New York Law Journal
TRENDS IN REAL ESTATE AND TITLE INSURANCE
Monday, March 12, 2007
ALM

Mezzanine Loan Foreclosure

If it's necessary, do it right.

BY JEFFREY J. TEMPLE

AS RECENTLY as five years ago, most people associated "subordinate" debt with second mortgages. Due to structuring issues and the lack of comfort that most senior lenders had in sharing their collateral with a subordinate lender, these transactions were seen infrequently. As more and more capital has flowed into the real estate capital markets, however, debt providers looking for higher yields but more "certainty" with structures and collateral are now frequently making subordinate loans on real estate projects that are secured by pledges of the equity of the project owner or its investors (typically limited liability companies), rather than second mortgages on the project itself. Such loans are commonly referred to as "mezzanine loans."

Given the separate nature of this pledged collateral, the creation and enforcement of a security interest in such an equity pledge, as opposed to a second mortgage, is governed by the Uniform Commercial Code (UCC), rather than state specific real property laws and customs. This distinction results in substantial differences in how a mezzanine lender pursues its remedies, including, most importantly, foreclosure on its collateral.

As the economic climate becomes less certain and as select markets clearly show evidence of being "overbuilt," mezzanine lenders will likely begin to see more instances of defaulted loans. Mezzanine loans, which are almost always subordinate to senior loans in terms of receipt of cash flow, will likely be the hardest hit as declining rental streams yield insufficient cash flow to service this mezzanine debt.

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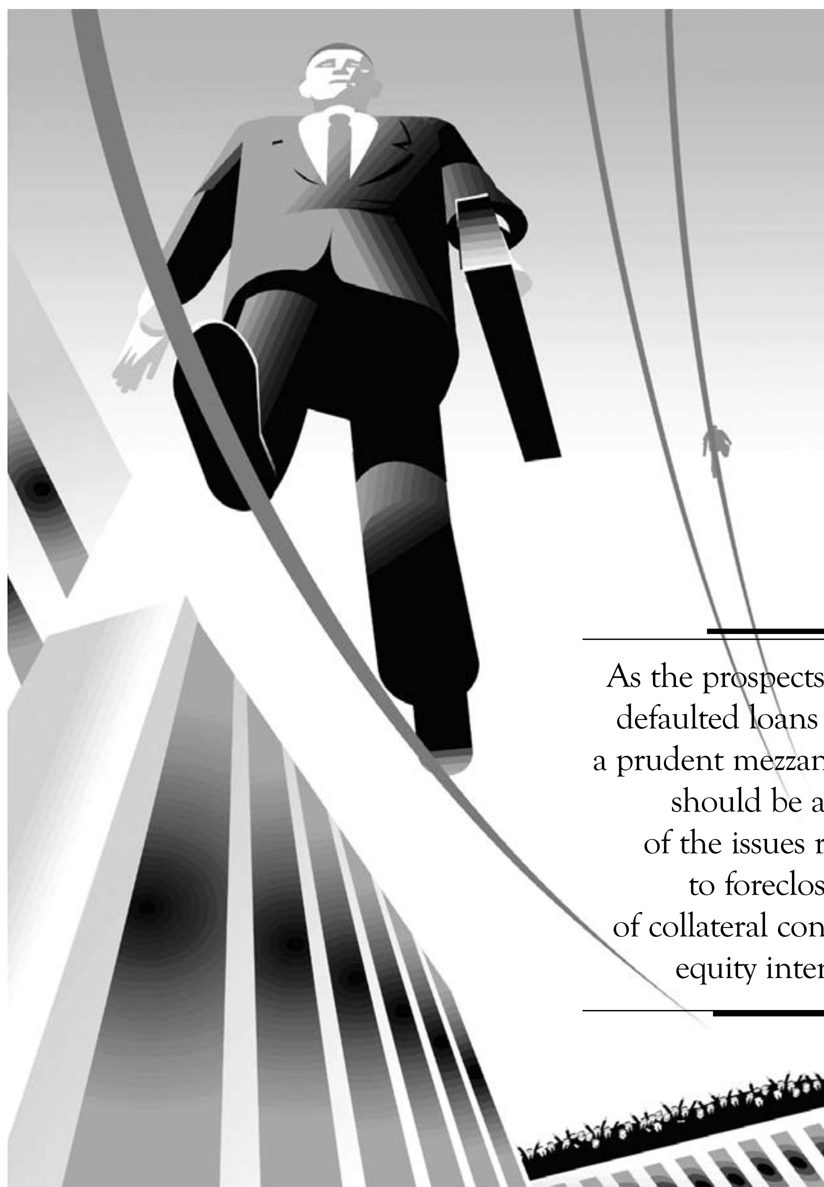

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> As the prospects for more defaulted loans increase, a prudent mezzanine lender should be aware of the issues relating to foreclosure of collateral consisting of equity interests.

Given that most mezzanine lenders will have no enforcement rights against the real property itself (or its direct owner), and that many of such loans were made on a "non-recourse" basis, mezzanine lenders' remedies will typically be limited to foreclosing on the pledges of their borrowers' equity interests, if no consensual workout can be achieved.

This article will explore the procedures established by Article 9 of the UCC for foreclosures on mezzanine collateral as well as the limited case law interpreting these provisions.

In addition, the article will attempt to identify the

proper procedures to be followed in order to avoid a claim that such foreclosure was not completed in a "commercially reasonable" manner.

Finally, the intercreditor relationship between the mezzanine lender and senior lender, and how the mezzanine lender's rights and obligations under an intercreditor agreement may influence its conduct and strategy, will be examined.

'Commercially Reasonable'

Every aspect of a disposition of collateral governed by Article 9 must be commercially reasonable, including, the method, manner, time, place and other terms of the sale.[1]

Unfortunately, the UCC prov ides very little guidance as to what constitutes a commercially reasonable sale.[2] Unlike securities traded on public exchanges or goods for which established resale channels and methods exist, there is neither an established market nor a set of recognized standards for the sale of closely held limited liability company interests.

The result of all this uncertainty is that the mezzanine lender will need to thoroughly analyze commercial reasonableness in the light of the nature of the collateral in each step of the foreclosure sale process.

Since mezzanine loan collateral is, in effect, a hybrid of real and personal property, it may be useful for the mezzanine lender to look to real property sale practices to draw logical and appropriate comparisons for commercial reasonableness. In addition, one of the few cases considering the issue of commercial reasonableness in the context of mezzanine loan collateral, *Vornado PS, L.L.C v. Primestone Inv. Partners L.P.*,[3] now provides significant guidance.

In *Vornado*, the Delaware Chancery Court, applying New York law, determined as a matter of summary judgment that the foreclosure on the shares of an operating partnership of a real estate investment trust was conducted in a commercially reasonable manner.[4] The court found that commercial reasonableness consists of two main elements, price and procedure.

It stated that the sale price does not need to be the market price, and indeed could be considerably lower.[5] With respect to procedure, the court emphasized that the lender hired a major brokerage firm to handle the marketing, and that that marketing was consistent with past marketing processes of the brokerage relating to equity interests in real estate-related companies.[6]

Public or Private Sale

UCC foreclosure sales may be public or private.[7]

However, the secured party may purchase at a private disposition only if the collateral is of a kind customarily sold on a recognized market or is the subject of widely distributed price quotations.[8] Of course, this exception would not include collateral such as limited liability company interests not listed on a securities exchange.

If the mezzanine lender expects or desires to be the purchaser at the foreclosure sale, which is usually the case, then the disposition must be structured as a public sale under the UCC.[9] The *Vornado* court found that, though the New York UCC encourages private sales,[10] because the lender was "one of the most interested and able purchasers," it was justified in holding a public sale.[11]

> Any analysis by the mezzanine lender of its rights and remedies must take into account the rights of the senior lender and the intercreditor agreement that governs that relationship in almost all cases.

A public sale is not limited strictly to the proverbial auction on the courthouse steps; it is any sale where the price is determined after the pubic has had a meaningful opportunity for competitive bidding. The public sale itself should ideally be conducted by or with the assistance of a qualified auctioneer such as a licensed real estate broker having experience selling property of a type similar to the mezzanine lender's collateral.

The *Vornado* sale was conducted by an auctioneer in the offices of the lender's counsel, after an extensive and repetitive process of advertising and contacting potential bidders.[12] The lender may want to arrange for a transcript of the sale to be prepared so that there is a printed record of the actual auction process. This record could be important should the mezzanine borrower later challenge the sale proceedings.

Engaging a Broker

Retaining a broker or financial advisor to advise on the sale and marketing of the interest to targeted potential bidders is strongly recommended, as many brokers are experienced in marketing equity interests in real estate entities because they typically structure a variety of real estate transactions.

They can not only advise on where and how to advertise and conduct the sale, but also assist in organizing and distributing appropriate due diligence information to bidders, and identifying and soliciting the interest of bidders. In addition, the fact that the foreclosing lender sought the advice of a qualified real estate sales expert will help demonstrate commercial reasonableness should the pledgor ultimately challenge the commercial reasonableness of the sale.

In *Vornado*, Goldman Sachs acted as broker/sales agent and was able to use its experience and connections to disseminate sales information to more than 50 parties. The court went into great detail in considering the number of parties contacted, as well as the advertising done in The New York Times and the Chicago Tribune, characterizing this as a "significant marketing process."[13]

Notice and Right to Inspect

The first critical decision in any foreclosure analysis will be where and how to provide notice of the pending sale.

Notice should be reasonably accessible to entities that are likely to be interested in purchasing the collateral. In the case of equity interests in a real estate owner, those entities could be financial institutions or investors and real estate companies doing business in the geographic region in which the real property is located.

Ideally, the mezzanine lender should advertise in the publications, such as newspapers or specialized trade journals, which are most likely to be distributed to and read by the target group. It may be appropriate to publish in multiple publications covering more than one region, as the lender in *Vornado* did.[14]

It also may be useful to look to the procedures for public notice under the real property foreclosure laws applicable in the jurisdiction of the underlying real property because these procedures have been, in effect, legally validated as sufficient to provide public notice to potential buyers of similar real property in that jurisdiction (which buyers, presumably, will be some of the same parties targeted in the mezzanine collateral sale).

The content of the public notice should provide the reader with basic information describing the collateral (i.e., the identity and nature of the equity interests) and the underlying assets (i.e., a description of the real estate), as well as the conditions of the sale such as place, time and terms. In addition, the notice should clearly inform readers how and where the due diligence information will be made available to qualified bidders.

The notice should be given far enough in advance of the sale date to allow potential bidders to analyze the information regarding the subject limited liability company interests and the underlying real estate assets before making a bid.

The necessary information will include not only the operative limited liability company agreements and financial information regarding the pledged entities, but also typical due diligence information

regarding the underlying real estate assets such as rent rolls, title information, physical inspection reports and market analysis, as well as information regarding the terms of the underlying mortgage loan to which the real property is subject.

Of course, private due diligence information will not be available if the borrower refuses to provide it, but such failure will not impact the analysis of whether the lender acted in a commercially reasonable manner.[15]

Although the UCC provides a 10-day safe harbor provision for notice of the sale to the debtor,[16] it probably would not be commercially reasonable to expect potential bidders to inspect the underlying real property, perform due diligence on all of the necessary information and prepare a bid within such a brief period. In *Vornado*, the lender gave 20 days' notice to the borrower and, together with Goldman Sachs, began contacting potential purchasers approximately two weeks in advance of the initially planned sale.[17]

Location, Location, Location

Another consideration should be the location of the public sale; the location should have a reasonable relationship to the collateral and the potential bidders.

Given that the collateral consists of intangibles, it is difficult to determine where collateral such as this is located. Logically, it should either be the city or town where the underlying real property is located or the place where the mezzanine borrower has its principal offices or conducts its business. In addition, because the mezzanine lender will be targeting financial investors as likely bidders, it would be prudent to locate the sale in a major financial center.

The practices of real property foreclosure support the conclusion that a place near the underlying real property is the appropriate location.

Other Considerations

A foreclosure sale of limited liability company interests may also be subject to applicable state and federal securities laws, further complicating the process.

The mezzanine lender should initially consult with securities counsel to determine if this is the case and, if so, what limitations or requirements of the securities laws might be imposed on the sale, including a private placement and "accredited investor" restrictions.

Courts have occasionally imposed a duty of "preparing the collateral for sale" on the secured party where it would be commercially unreasonable not to do so. No case law exists as to whether, under this duty, mezzanine lenders are required to cure defaults in either the underlying mortgage loan, such as making an interest payment, or the real property, such as paying back taxes.

The mezzanine lender must also consider whether any consents of other equity holders are required to complete the transfer pursuant to the foreclosure (if the collateral does not represent 100 percent of the equity interests in the property owner) and whether foreclosure may require the consent of the senior lender. Mezzanine lenders have recently been able to address this issue with the senior mortgage lender in the intercreditor agreement.

Intercreditor Issues

Any analysis by the mezzanine lender of its rights and remedies must take into account the rights of the senior lender.

In almost all cases, the relationship between the mezzanine lender and the senior lender will be governed by some form of intercreditor agreement. In recent years, intercreditor agreements have become more standardized, and many practitioners regularly utilize a form developed and recommended by one of the rating agencies, Standard & Poor's, and its counsel.

Most intercreditor agreements, including the Standard & Poor's form, grant the mezzanine lender the right to foreclose on its collateral, subject to certain limitations, such as who the ultimate transferee may be. In light of the foregoing, the intercreditor agreement may impact the marketability of the mezzanine loan collateral, as only "qualified transferees" will be permitted to participate in the sale.

The mezzanine lender may also elect to avail itself of certain rights under the intercreditor agreement prior to foreclosing on the mezzanine loan collateral, in order to avoid triggering defaults (and the exercise of remedies) under the senior loan, which could ultimately lead to foreclosure of the real estate which would in turn result in the mezzanine lenders' collateral becoming essentially worthless.

The circumstances that have led to the mezzanine lender's right to foreclose on its collateral will often have caused a default under the mortgage loan as well. Most intercreditor agreements will permit the mezzanine lender to cure certain defaults under the mortgage loan prior to foreclosing on the mezzanine loan collateral, with limits, however, on the number of monetary defaults that are curable. Such restrictions may impose practical limitations on how long a mezzanine lender can wait before commencing a foreclosure.

Finally, an intercreditor agreement will normally provide the mezzanine lender with the option to purchase the mortgage loan at "par value," as that term is negotiated and defined in the intercreditor agreement. In such cases, the mezzanine lender must decide whether to (a) foreclose and take over control of the property subject to the mortgage loan or (b) purchase the mortgage loan and dramatically increase its investment in a troubled property.

In any event, the mezzanine lender may choose to exercise its rights under the intercreditor agreement in order to avoid the foreclosure of the mortgage, thereby leaving the mezzanine lender with collateral that consists only of equity interests in an entity that no longer owns any property.

Conclusion

As the prospects for more defaulted loans increase, a prudent mezzanine lender should be aware of the issues relating to foreclosure of collateral consisting of equity interests. In making itself aware of common mezzanine foreclosure practices and caselaw as these continue to develop, a mezzanine lender will be better prepared for workout negotiations with mezzanine borrowers.

In addition, a mezzanine lender should always approach any workout negotiation fully aware of the remedial actions available to it should those negotiations fail to produce a viable restructuring of the loan, as well as defenses likely to be raised by the borrower.

1. U.C.C. §9-610(b).
2. Margit Livingston, "Survey of Cases Decided Under Revised Article 9," 2 DePaul Bus. & Comm. L.J. 47 (2003).
3. 821 A.2d 296 (Del. Ch. 2002), affirmed by *Primestone Inv. Partners L.P v. Vornado PS, L.L.C.*, 822 A.2d 397 (Del. 2003).
4. *Vornado*, 821 A.2d at 300.
5. Id. at note 43, citing *First Fed. Sav. & Loan Ass'n v. Romano*, 676 N.Y.S.2d at 164.
6. *Vornado*, 821 A.2d at 316.
7. U.C.C. §9-610(c).
8. Id.
9. *Vornado*, 821 A.2d at 315.
10. NY U.C.C. §9-610 Official Comment 2, as cited by *Vornado*, 821 A.2d, at note 42.
11. *Vornado*, 821 A.2d at 315.
12. Id. at 309.
13. Id. at 300.
14. Id. at 306.
15. Id. at 316.
16. U.C.C. §9-612(b).
17. *Vornado*, 821 A.2d at 306.

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