

Pillsbury's Distressed Real Estate Task Force Presents: Mezzanine Loan Enforcement under the UCC

As part of Pillsbury's Swimming Lesson Series - Surviving and Navigating
the Choppy Waters of Distressed Real Estate

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Today's Discussion

- Scope
 - Mezzanine lenders' self-help remedies under article 9 of the Uniform Commercial Code following a default by the mezzanine borrower.
 - Mezzanine lender's relationship with others in the debt stack, particularly the senior mortgage lender, may impact the choice of enforcement options.
- Topics
 - Pre-foreclosure process and planning.
 - Types of self-help remedies under the UCC.
 - Foreclosure process and recent lessons.

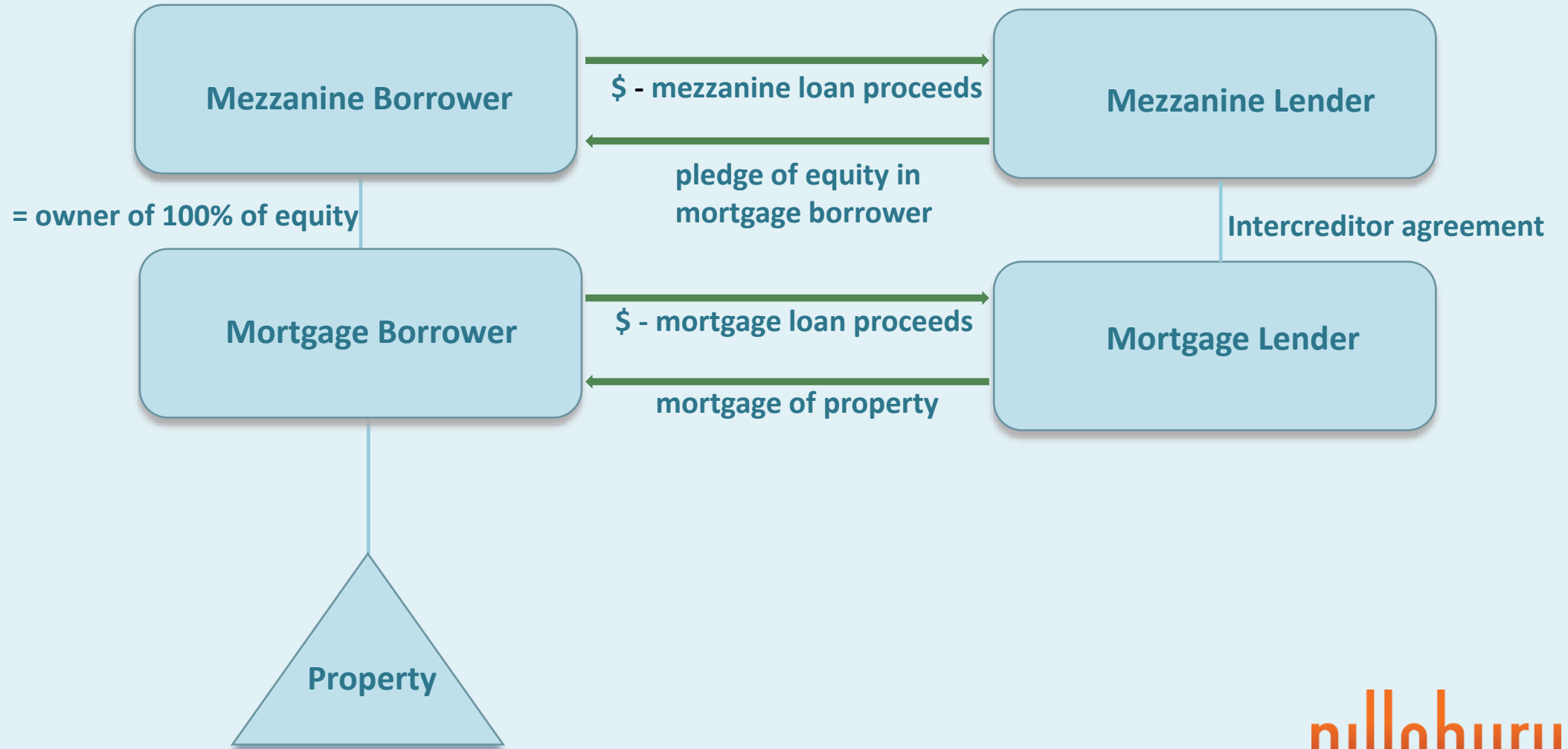
Mezzanine Loans – Background

- A mezzanine loan is not a real estate loan and does not give the mezzanine lender a lien on real estate collateral. Instead, it is a loan to an entity that directly or indirectly owns real estate and is secured by a pledge of the mezzanine borrower's interest in that entity.
- Even though the value of the mezzanine loan is tied to the value of the underlying real estate, because the collateral for the loan is comprised of pledged equity interests, personal property, the Uniform Commercial Code (UCC) and not real property law will apply when the mezzanine lender enforces its remedies.

Mezzanine Loans – Background Continued

- The mezzanine loan interest is junior to any mortgage loan(s) as well as real estate and tax liens that may have been filed against the real property. As a result, the mezzanine lender's foreclosure does not impact those liens and the mezzanine lender (or, potentially, a higher bidder at the foreclosure sale) forecloses on its collateral 'subject to' those senior interests.
- Mezzanine lenders derive some protections (in terms of cure and other rights) by entering into intercreditor agreements with mortgage lenders and other mezzanine lenders, discussed below.

Mezzanine Loans- Basic Structure



Pre-Foreclosure Process and Planning

- The mezzanine loan's junior status as relates to the real property creates a need for additional diligence and planning before enforcement efforts can begin.
- For example, the mezzanine lender must understand:
 - The nature of the default and any cure rights the borrower may have.
 - Any limitations or obligations that are impose on a foreclosing mezzanine lender by an intercreditor agreement.
 - Property-related lien issues and whether those have changed since the loan was originated.
 - Tax, employment, union and other potential liabilities that may relate to the property or the business being operated at the property.
 - If the mezzanine lender is "behind" a construction loan, the status of construction, the nature of the defaults and how the project can be completed.
 - If the business operated at the property is a hotel the mezzanine lender just understand any management agreements and any cross-default or restrictions on transfers.

Intercreditor Concerns: Think Ahead

- *Standstill* - One of the key provisions in an intercreditor agreement is the standstill provision, which gives the mezzanine lender a set amount of time to enforce its remedies before the senior lender can exercise its remedies.
- *Cure* - Mezzanine lenders have certain rights to cure both monetary and non-monetary Events of Defaults under the senior loans, but the number of monetary cures are usually capped in number.
 - The existence of standstill and accompanying cure rights can be particularly useful to buy time and evaluate options on how best to proceed.
 - Note that mezzanine lenders should carefully review the cure provisions and make sure there are no “Stuy-Town” issues so that the senior loan is not accelerated or needs to be paid in full in order to foreclose on the mezzanine loan.

Intercreditor Concerns: Think Ahead (cont'd)

- *Qualified Transferees* - Sometimes referred to as a Qualified Institutional Lender requirements, these provisions (and related definitions) place restrictions on the kind of entity that can purchase the loan or the equity - or that can foreclose on the mezzanine loan – in each case without senior lender consent- by imposing financial and experience metrics that have to be met.
- *Replacement Guaranties upon consummation of the Foreclosure* – The intercreditor agreement typically will require that the foreclosing lender or party put up new “replacement guaranties” within a set time period after the foreclosure occurs.
 - If possible, these should be pre-negotiated with the senior lender in order to speed the process along and provide some certainty to potential purchasers.

Intercreditor Concerns: Think Ahead (cont'd)

- *Purchase Option*– In addition to the standstill and cure rights, intercreditor agreements also give the mezzanine lender the right to purchase the senior loan(s) and to step into the shoes of the senior lender.
 - Some intercreditor agreements will provide that the purchase option must be exercised all the way down in the case of multi-tier debt stacks.
- *Deed in Lieu*- Intercreditor agreements also will provide protections to mezzanine lenders in the case of a borrower surrendering the keys to the senior lender. Typically, the intercreditor will have restrictions on the ability of the senior lender to accept the deed in lieu before the mezzanine lender can act and/or allow the mezzanine lender to exercise the purchase option a set amount of time after the deed in lieu, functionally allowing it to purchase the property.

Enforcement under the UCC

- The UCC provides for judicial foreclosures (not unlike foreclosure on a real estate mortgage), but it also affords mezzanine lenders “self-help” remedies.
- This means that the secured lender can pursue remedies against its collateral without the need for, and the cost (and delay) involved in, judicial action.
- These remedies are subject to UCC requirements that supplement (and often override) provisions in the mezzanine loan security documents.
- They are:
 - Public sale
 - Private sale
 - Strict Foreclosure

Enforcement under the UCC

- The UCC requires that every aspect of a mezzanine loan foreclosure must be “commercially reasonable,” but does not include much guidance as to what that means. In the words of the UCC:
 - “[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.”
- What is commercially reasonable is fact-specific and dependent on market conditions.
- Any after-the-fact analysis by a court will focus on the process and procedure employed by the foreclosing lender.
- Experience and market awareness are key.

UCC Remedies – Public Sale

- A public sale is one where there is a meaningful opportunity for competitive bidding and requires some form of advertisement to the public.
- Several provisions of the UCC (9-611 – 9-614) provide guidance concerning the notice of sale that must be given.
- 10-day notice is “safe harbor”.
- The secured lender may bid on the collateral in a public sale. This is a key advantage for mezzanine lenders with a loan-to-own strategy (unlike private sales).
- Private parties may agree by contract to procedures or standards for public sale. If ever litigated, generally will be enforced by a court provided they are not manifestly unreasonable or inconsistent with express terms of UCC.

UCC Remedies- Designing a Public Sale

- In developing a commercially reasonable sale process, a mezzanine lender should consider:
 - Retaining advisors, including a broker and/or an auctioneer.
 - Outreach to prospect purchasers through multiple channels.
 - Information and time available for diligence including the establishment of a data room.
 - Allowing prospective bidders to have access to the property before the auction;
 - Public notice.
 - Bidding procedures.

UCC Remedies – Conducting A Public Sale

- Today, auction probably will be virtual. Consider setting up virtual break-out rooms to allow for separate discussions with bidders.
- Secured party does not necessarily need to accept the highest bid.
 - E.g., it may be better to accept a lower price that's all-cash than a higher price that's part cash, part notes.
- It is not necessary to show that the auction price was the best price available in the market.
- An auction can be adjourned without a sale.

Foreclosure Process- a Note on Timing

- Collapsed market: it may be imprudent and therefore commercially unreasonable to dispose of collateral when market has collapsed.
- However if a court were to find a that the secured party held collateral for too long a period without disposing of it, and there is no reason for not making a prompt disposition, the creditor may face claims that the disposition was commercially unreasonable or violated the duty of good faith.
- This leaves mezzanine lenders between a rock and hard place in the present environment. If they act too quickly, they may be unreasonable, but if act too slowly they may be liable or even lose their remedies to the senior lender.

UCC Remedies – Conducting A Private Sale

- A private sale is one where there has not been an advertisement that gave the public meaningful opportunity to participate.
- The secured party cannot be the buyer of the collateral at a private sale (except for certain commodities with publicly quoted market prices).
 - The mezzanine borrower cannot modify this UCC provision.
- As with a public sale, a private sale must be conducted in a commercially reasonable manner. Otherwise the creditor risks exposing itself to liability.
- Here, too, no need to demonstrate that the private sale yielded the best price available.

UCC Remedies – Strict Foreclosure

- The secured party may make a proposal to the mezzanine borrower to accept the collateral in full or partial satisfaction of the mezzanine loan.
- The proposal must be consented to by the mezzanine borrower after the default.
 - Either affirmatively or by the mezzanine borrower giving its deemed consent by not responding to a notice of strict foreclosure within a designated time.
 - This consent requirement cannot be waived or otherwise consented to before default.
 - If proposal is rejected, secured party can only pursue a public sale.

UCC Remedies – Strict Foreclosure

- If the secured party has proposed a partial strict foreclosure (retaining its rights to pursue a deficiency claim against the mezzanine borrower or any secondary obligor), the secondary obligors must be notified as well - and if they object to the secured party's proposal then a strict foreclosure cannot be consummated.
- While a proposal to accept collateral in full or partial satisfaction is not subject to a requirement that the secured party act in a commercially reasonable manner, the mezzanine lender is required to make its proposal in good faith.
- Accordingly, it still may be advisable to engage appraisers or other advisers to make sure that the price offered is in good faith.

Additional Considerations- Traps for the Unwary

Potential Consequences- A mezzanine lender whose enforcement efforts are not commercially reasonable or otherwise violate the UCC's terms may expose itself to liability under the UCC:

- Under UCC 9-625(a) a debtor or obligor may be able to seek injunctive relief against the sale.
- Under UCC 9-625(b) – (c) a debtor or another junior secured creditor may seek a claim for damages against the lender.
- Under UCC 9-625(d) a debtor or obligor can seek recovery of damages for loss of surplus.
- Under UCC 9-626 a lender may lose its right to a deficiency claim.
- Failure to comply with UCC 9-617 may result in the lender or the purchaser losing its good faith transferee status.

Additional Considerations- Transfer Taxes

- Consider transfer tax concerns and build into cost model
 - Transfer taxes are not only triggered by a formal “sale.” In many jurisdictions transfer taxes may also be triggered by change of control of the mortgage borrower.
 - For instance in New York, Section 575.11(16) of 20 NYCRR specifically provides that, “[a] conveyance of real property pursuant to a secured party's enforcement of a lien, security interest or other rights on or in shares of stock, partnership interests or other instruments, . . . is subject to tax.”
 - In some cases the foreclosing lender will be able to collect this amount from a guarantor but doing so raises the risk that the guarantor will be unable to pay.

Recent Cases on Mezzanine Foreclosure: *1258 Mezz II LLC*

- New York courts have weighed in regarding the “reasonableness,” or availability, of UCC foreclosures during the Coronavirus pandemic. A short description of some of these decisions follows:
 - *1258 Assoc Mezz II LLC v 12E48 Mezz II LLC*- In this case, the court initially granted a temporary restraining order enjoining the mezzanine lender’s UCC foreclosure sale, but later reversed course and allowed the sale to proceed on the ground that the Executive Order, which barred judicial mortgage foreclosures of underlying real estate for a period of ninety days, did not expressly prevent UCC foreclosures from proceeding. The court reasoned that a foreclosure on the equity interests in a company that holds real estate is not, strictly speaking, a mortgage foreclosure and therefore was not covered by the Executive Order. The court further determined that an injunction was not warranted because any damage to the mezzanine borrower that flowed from the UCC foreclosure could be remedied by a claim for damages.

Recent Cases on Mezzanine Foreclosure: *D2Mark LLC*

- *D2 Mark LLC v. Orei VI Investments LLC*- In this case, the court enjoined a UCC foreclosure sale from moving forward but not because the sale was barred by the Executive Order. Instead, the court focused on language in the mezzanine loan agreement which the court interpreted as limiting the mezzanine borrower's remedies to injunctive relief (meaning that monetary damages were unavailable). The court scrutinized the terms of the mezzanine lender's proposed foreclosure sale and found that the mezzanine borrower had established a likelihood of success on its claim that the terms, as proposed, were commercially unreasonable, particularly in light of the continuing impact of the COVID-19 pandemic. The decision was not a complete defeat for the mezzanine lender, because the court provided a clear path forward, recommending specific measures that could be taken by the mezzanine lender to proceed with the UCC foreclosure sale.

Recent Cases on Mezzanine Foreclosure: *Shelbourne BRF LLC*

- *Shelbourne BRF LLC v. SR 677 BWAY LLC*-
 - The court issued an injunction against the mezz lender's collateral auction because the "[s]evere turmoil in the real estate market due to the pandemic"— rendered it unlikely that the sales process would produce a fair market price.
 - The court noted that "valuation of an equity interest in a company that owns real estate is based on the value of the real estate itself" and the current market distress "makes the notion of sale resulting in fair market value highly uncertain." The court then offered its view that "[b]ids will likely be discounted due to uncertainty about the continued length and severity of the pandemic."
 - The court ruled that "[c]onsequently, it would be unreasonable to permit the foreclosure sale to proceed on August 19, 2020.

Recent Cases on Mezzanine Foreclosure: *Shelbourne, part deux*

- The court's initial decision ordered that the mezz lender was enjoined from noticing or proceeding with a foreclosure auction "prior to October 15, 2020."
- On October 16, 2020, the mezz lender served a new notice of disposition and set a new date for an auction of the collateral.
- As before, the mezz borrower filed a motion for an injunction precluding the sale, this time with different results.

Shelbourne, part deux continued

- The court declined to enjoin the sale stating, in part, that:
 - “the balance of the equities does not favor plaintiff. Forcing defendant to continue funding the costs that plaintiff failed to pay would be commercially unreasonable given the state of the property and the debt to the senior lender.”
 - And, “[u]nder current conditions, mezzanine foreclosures are proceeding and the previously-cited administrative order is no longer in effect. Given the circumstances of this case and the current state of the pandemic, further enjoining this sale would be highly inequitable.”

Pillsbury's Distressed Real Estate Practice

We understand that clients must act *quickly and decisively* to create or preserve value, achieve stability and seize market opportunities. Pillsbury's Real Estate team is adept at working with clients to capitalize on the effects of market disruptions – whether resulting from inefficient capital structures, asset-specific difficulties or event-driven (or macroeconomic) distress situations.

Pre-bankruptcy experience:

- debt and equity restructurings, including loan modifications and workouts, and extension and forbearance agreements
- preferred equity investments and mezzanine loans in distressed situations
- acquisition and restructuring of distressed loans or interests in loans and ownership vehicle (including from government entities),
- formation of investment structures to acquire such assets
- loan enforcement and lien priority disputes, including judicial and non-judicial foreclosures and UCC foreclosures, deeds or assignments-in-lieu-of-foreclosure, receiverships and property recovery issues, writs of attachment or possession, analysis and defense of liability claims and analysis of intercreditor or co-lender agreements in complex debt stacks
- providing advice on alternatives to bankruptcy
- negotiation of rescue and exit financing

Real Estate bankruptcy experience:

- relief from stay litigation
- cash collateral stipulations and adequate protection
- bankruptcy sales
- resolution of lien priority and intercreditor issues
- cram-down litigation
- prosecution and defense of avoidance actions (e.g., fraudulent transfers and preferences)
- representation of indenture trustees
- all facets of unexpired leases, executory contracts and intellectual property licenses
- bankruptcy discharge and non-dischargeability actions
- negotiating and confirming plans of reorganization

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