of remedies. The mezzanine lender’s best strategy may be to use the cure rights in the intercreditor agreement to stave off a foreclosure action by the senior lenders. One option provided to each junior mezzanine lender in the standard intercreditor agreement, in the event the mortgage loan is accelerated, foreclosed or becomes ‘specially serviced’, is the right to purchase at par each position senior to it.³

In exercising remedies, the collateral description is often broader than just equity interests (license rights, franchise rights etc.); therefore there may be additional foreclosure aspects outside the scope of this article to consider. There is generally no concern over a “one action” rule in that the collateral security for a mezzanine real estate loan is usually only personal property collateral (the equity in the land-owning entity), unless the mezzanine lender also obtained a second mortgage on the realty from the land-owning entity to secure the land-owning entity’s obligations under a guaranty of the mezzanine loan, and generally, there is no applicable anti-deficiency rule in Article 9 limiting a secured party’s claim for that portion of its debt and other charges remaining unpaid after the proceeds of a commercially reasonable foreclosure sale are applied.⁴ However, given the non-recourse nature of many mezzanine loans and the single-asset nature of the borrowers in real estate finance transactions, a deficiency judgment against the mezzanine borrower is of little value at best. In any event, a court may deny a deficiency judgment if it determines that a sale was conducted in a manner that was not commercially reasonable.

³ The industry standard intercreditor agreement can be found at <http://www.cmbs.org/WorkArea/showcontent.aspx?id=10064>

⁴ UCC Section 9-615(d). Some states, such as California, have non-uniform amendments to Article 9 governing mixed collateral foreclosures. Local law should always be reviewed prior to any foreclosure action.

Once a secured party has accelerated its loan (or upon maturity of the loan), several remedies are available. The watchwords for any mezzanine lender contemplating exercise of its remedies are commercial reasonableness. The UCC requires that commercial reasonableness be exercised at every turn, and at each stage of the process the mezzanine lender must confirm to itself that it has acted in a commercially reasonable manner.⁵ Failure to conduct a commercially reasonable sale can result in the loss of the right to a deficiency judgment (though not of great import to a mezzanine lender in a typical real estate transaction as previously indicated), and can also expose the mezzanine lender to damage claims by the debtor and others.

While mezzanine lenders will likely avail themselves of the expedited remedies under Article 9 of the UCC, it is at least worth mentioning that common law remedies remain available to a mezzanine lender. The mezzanine lender retains the right to maintain an action to enforce the note, obtain a judgment, then enforce the judgment by executing on the collateral and the other assets of the borrower (subject to any nonrecourse provisions, of course). Such a path is likely to be significantly more costly and time-consuming than UCC remedies.

Exercise of remedies under Article 9 of the UCC does not require resort to the courts or the entry of a judgment on the note, though the collateral disposition process under Article 9 allows the debtor and other parties entitled to notice the opportunity to bring an action in the courts on legal or equitable grounds to contest the secured party's exercise of its remedies. Once in receipt of a foreclosure notice, debtors may also interpose lender liability claims against the secured party which can create a drag on the process, whether or not they have merit, and as a last resort, file bankruptcy to take advantage of the automatic stay.

Article 9 provides that a disposition of collateral can be accomplished by either a "public disposition" or a "private disposition," though it offers limited guidance with regard to a public sale. Official Comment 7 to Section 9-610 states:

"Although the term is not defined...a "public disposition" is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. "Meaningful opportunity" is meant to imply that some form of advertisement or public notice must precede the sale...and that the public must have access to the sale...."

The leading case interpreting what is sufficient advertising to fulfill a secured party's duty of commercial reasonableness in conducting a public sale is *Ford & Vlahos v. ITT Commercial Finance Corp.*,⁶ which held, *inter alia*, that "the purpose of requiring adequate advertising of a foreclosure sale is to force the secured party to ensure the auction is well attended by legitimate bidders, so that the highest commercially reasonable price for the collateral will be obtained."⁷

⁵ UCC Section 9-610(b) provides that "Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable."

⁶ 8 Cal 4th 1220 (1994).

⁷ *Ibid.*, 8 Cal 4th at 1232-33.

Any advertisement for the sale of collateral at a public sale should, therefore, be calculated to maximize public participation.

UCC Section 9-610(b) provides that a public disposition must be a “commercially reasonable” disposition with advance notice under Sections 9-611 and 9-612 to the debtor, any secondary obligor and, depending on the facts of the loan transaction, certain additional parties. It is important to carefully parse the definitions of “debtor” and “obligor” to ensure that notice of the disposition is given to all proper parties.⁸ Section 9-613 sets forth a form of notice for both a “private” and “public” disposition of non-consumer goods collateral. These forms of notice should be used, as there is likely little benefit to any creativity by the mezzanine lender in this exercise. UCC Section 9-612(b) provides a 10-day “safe harbor” for notice of public dispositions of collateral.⁹ The Official Comment to Section 9-612 states that the 10-day notice period is intended only to be a “safe harbor” and not a minimum requirement. However, in the real estate financing arena, as discussed below, the process to prepare for the sale and market the interests will usually result in a notice period far in excess of the safe harbor.

While the disposition may be either private or public, a secured party may only purchase collateral at a private disposition “if the collateral is a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.”¹⁰ The sale of collateral consisting of privately held, limited liability company or partnership interests or shares of stock in a closely held corporation should therefore be sold at a public disposition unless the collateral falls into the description above or the secured party has no intention of purchasing it. This is not likely to apply in the context of the foreclosure of a real estate mezzanine loan. Where a secured party is pursuing a “loan to own” strategy, a public disposition is clearly preferred, unless the debtor is amenable to strict foreclosure.

Both public and private dispositions must, in all aspects, be “commercially reasonable”. As stated above, Official Comment 7 to Section 9-610 provides that, for a public disposition, this means that the public must have a “meaningful opportunity” for competitive bidding, therefore requiring “some form of advertisement or public notice” preceding the sale and public access to the disposition. A rule of thumb for a secured party is to market the security as a non-foreclosing seller might market the underlying property – if possible, structure the public notice and the disposition to comply with exemptions from securities laws, advertise in a way calculated to reach likely buyers (such advertisement should put forth all information typically given in similar advertisements), provide sufficient diligence materials and time to allow potential buyers to review those materials, and minimize restrictions on the sale of or future rights attaching to the collateral (which may require obtaining various consents under the mortgages or intercreditor or

⁸ A UCC Foreclosure Notice Insurance Policy, certifying the identities of security interest holders and lien holders of record, will soon be available from First American Title Insurance Company.

⁹ “In a transaction other than a consumer transaction, a notification of disposition sent after default and 10 days or more before the earliest time of disposition set forth in the notification is sent within a reasonable time before the disposition.”

¹⁰ UCC Section 9-610 (c).

entity agreements). Diligence materials should include many of the materials that a buyer of a commercial property would require, such as information pertaining to the mortgage and other senior loans, a rent roll, title report, survey and structural and environmental assessments, to the extent available to the mezzanine lender, and subject to any confidentiality restrictions in the loan documents or the intercreditor agreement. A foreclosing mezzanine lender should consider retaining a local third-party broker or auctioneer experienced in selling property similar to the underlying real estate to handle the marketing of the interest.

In addition, the location and manner of the sale should also be appropriate. In the case of a sale of privately held, limited liability company or partnership interests or shares of stock in a closely held corporation, this may mean in an electronic forum, or in the major city nearest the underlying real property interests. The commercial reasonableness of each of these steps is a fact-specific inquiry, and depends on a cost/benefit analysis and the surrounding circumstances (for example, a reasonable period of time from the initial advertisement of the disposition and the disposition itself may depend on, *inter alia*, market conditions, the complexity of the documentation relating to the underlying assets, how long it would take a typical buyer to obtain financing, and whether or not the senior mortgage loan is also in default). While the UCC gives little specific guidance, the secured party has some latitude in setting the terms of the sale, subject to the commercial reasonableness standard. The secured party should also have the discretion (exercised in a commercially reasonable manner) to assess the bona fides and qualification of any bidder and reject a higher bid on that basis. An unscrupulous debtor could easily send an unqualified bidder to the sale without any real intention of completing a transaction in order to buy more time.

Whether the collateral is a “security” under federal and/or state securities laws is a threshold issue when contemplating acceleration and/or foreclosure. Securities laws prohibit the offering and public sale of unregistered securities. Conducting a foreclosure sale that is sufficiently public to be “commercially reasonable” without crossing the line into a public offering of unregistered securities can be challenging. Comment 8 to Section 9-610 advises: “Although a “public” disposition of securities under this Article may implicate the registration requirements of the Securities Act of 1933, it need not do so. A disposition that qualifies for a “private placement” exemption under the Securities Act of 1933 nevertheless may constitute a “public” disposition within the meaning of this section.”¹¹

The third remedy available to a foreclosing mezzanine lender is strict foreclosure, in which the secured party retains the debtor’s collateral in full or partial satisfaction of the secured debt. UCC Section 9-620 expressly permits “acceptance in satisfaction” for all types of collateral, tangible or intangible and irrespective of whether it is in the secured party’s possession. Section 9-620 (a) provides that a secured party can propose acceptance of the collateral in “full or partial satisfaction” of the obligation. Where the secured party seeks *partial* satisfaction, the debtor must affirmatively consent to the proposed acceptance of collateral as provided in Section 9-620 (c) (1) “in a record authenticated after default.” A debtor’s consent to acceptance of the secured party’s proposal in *full* satisfaction of the debt may be passive (e.g., where the secured party sends a

¹¹ For a comprehensive discussion of this issue, see Lynn A. Soukup, *Securities Law and the UCC: When Godzilla Meets Bambi*, 38 UCC L.J. 1 Art. 1 (2005).

proposal to the debtor and does not receive an objection within twenty days).¹² Without such consent or lack of objection, strict foreclosure is not an available remedy.

Strict foreclosure is, arguably, the best remedy for foreclosing against closely-held mezzanine loan collateral where recourse to a well capitalized borrower and other collateral are unavailable.¹³ It is a streamlined process that eliminates the need for a sale or other disposition and is certainly a preferred outcome for a “loan to own” strategy. The practical difficulty with strict foreclosure, however, is that in most cases a debtor has little incentive not to raise an objection for strategic reasons. The presence of appropriate non-recourse carveouts in the mezzanine loan documents, and a guaranty of those carveouts by the principals of the borrower, are likely to be effective in conforming a borrower's actions in the face of a strict foreclosure to the economic realities of the situation.¹⁴ In other cases, as unpalatable as it may be for a secured party, it may make sense to compensate the debtor to incentivize cooperation.

Other Considerations:

There are usually contractual limitations on the transfer of membership or limited partnership interests in the mezzanine loan borrower arising out of one or more of (i) the underlying mortgage or deed of trust, (ii) the intercreditor agreement and/or (iii) the borrower's operating agreement or limited partnership agreement. These restrictions apply to public and private foreclosure sales and to strict foreclosure. One of the most significant restrictions on the transfer of mezzanine collateral, often a condition to a permitted transfer without the mortgage lender's consent under the intercreditor agreement, limits such transfers to a “Qualified Transferee”, an entity generally defined in the operative document as either the mezzanine lender itself or an institutional investor meeting certain requirements.¹⁵ This significantly restricts the potential universe of purchasers at a foreclosure sale, and the process of “qualifying” the winning bidder may inject uncertainty surrounding the ability of a buyer to close and, at a minimum, may delay the closing.

Additionally, without any necessary consents from other partners or members, the successful purchaser at a foreclosure sale cannot succeed to the rights or powers of a partner or member and is only entitled to receive proceeds and distributions from the limited partnership or LLC that otherwise would have been made to the defaulting debtor. In many cases, the mezzanine lender is the beneficiary of a pledge of all of the equity interests in the subject pledged entity, so

¹² UCC Section 9-620(c)(2)(C).

¹³ Donald J. Rapson commented that strict foreclosure “provides a method of enforcement that is nonadversarial, requires lower transaction costs, and is not likely to result in litigation. *Default and Enforcement of Security Interests Under Revised Article 9*, 74 Chi. Kent L. Rev. 893, 923 (1999).

¹⁴ See John C. Murray, *Carveouts to Nonrecourse Loans: They Mean What They Say!*, 19 No. 3 Prac. Real Est. Law. 19 (2003).

¹⁵ See the form intercreditor agreement (<http://www.cmbs.org/WorkArea/showcontent.aspx?id=10064>), at page 6. The institutional investor would need to meet a negotiated assets management threshold, be a ‘33 Act “qualified institutional buyer” or meet certain other related requirements.

this issue does not arise. In other cases, though, the lack of rights as a partner or member will seriously inhibit the purchaser's ability to enforce payment of distributions, deny such purchaser access to books and records, and undermine a claim by such purchaser for breach of fiduciary duty; moreover, the lack of a voting interest impairs the value of the collateral in a foreclosure sale. When documenting a mezzanine loan which is secured only by a partial interest in a pledged entity, it is important to obtain a recognition agreement or other consent to admission into the pledged entity from the other partners or members.¹⁶

In a real property foreclosure, whether the sale price is too low is a question of whether the price "shocks the conscience" of the court.¹⁷ In a UCC Article 9 foreclosure sale, commercial reasonableness is the standard. "The fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition or acceptance was made in a commercially reasonable manner."¹⁸ Nonetheless, in determining whether a given purchase price is commercially reasonable, courts have been divided. Because the Article 9 definition of a commercially reasonable sale is vague and because a judgment as to whether or not a sale was reasonable will frequently turn on the circumstances of a particular case, many courts have held this to be a question of fact with the burden of proof on the secured party.

Complexities may arise due to the 'carving up' of the capital structure. Many mezzanine loans are originated as part of a mortgage/mezzanine structure in the CMBS market, with the originator selling off certain pieces and keeping others. Often, the servicing or collateral agency rights for each tier of indebtedness are retained in the originator or its successor, who also may have significant exposure in one or more of the tiers of indebtedness. In a distress situation, this can create significant conflicts of interest between a servicer/collateral agent that also holds an interest in a mortgage or mezzanine tranche and another holder of an interest in a mezzanine tranche. This conflict may impede the exercise of remedies by a mezzanine lender. For example, if the servicer/collateral agent or holder of a mortgage loan also holds a blocking or controlling interest in a mezzanine tranche, and such party is in negotiations with the borrower to grant concessions under a matured or defaulted loan, that party can effectively block the exercise of remedies by the mezzanine tranche or provide any necessary consent on behalf of the mezzanine

¹⁶ Note that with respect to contractual restrictions on grants of security interests, in all jurisdictions other than, to date, Delaware, Virginia and Kentucky, UCC Section 9-408 renders unenforceable any contractual restriction in a limited partnership or operating agreement upon the creation and enforcement of security interests in limited partnership or membership interests, to the extent they are "general intangibles". This provision does not apply to investment property. In a seemingly uncharacteristically anti-business move, the legislators in Delaware amended that state's Revised Uniform Limited Partnership Act and Limited Liability Company Act to eliminate the invalidation of contractual and statutory restrictions under 9-408 of the Delaware UCC. Accordingly, if a Delaware partnership agreement or operating agreement imposes restrictions on the grant of a security interest in general intangibles, those restrictions will be enforceable.

¹⁷ N.Y. Jur. 2d, Mortgages § 756.

¹⁸ UCC Section 9-627(a).

tranche, even if it is against the interests of the other holders of that tranche to do so, on the basis that such party's interest as mortgage lender is better served by making the concessions.

Regardless of its interests, the servicer/collateral agent has fiduciary obligations to its principal, the mezzanine holder, under general principles of agency law. The relevant agreements may contain express waivers of such fiduciary obligations, though it is not clear to what extent any such waivers would be enforced by a court, especially on facts such as these. In any event, a prudent mezzanine lender will fight the inclusion of any waivers of fiduciary duty with vigor. In the event any conflict becomes apparent, the mezzanine lender must also put the servicer/collateral agent on notice of the conflict of interest, underscoring the fiduciary obligations of the servicer/collateral agent.

Conclusion:

Foreclosure of a mezzanine loan under Article 9 offers many benefits to a secured party, chief among them the streamlined process that generally achieves the desired result both faster and more economically than a mortgage foreclosure. A foreclosing mezzanine lender should make sure that at each point in the foreclosure process its actions are carefully considered to minimize the chance of a challenge for lack of commercial reasonableness. The secured party who has followed the recommendations of Moody's Investors Service in structuring and documenting the mezzanine loan at the outset will be in the best position to negotiate a satisfying outcome in a distressed loan situation. Moody's recommends a pledge of 100% of the equity, opting in to Article 8, certificating the equity, filing a financing statement, control of the ability to opt out through hardwire or proxy and the purchase of UCC insurance.¹⁹

One final note: a mezzanine lender must also be careful what it wishes for. Once the foreclosure is completed, the mezzanine lender may find itself in the unfamiliar situation, for which it may be ill-equipped, of having to operate the property and deal with the various competing property interests. Moreover, once the mezzanine lender takes control of the pledged entity, various claims against the distressed entity may only begin to come out of the woodwork.

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¹⁹ DANIEL B. RUBOCK, MOODY'S INVESTORS SERVICE, INC., US CMBS AND CRE CDO: MOODY'S APPROACH TO RATING COMMERCIAL REAL ESTATE MEZZANINE LOANS 3 (2007).