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Mezzanine Loan Foreclosure Contains Potential Pitfalls



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If the past business cycle brought the real estate finance industry increasingly sophisticated and more highly-tranched debt structures, the recent downturn has seen and will continue to see such structures severely tested as loans go into default and property values significantly decrease. In this article we will analyze several of the issues that a mezzanine lender should consider when contemplating enforcement of its remedies upon the occurrence of such defaults.

Mezzanine loans are commonly used to fill the gap between equity and conventional mortgage debt and are typically subordinate to a senior mortgage loan encumbering the subject property. Although generally underwritten on the strength of a real estate asset, mezzanine loans are not secured by a mortgage, but rather by a pledge of all equity interests (i.e., partnership or limited liability company membership interests) in the property owner or another company in the ownership structure having control over the ultimate real property collateral. As such, the remedies available to mezzanine lenders differ from traditional first mortgage remedies (such as the ability to sell the property unencumbered by debt and liens recorded after mortgage at a foreclosure auction) when such a loan goes into default.

As typically structured, commercial mortgage leverage ratios (typically only up to 70-80 percent of property value) have been such that the senior debt remained fully collateralized even in light of significant value changes in the underlying property. Consequently, mortgage lenders could expect their outstanding loans to weather the market changes better than mezzanine loans. Mezzanine lenders, on the other hand, whose loans have characteristically higher leverage and subordinate positions (in the most recent cycle, sometimes as high as 95 percent), are situated to be affected by the current market declines more directly and immediately.

The relationship between a mezzanine lender and the senior mortgage lender is typically governed by an intercreditor agreement. Intercreditor agreements should specifically set forth the rights of each lender

to exercise its remedies, including the terms under which a mortgage lender must temporarily forebear from enforcement of its mortgage, and the right of a mezzanine lender to cure defaults under senior loans. When a mortgage loan goes into default, the mezzanine lender risks losing its collateral if it fails to either exercise its right to cure, as provided in the intercreditor agreement, or effect its own remedies before the mortgage lender forecloses on the subject property. If the mortgage lender forecloses, the mezzanine lender will be cut off from any interest in the property and secured only by a pledge of ownership interests in a company that, by virtue of the foreclosure and the fact that such entities are almost universally structured as SPE entities, has no assets. As such, it is critical for a mezzanine lender to act quickly when a loan goes bad and to understand the elements and restrictions of mezzanine loan remedies and the relevant terms of the intercreditor agreement.

Though specific terms and time periods may vary, most intercreditor agreements have relatively uniform restrictions on the rights and remedies of the respective parties thereto (this is especially true when the mortgage loan has been securitized and rating agency guidelines are imposed). Although typically broadly written in the underlying mezzanine loan documents as against the borrower, the remedies of a mezzanine lender are often restricted by an intercreditor agreement in several different ways, including restrictions on the type of entity which may hold a mezzanine loan and foreclose on the collateral. In the context of a securitized first mortgage loan, this consists of a requirement that an entity foreclosing on the mezzanine collateral either obtain a "no-downgrade letter"¹ or is itself a "qualified transferee"² before it may step into the role of controlling sponsor. Additionally, most intercreditor agreements require that the subject property be operated at all times by a "qualified property manager," thereby requiring a foreclosing mezzanine lender to hire an outside management team, unless it has the requisite operational experience.

The procedure of foreclosing on mezzanine collateral is unlike a typical mortgage foreclosure and, even though the process should be relatively expeditious, it is fraught with difficult issues. As mezzanine collateral consists of equity interests, the governing law of mezzanine foreclosure is

either Article 8 or 9 of the relevant UCC rather than real estate enforcement statutes. Although the UCC grants a variety of remedies to a lender, the sui generis nature of the pledged interests severely limit the actions a mezzanine lender may take. The UCC mandates that a sale of collateral must be "commercially reasonable"³ but gives little applicable direction on how to affect such a sale. To satisfy the requirements of the UCC, most foreclosing mezzanine lenders have employed public auctions that frequently result in the lender being the only bidder. Failure to dispose of the collateral in a commercially reasonable manner, as required by the UCC, may give rise to a claim by the mezzanine borrower against the foreclosing lender.

Unlike a first mortgage foreclosure, the subordinate nature of a mezzanine loan means that after the completion of a mezzanine foreclosure, the collateralized real property continues to be subject to the lien of the mortgage and senior debt. Thus, after a mezzanine foreclosure, the mortgage remains unmodified and in full force and effect and the mortgage lender maintains its first lien priority. Once a mezzanine lender has foreclosed, it owns all of the equity interests in the mortgage borrower and, in all likelihood, will need to either cure an existing mortgage default or sell the property to the extent prepayment terms allow. Obviously, as the first step in deciding its course of action, a mezzanine lender must make a financial analysis of the property securing the mortgage loan. If the value of the property has decreased such that the full proceeds of the foreclosure sale will be used to pay off the mortgage debt, a mezzanine lender will have no incentive to move forward with the process and may not pursue a foreclosure in the first place. If curing a mortgage default or operating the real property requires the mezzanine lender to fund shortfalls, recouping its investment may be implausible given the current market.

Notwithstanding the fact that the collateral being foreclosed upon is not real property, certain jurisdictions require payment of real property transfer taxes on the resulting ownership transfer. In New York state for example, if the pledged collateral for the mezzanine loan consists of a controlling interest in an entity which owns real property, upon foreclosure the beneficial ownership of the property will be transferred and transfer taxes will be due and owing. The tax will be calculated based on the value

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of the property, which is assumed to be the aggregate amount of the mezzanine loan being foreclosed plus the amount of all loans senior to the foreclosing mezzanine loan (i.e., any superior mezzanine loans and the mortgage loan). Since such tax rates can approach three percent if the property is located in New York City,⁴ they are no small issue.

In order to avoid the financial strain of transfer taxes resulting from a foreclosure, mezzanine lenders may look to purchase the mezzanine collateral by collaborating with the borrower (and mortgage lender) to effectuate a Section 363 sale under the Bankruptcy Code. Historically, a debtor in bankruptcy could sell its assets to a creditor under Section 363 without requiring the payment of transfer tax provided the sale occurs in contemplation of a plan under Section 1146.⁵ However, a recent United States Supreme Court decision cautioned that the Section 1146(a) transfer tax exemption must be narrowly construed to apply only to those sales of assets occurring after the debtor's Chapter 11 plan is confirmed; not to those sales that occur in accordance with or in contemplation of the filing and confirmation of the plan.⁶ An additional impediment to a Section 363 sale may be a mortgage borrower's non-recourse carve-out guaranty. A bankruptcy filing by the mortgage borrower would trigger personal liability under a typical non-recourse carve-out guaranty, and therefore, most borrowers are unlikely to agree to such a sale without the consent of the mortgage lender and such lender's agreement to waive its rights under the guaranty.

In addition to considering potential financial impediments, a mezzanine lender should closely examine the obligations it will undertake by foreclosing on the mezzanine collateral. For example, if the property is a condominium development, foreclosure will result in the mezzanine lender displacing the borrower as the project's sponsor and, in turn, assuming all of the sponsor's obligations under the offering plan and existing contracts of sale. Under such circumstances, a foreclosing mezzanine lender should have a firm understanding of the terms of the contracts of sale that obligate purchasers to acquire particular condominium units. In order to avoid breaching those contracts (and thereby affording the purchasers a right of rescission),⁷ a mezzanine lender contemplating instituting foreclosure proceedings should first ascertain whether it can comply with construction deadlines and conditions precedent that must be satisfied in order to consummate the contract sales within the allotted time frame. Alternatively, the foreclosing mezzanine lender may proceed with the foreclosure, notwithstanding the rescission risk, if it expects the project's value to increase or wishes to pursue different development opportunities. In the current financial climate, failure to meet the provisions of the sale contract may encourage opportunistic purchasers to exercise their right of rescission, thereby recouping the down payment and either negotiating a reduced purchase price or walking away altogether. Additionally, mezzanine lenders should be conscious of the risks associated with foreclosing on condominiums with name-brand or otherwise prominent sponsors. Under such rare circumstances, displacing the sponsor could potentially give rise to a right of rescission if the change of sponsor amounts to the type of material change to the offering plan that the attorney general or a court determines adversely affects the purchaser.

One unique aspect of a traditional mortgage foreclosure is the ability of the foreclosing lender

to extinguish liens on the property that have been incurred by the mortgagor subsequent to the mortgage financing. In contrast, mezzanine lenders take on equity risks when realizing upon their collateral since they take ownership of such equity interests subject to liens and encumbrances that have arisen since the inception of the loan. Consequently, an enforcing mezzanine lender must aggregate the existing mortgage loans together with additional trade debt, loans, mechanics liens or other encumbrances that may have been incurred by the mortgage borrower to more fully understand the degree of return they may realize as a result of the mezzanine loan foreclosure; the mezzanine lender's collateral may be too heavily burdened by debt to allow it to recover effectively. While the fact that mezzanine loan documents customarily require both the mortgage borrower and mezzanine borrower to be a "single purpose entity" may be an effective mitigant to such equity risks, the mezzanine lender should nonetheless order up-to-date litigation and title searches and conduct other corporate due diligence prior to instituting foreclosure proceedings, allowing the lender to better assess the risks being assumed as a result of such foreclosure.

Intercreditor agreements should specifically set forth the rights of each lender to exercise its remedies, including the terms under which a mortgage lender must temporarily forbear from enforcement of its mortgage, and the right of a mezzanine lender to cure defaults under senior loans.

In analyzing its collateral package and options to pursue remedies, a mezzanine lender should also understand the benefits and limitations of any UCC insurance policy purchased in conjunction with the mezzanine loan. Unlike a mortgage lender, the mezzanine lender is ineligible for an ALTA Loan Policy because its insurable interest is a UCC security interest, rather than a real property mortgage lien. Dissimilar to the mortgage lender's ALTA Loan Policy, a UCC insurance policy does not insure that title to the real property is properly vested in the mortgage borrower,⁸ but does insure mezzanine lender's security interest in the partnership or LLC membership interests pledged to it. To the extent the pledged interests have been "certificated" and the transaction is governed by Article 8 of the UCC,⁹ the UCC Insurance Policy may also include a "mezzanine endorsement" which expands coverage in several respects, including by insuring that (i) the borrower owns the mezzanine collateral (which is not insured, only assumed, without such endorsement), and (ii) the mezzanine lender is a "Protected Purchaser"¹⁰ under Article 8 of the UCC, meaning that no adverse claim in the pledged collateral can affect its interest.

As the process and results of mezzanine foreclosure in sophisticated and highly-tranched debt structures differ significantly from standard mortgage remedies, a mezzanine lender and its counsel must recognize the potential pitfalls thereof before exercising its remedies.

1. A no-downgrade letter generally confirms that the contemplated transaction will not result in the qualification, downgrade or withdrawal of the current rating of any class of securities issued in connection with the applicable securitization.

2. While a typical definition of "Qualified Transferee" is too extensive to include in this article, the definition generally includes the following types of entities, provided the transferee satisfies certain net worth requirements set forth in the applicable intercreditor agreement: a real estate investment trust, bank, savings and loan association, investment bank, insurance company, trust company, commercial credit corporation, pension plan, pension fund or pension advisory firm, mutual fund, government entity, an investment company, money management firm or "qualified institutional buyer" within the meaning of Rule 144A under the Securities Act of 1933, or a permitted fund manager with a specified amount of committed capital.

3. U.C.C. Section 9-610

4. New York State Tax Law §1400 et. seq. and New York City Administrative Code §1201 et. seq.

5. 11 U.S.C. §1146(a).

6. *Florida Department of Revenue v. Piccadilly Cafeterias Inc.*, 128 S.Ct. 2326, 2331 (2008).

7. New York Codes, Rules and Regulations, Title 13, Section 23(a)(5).

8. The mezzanine lender may obtain some protection from the mortgage borrower's owner's title insurance policy by obtaining a "Mezzanine Endorsement," though these are often very expensive.

9. This is accomplished by including "opt-in" language in the partnership agreement or operating agreement of the mortgage borrower.

10. U.C.C. Section 8-303.