# When The Workout Hasn't Worked

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When a mortgage or mezzanine lender has concluded that a loan modification or workout won't resolve a problem loan or the lender is a loan to own market participant, the focus turns to remedies against the collateral. Where the collateral consists of a mix of real and personal property, such as a hotel, apartment, office building or industrial facility or exclusively personal property, including a real estate mezzanine loan secured by a limited liability company or partnership interests, non-real estate law will be a consideration.

Most real estate-secured loans will include some personal property in the collateral. The most obvious case is a hotel, where the personal property—such as franchise rights, furniture, restaurant equipment, dishes, sheets and towels—are essential components of the value of and ability to operate the real estate. It is unlikely that a purchaser will close a sale without some or all of these assets.

Other real estate loans also may include necessary or valuable personal property, such as security, HVAC and other building systems, equipment and contracts necessary for operation of the building and provision of tenant services, at least in the short term. Real estate mezzanine loans, of course, are secured entirely by personal property.

Because only a small minority of real estate-related loans have no personal property in the collateral, personal property and its impact on how to proceed needs to be evaluated from both a business and a legal perspective.

In foreclosing on a mixed real and personal property collateral loan, the first issue to evaluate is whether the collateral is to be sold as a whole or whether some or all of the personal property is to be sold separately. This will, in turn, require evaluation of state real property foreclosure laws (which may be used for sales of mixed real and personal property collateral), as well as whether any rights will be lost if multiple remedies are pursued.

For example, California's one form of action rule applies to loans secured by real property and requires lenders to look first to their collateral before pursuing any other actions against the borrower, limits their rights to obtain deficiency judgments and imposes harsh penalties such as loss of lien rights if the rule is violated. State real estate foreclosure statutes vary, often imposing specific notice and advertising requirements before a sale can be concluded by the lender and sometimes allowing sales to be challenged if procedures are not strictly followed.

The legal regime that provides a lender with remedies against its personal property collateral—including mezzanine loan collateral—is quite different in many respects from the laws applicable to real estate foreclosures. For personal property collateral sold outside of a state's real property foreclosure regime, the Uniform Commercial Code (UCC) is the applicable law, and, while there are some variations, the general principles and requirements of the UCC are consistent from state to state. There are several important concepts affecting the lender's pursuit of remedies under the UCC:

- the UCC does not apply to real property or a lease or rents thereunder and cannot be used to foreclose on those components of mixed collateral;
- remedies under the UCC are a "self-help" process in which the lender determines what remedy to pursue and how to implement that decision;
- with respect to foreclosure on the collateral, the UCC provides little specific guidance on important aspects of that decision, leaving the lender and its counsel to determine how to comply with the lender's obligations under the UCC as to the conduct of the sale;
- the UCC provides a number of statutory protections for the debtor and for guarantors, as well as obligations of the lender, most of which cannot be altered or waived by the parties; and
- other laws (such as securities laws) and contractual restrictions (such as the terms of a mezzanine loan intercreditor agreement, which may limit the qualified transferees that may acquire the pledged entity interests in a foreclosure sale) may affect how remedies are pursued.

The UCC provides a lender with three basic remedies to pursue once a default has occurred: the lender may collect payment obligations that are part of the collateral; propose to retain collateral in full or partial satisfaction of the secured obligations (the equivalent of a deed-in-lieu of foreclosure with respect to real property); or seek to dispose of the collateral.

The collection remedy is most often pursued with non-real estate loans. It may not be applicable to some or all of the most significant payment obligations included in real estate collateral because the UCC does not apply to real estate leases. The retention of collateral must follow the procedural protections that the UCC provides to the debtor, guarantors and other third parties.

The remedy of disposition of collateral is not restricted to sales (and can include leases and licenses of the personal property collateral). However, with mixed-collateral mortgages or mezzanine loans, a foreclosure sale is the typical form of disposition.

Under the UCC, little specific guidance is given as to how a foreclosure sale is to be conducted. Instead, the secured party is required to proceed so that every aspect of disposition is commercially reasonable. For property that is not sold on a recognized market (such as a stock or commodities exchange), there is only very general UCC guidance: the lender is protected if the disposition is made in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

While a lender may obtain court approval of the sales process, and be protected as to its commercial reasonableness, that can be a time-consuming process that will delay a disposition at a time when the lender feels value is best preserved by removing the debtor from ownership and operation of the property.

While the commercial reasonableness requirement is one that the debtor and guarantors cannot waive, they can set standards by agreement. However, that agreement may not bind all of the parties, such as junior secured creditors, with rights to challenge the conduct of a sale, and the standards agreed to cannot be manifestly unreasonable.

This leaves the secured party and its counsel to determine how to conduct the sale so that, if it is challenged after the fact, the secured party will be able to defend every aspect, including the method, manner, time, place and other terms as commercially reasonable.

Aspects of the sale that courts have examined have included the sufficiency of advertising (including type of publication, geographic reach of the publication and its relationship to the location and nature of the collateral; number of times a notice is published and length of time between the last publication and the time of the sale); whether dealers, brokers and likely buyers were contacted; whether cleaning or repair of the collateral was appropriate (and if done, whether the cost was reasonable; whether prospective bidders were given access to information available or obtainable by the lender; the location, time and place of a public auction, and any procedural or other requirements imposed on the bidding process. For some types of collateral, the lender will be familiar with the relevant market's process for soliciting bids, while for others, hiring a broker or other adviser may be advisable.

If the lender wants to acquire the collateral, then, with limited exceptions that will not be applicable to a mortgage or mezzanine loan, the lender is permitted to purchase the collateral only if it is the winning bidder at a public sale. This requires the lender to make efforts to locate other bidders for the collateral, as well as to determine the amount of its credit bid. There is no guidance in the UCC and little guidance in case law on the appropriate amount of the credit bid, but, generally, the lender should consider the same factors as if it were seeking to acquire the property outside a foreclosure context, including appraisals and other valuations.

If a lender fails to comply with the UCC in the conduct of a personal property foreclosure sale, it risks the loss of its deficiency claims against the debtor and guarantors, as well as liability for damages in some circumstances. The debtor also may be able to obtain an injunction against the sale, which would increase expense and cause delays.

In addition to the UCC requirements, the lender must consider whether there are other applicable laws or agreements that will affect the sale. Some sales of partnership or limited liability company interests are subject to federal and state securities laws, and additional requirements must be satisfied to avoid violating those laws. Agreements included in or relating to the collateral may restrict who can become a party to the contract or acquire the collateral. For example, with respect to a hotel, the franchise agreement may provide that the buyer must satisfy eligibility requirements relating to business experience, assets and equity and, as noted above, intercreditor agreements may include similar restrictions with respect to who can acquire the pledged interests in a foreclosure by the mezzanine lender.

Analyzing how to foreclose on personal property collateral can involve UCC requirements, other laws and contractual requirements. All of these need to be taken into account to avoid potential losses and liability.

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