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Foreclosing on a Mezzanine Loan Under UCC Article 9

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.

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.

The repayment obligation of the mezzanine borrower (usually a direct or indirect parent of the property owner) is typically secured by a perfected security interest in the equity interests owned by such borrower in the property owner under Article 9 of the Uniform Commercial Code (UCC).

This article will focus on the remedies of a mezzanine lender under Article 9.

Intercreditor Arrangements

As real estate markets head into a downturn, mezzanine lenders, in prior loss positions relative to mortgage lenders, will increasingly find themselves with borrowers in distress or 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 noncertificated or certificated securities, perfected by filing, possession or control under Article 9 or (2) a "general intangible" perfected only by filing under Article 9, though a secured lender will have more leverage if it holds a certificated interest.[1]

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. 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 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 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 will provide the most significant input into the timing and nature of remedies.

Using the Cure Rights

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 lender(s). 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.[2]

Once a secured party has accelerated its loan (or upon maturity of the loan), three remedies are available: 1) common-law remedies through the courts; 2) foreclosure by disposition of collateral under Article 9; and 3) strict foreclosure under Article 9. Common-law remedies would entail maintaining an action to enforce the note, obtaining a judgment, and enforcing the judgment by executing on the collateral and the other assets of the borrower (subject to any nonrecourse provisions). However, such a path is likely to be significantly more costly and time-consuming than Article 9 remedies.

Exercise of remedies under Article 9 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 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.

Disposition of Collateral

Article 9 provides that a disposition of collateral can be accomplished by either a "public disposition" or a "private disposition." "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…."[3]

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Any advertisement for the sale of collateral at a public sale should be calculated to maximize public participation. UCC §9-610(b) provides that a public disposition must be a "commercially reasonable" disposition with advance notice under §§9-611 and 9-612 to the debtor, any secondary obligor and, depending on the facts of the loan transaction, certain additional parties.[4]

The forms of notice set forth in UCC §9-613 should be used, as there is likely little benefit to any creativity by the mezzanine lender in this exercise. UCC §9-612(b) provides a 10-day "safe harbor" for notice of public dispositions, which the Official Comment to §9-612 states 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."[5] 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. 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." A rule of thumb for a secured party is to market the security as a nonforeclosing 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 the highest number of likely buyers[6] (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 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 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 and how long it would take a typical buyer to obtain financing).

The secured party can exercise some discretion in setting the terms of the sale and assessing the bona fides and qualification of any bidder, and reject a higher bid on that basis (such discretion must, of course, be exercised in a commercially reasonable manner). 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.

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

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 §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."[7]

Commercial Reasonableness

As with all other aspects of an Article 9 foreclosure sale, commercial reasonableness is the standard by which the eventual sale price is judged (not the "shocks the conscience" standard applied to mortgage foreclosures). "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."[8] 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.

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 §9-620 expressly permits "acceptance in satisfaction" for all types of collateral, and that such satisfaction can be "full or partial." Where the secured party seeks partial satisfaction, the debtor must affirmatively consent to the proposed acceptance of collateral as provided in §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 proposal to the debtor and does not receive an objection within 20 days).[9] Without such consent or lack of objection, strict foreclosure is not an available remedy.

While strict foreclosure may be desirable, as 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 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.[10] In other cases, 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.

One of the most significant restrictions on the transfer of mezzanine collateral is a limitation under the intercreditor agreement that such transfers must be 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.[11] 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.

In cases in which the mezzanine lender is the beneficiary of a pledge of all of the equity interests in the subject pledged entity, 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.

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 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. 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.

The mezzanine lender's best strategy may be to use the cure rights in the intercreditor agreement to stave off foreclosure by senior lenders. One option provided to each junior mezzanine lender in the standard agreement…is the right to purchase at par each position senior to it.

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.[12]

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.

1. Article 9 governs the perfection of security interests, and 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. In general, 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. For further discussion, see James D. Prendergast and Keith Pearson, "How to Perfect Equity Collateral Under Article 8," 20 No. 6 Practical Real Estate Lawyer 33 (2004).

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

3. Official Comment 7 to UCC §9-610.

4. 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 Co.

5. UCC §9-610 (c).

6. See *Ford & Vlahos v. ITT Commercial Finance Corp.*, 8 Cal 4th 1220 (1994).

7. 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).

8. UCC §9-627(a).

9. UCC §9-620(c)(2)(C).

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

11. 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.

12. See 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). Moody's recommends a pledge of 100 percent 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.