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The Commercially Reasonable Real Estate Mezzanine Loan Foreclosure – Lessons from the Front Lines

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Introduction

More and more real estate mezzanine loans go into default every day. It is inevitable that some mezzanine lenders, after considering possible restructuring options, conclude that foreclosure presents the only viable solution. Numerous articles have been written recently on the mechanics of foreclosing mezzanine loans under Article 9 of the Uniform Commercial Code ("UCC"), but little practical advice has come back from the front lines as borrowers and lenders vie for control of complex real estate assets. The UCC was not drafted with membership interests in limited liability companies owning real estate assets specifically in mind and provides scant guidance for lenders looking to convert mezzanine debt into equity ownership. It is clear, however, that public sale foreclosures must be conducted in a "commercially reasonable" manner.[1] Meeting that standard, of course, is easier said than done. This article focuses on the real world strategic and tactical issues a mezzanine lender may encounter when conducting a mezzanine loan foreclosure involving a multi-faceted real estate asset.[2]

1. Know Your Asset

The current facts surrounding a real estate asset may be significantly different from those that existed at the time of the loan origination. In the course of operating or developing the asset, the borrower may have put new easements, long term leases, license agreements, management agreements or other arrangements in place. Similarly, certain permits or other arrangements with municipalities may not reflect the mezzanine lender's original understanding of how the property would be operated. Over the course of the loan, the borrower may have entered into affiliate contracts, made shareholder loans, transferred certain development rights or granted easements that benefit neighboring properties. The likelihood of such transactions having occurred rises as years pass and may rise substantially if the sponsor controlling the borrower is a developer with interests in any property adjacent to the asset. Accordingly, it is important to request and review as much documentation relating to the asset as the borrower or its third party managers and consultants will provide. Speed is crucial in this regard, as a borrower may have limited incentive (and even more limited resources) to follow the letter of the loan documents, respond to follow-up requests, or answer inquiries regarding current operational matters. This is more likely to be the case if a major default has occurred under the loan documents. Particularly in the case of large, multi-component assets, engaging local land use counsel (or even a private investigator) may be helpful in understanding the subtleties of the asset and the sponsor's operations and activities. Also, contact the title company early on to determine whether any liens or new encumbrances have been filed against the asset and whether any rights or interests have been transferred to affiliates of the sponsor. But remember that documents binding on the property owner need not be recorded in the land records to become binding on the foreclosing

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mezzanine lender (which, upon foreclosure, would become of the owner of the equity interests in the property owner).

2. Follow the Cash

Assuming the loan documents provide for a cash management system, review the cash management waterfall and any reserve accounts as currently administered (or not) by the servicer or mortgage lender. The identities of the servicer or the mortgage lender may have changed during the term of the loan, and some or all of the accounts contemplated by the loan documents may have been moved to another institution or placed under the control of the borrower or sponsor. It is also possible that the cash management provisions of the loan documents may never have been properly observed, particularly if a third party manager or operator (whose cooperation would have been required) was in place at the time the loan was originated. A mezzanine lender may require the assistance of the mortgage lender, the servicer or the property manager to rectify any deficiencies in cash management practices and to ensure that the sponsor cannot withdraw or misuse funds that are required to be held in the cash management accounts. Initiating the inquiry with respect to the current status of the cash management system immediately is critical to confirming that the reserve funds required to operate the asset will be in place following a successful mezzanine foreclosure. Keep in mind that depository banks and other third parties are generally less likely to cooperate as the foreclosure date draws near.

3. Run Multiple Foreclosures

The UCC provides for two alternative methods of foreclosure on real estate mezzanine loan collateral:

- A public sale process, which requires advertising in print media and holding an auction at which competitive bids can be made; and
- A "strict foreclosure" process, whereby the lender takes ownership of the collateral in full or partial satisfaction of the secured debt.

Although reviewing the many differences between these two processes is beyond the scope of this article, it is significant that the UCC permits a mezzanine lender to initiate both a public UCC foreclosure process and a strict foreclosure process simultaneously.

Strict foreclosures have two distinct advantages – time and money. If all goes well, a strict foreclosure can be consummated within 20 days after being commenced, which compares favorably to the 60 to 90 days typically required to consummate a public sale foreclosure under the UCC. Moreover, no cumbersome advertising or auction requirements apply to strict foreclosures. Even better, many non-recourse carve-out guaranties[3] contain provisions that make the entire mezzanine loan fully recourse to the guarantor if the borrower contests a foreclosure action undertaken by the mezzanine lender. Where this is the case, a borrower may decide not to contest the strict foreclosure for fear that lodging an objection could make the loan fully recourse to the guarantor.

Keep in mind that the UCC allows a borrower (or any other party with an interest in the mezzanine loan collateral) to prevent a strict foreclosure simply by sending an objection notice. For this reason, prudent mezzanine lenders will not assume a strict foreclosure can necessarily be consummated. A simultaneous public sale foreclosure should be initiated. If the strict foreclosure goes through, then the public sale process can be terminated early with no difficulty. In fact, the public sale process can be cancelled as late as the scheduled sale date.

4. An Asset Manager is an Asset

Interview and engage an asset manager early in the process. A qualified asset manager will point out any property-level issues that should be addressed early in the foreclosure process and will have the industry-specific acumen required to coordinate effectively with any existing third party managers or consultants. Remember, the borrower may use its familiarity with the asset as leverage to extend the foreclosure process and extract concessions while the foreclosure process is unfolding. The faster a lender can understand the unique attributes of the asset from an operations and management

standpoint, the quicker the borrower's leverage in this regard can be eliminated.

All too often, lenders delay engaging an asset manager until the UCC foreclosure sale is imminent. While avoiding several "extra" months of asset management fees is certainly beneficial, that benefit may pale in comparison to the costs associated with an asset manager who is "learning on the job". Another alternative, of course, is to delay the UCC foreclosure while the asset manager comes up to speed. The potential costs of that scenario, however, may be significant, as delay could allow the collateral to deteriorate or give the borrower or the sponsor time to launch acrimonious litigation.

5. Engage an Experienced Broker

As noted above, the UCC foreclosure process requires that a lender conduct all aspects of the foreclosure sale in a "commercially reasonable" manner. In determining what is commercially reasonable, the UCC provides protection for lenders that dispose of collateral in a manner similar to that followed by other sellers of similar collateral in the relevant industry.[4] It is customary for sellers of interests (direct or indirect) in real property to engage a broker. By doing so, therefore, a mezzanine lender gains a defense to any later claim an aggrieved borrower, sponsor or other party may lodge that the lender did not conduct its foreclosure in a commercially reasonable manner.

It is important, however, to ensure that the statements and materials provided to potential purchasers by the broker clearly indicate that the sale is a sale of the collateral (usually membership interests in a limited liability company asset owner) and not as a sale of the fee interests in the underlying asset. A broker should be cautioned not to give "guidance" to the market by communicating a range within which the lender might be expected to allow the membership interests to pass to a third party bidder. If the broker creates confusion in the marketplace or nurtures competing beliefs regarding the lender's intentions with respect to selling the collateral, a lender may expose itself to attack for running a foreclosure process that is not commercially reasonable. Worse, the lender could be exposed to lender-liability claims.

Similarly, great care should be taken that the broker does not communicate to the market that the mezzanine lender intends to take title to the collateral and then market the fee interests in the asset in a subsequent sale. Any such statements (even if true) could have the effect of chilling the bidding at the UCC foreclosure sale and thus could open the sales process up to attack as not being commercially reasonable. Even if all parties (including the broker) expect that the mezzanine lender will likely be the only bidder at the UCC foreclosure sale, the marketing process implemented ahead of the sale should be designed to maximize the possibility of competing bids.

6. Pick Your Battles with the Senior Lender

The intercreditor agreement between the mezzanine lender and the senior mortgage lender will govern certain aspects of the process by which the mezzanine loan collateral must be transferred to the mezzanine lender or (in the unlikely event of a successful third party bid) a third party purchaser. Any potential purchasers must be advised of any documentation that must be delivered or other requirements that must be satisfied by a transferee. The notice of sale and other transfer documents must also take into account any "qualified transferee" or other eligibility requirements set forth in the intercreditor agreement. Assuming the mezzanine lender expects to be the purchaser, it should devote thought early in the process to the ownership structure it will employ to take title to the collateral, recognizing that internal approvals and regulatory concerns may cause unanticipated delays.

The obligation of the mezzanine lender, present in virtually all intercreditor agreements, to cure material defaults under the senior loan documents as a condition precedent to being entitled to foreclose on its collateral, must be kept in mind. As the UCC foreclosure date approaches, a mezzanine lender should not be surprised to be copied on default notices from the senior lender with increasing frequency. These notices may demand cure payments for the funding of debt service, reserve accounts, unpaid taxes or insurance premiums, or reimbursements for senior lender legal costs. While these demands should come as no surprise to a savvy mezzanine lender, the culture shock a mezzanine lender

experiences when coming to grips with the fact that it will now be "the borrower" in the deal may be substantial.

There is little benefit to waging battles with the borrower and the senior lender simultaneously. This is especially true when the senior lender may have access to information (regarding property-level account balances, for example, or other operational matters) that the borrower refuses to share with the mezzanine lender. Having friends in high places, who are willing to share information, can be helpful at the final stages of the UCC foreclosure process. Moreover, mezzanine lenders are best advised to take title to the mezzanine collateral in full compliance with the intercreditor agreement and, wherever possible, without touching off an immediate battle with the senior lender. Any such battles can wait until after the UCC sale has been consummated and the mezzanine lender is comfortably ensconced in its new role as the property owner.

7. Manage the Managers

If the asset is managed by one or more third party managers, a subordination, non-disturbance and attornment agreement ("SNDA") between the mezzanine lender and the manager may exist. This document may address whether the mezzanine lender can obtain crucial information about the asset from the manager. In some cases, the mezzanine lender will need the cooperation of the senior lender to obtain such information. In other cases, direct requests of the manager can be made. Also, many SNDAs require a manager to provide an estoppel certificate upon request by the mezzanine lender. Such a certificate would serve to confirm that the management agreement is in full force and effect, whether any defaults exist and other critical information about the current status of management. Not only may such an estoppel certificate provide the lender with some peace of mind, it may be viewed as a valuable addition to the information contained in the data room established to market the collateral for the UCC sale. Accordingly, a prudent mezzanine lender will request a manager estoppel certificate early in the process.

The benefit to a foreclosing mezzanine lender of having an ally "on the ground" and physically present at the asset should not be underestimated. This is especially true in the case of longtime managers with deep knowledge of the asset. In this regard, if the mezzanine lender plans to terminate a third party existing manager following consummation of the UCC foreclosure, it is best to defer that decision until some weeks after the UCC sale. If the manager is a borrower affiliate, then such a termination will likely be unavoidable. That circumstance aside, however, the compounding impact of changing the sponsor and firing the manager simultaneously should be carefully considered before the mezzanine lender moves forward with any strategy that contemplates doing so.

8. Spin the Media

A well-connected borrower will likely already have contacts in the local media and may attempt to color any media coverage of the mezzanine loan foreclosure in a manner sympathetic to its own interests. Similarly, local and even national media may publish articles based solely on interviews with the borrower or the advertisements published in newspapers or other media attendant to the foreclosure process. This can lead to one-sided and ill-informed media coverage that could depress the potential selling price of an already distressed asset or make the property less desirable to prospective lenders, tenants, or hotel guests. Worse, media reports may further complicate tense negotiations with the borrower and third party managers. Mezzanine lenders should keep in mind that any bankruptcy case or local land use dispute will almost certainly be adjudicated in the local courts. Maintaining a good public image, particularly in any local media reports, can be a significant advantage in the event of litigation. Accordingly, a foreclosing mezzanine lender should appoint a proactive PR spokesperson early in the process. Left unmanaged, media relations will never break in the lender's favor.

9. Keep Confidences Confidential

The information exchanged among the various participants in the foreclosure process may be subject to any number of non-disclosure obligations. Confidentiality obligations may be created not only by confidentiality agreements, but also by the terms of a pre-negotiation agreement, common

interest information sharing agreement, third-party contract or property management agreement. Similarly, the loan documents governing the other positions in the debt stack may contain restrictions on sharing confidential information. In some cases, a mezzanine lender may have executed one or more stand-alone confidentiality agreements when considering whether to purchase other debt positions in the capital stack. Given all of this, populating a data room to be accessed by potential purchasers at the UCC public sale must be done in a manner that is mindful of any confidentiality restrictions. Carefully review all items contributed to the data room (and their source) before they are made available online, and make sure the broker requires all potential purchasers to sign a well-drafted non-disclosure agreement before gaining access to the data.

10. Consider the Bottom Line

In most cases, the economic fundamentals of a project will not change simply by reason of a mezzanine loan foreclosure. In other words, just because a mezzanine lender can foreclose does not necessarily mean that it should foreclose. To take an easy example, if the senior mortgage loan will soon mature and current market conditions allow for no realistic chance of a viable sale or refinancing, then a mortgage foreclosure may be inevitable. If so, then the cost of running a UCC foreclosure may outweigh the benefits. Indeed, the cost of conducting a mezzanine loan foreclosure is especially hefty in states like New York which impose transfer taxes on sales of controlling interests in entities that own real property.

In addition to the cost of the foreclosure itself, there may be ongoing property carrying costs with which to contend. Stabilizing an asset can be a time consuming and expensive process during which the mezzanine lender, as the new owner, may be required to fund deficits in interest payments, leasing rollover reserves and capital expenditure reserves, while simultaneously reimbursing the mortgage lender for all of its costs. A foreclosing mezzanine lender should assess its own appetite for "feeding the property" early on – before commencing the foreclosure process. The time and expense of conducting a successful mezzanine foreclosure should not be invested if the asset is running at a deficit and can be expected soon thereafter to be relinquished to the next lender in the capital stack.

11. Document Your Own Record, Not the Borrower's

The possibility that the borrower may launch a lawsuit at some point in the process cannot be ruled out. With that in mind, mezzanine lenders should avoid creating a record that will bolster the borrower's litigation case. Instead, create a record that demonstrates that the mezzanine lender conducted itself in an above-board fashion and that the UCC foreclosure was conducted in a commercially reasonable manner consistent with the requirements of the loan documents and the intercreditor agreement. Remember that the protections afforded to so-called "privileged communications" are sometimes lost and a senior mortgage lender that appears friendly today may forward all your emails to the borrower tomorrow. Communications that could be distorted by a creative litigator are best handled orally. On the other hand, items that tend to support the reasonableness of the auction process (a letter authorizing an affiliate of the borrower to submit a bid, for example) should be transmitted in writing. Bear in mind, however, that pre-negotiation agreements will preclude the admission in court of many types of communications. One practical approach is to include on all letters intended to be admissible in court a clear disclaimer indicating that they fall outside the umbrella of any pre negotiation agreement and are intended to be admissible.

Conclusion

Acting early and expeditiously, and anticipating potential stumbling blocks, is crucial to a successful outcome. To the extent possible, a mezzanine lender anticipating a UCC foreclosure should commence its due diligence with respect to a troubled asset early, preferably prior to the occurrence of a default under the loan documents. Advisors and brokers should be engaged at any early stage to assess the current condition of the asset, the costs associated with carrying it and the appetite, if any, that investors in the market may have for assets of this type. Finally, it is important to develop and exploit

relationships with senior lenders and property managers before such parties become uncooperative (by reason, for example, of following an agenda intended to maximize their own financial goals) or paralyzed (by reason, for example, of fearing potential litigation by the borrower as the foreclosure date approaches).

Undoubtedly, every mezzanine foreclosure will have unique elements. Stepping into the shoes of an existing property owner can be a chaotic process replete with unexpected developments. Nevertheless, keeping the points outlined in this article in mind can help a mezzanine lender ensure that its UCC foreclosure is completed expeditiously, that successful legal challenges to the process are unlikely, and that it has the knowledge it needs to effectively function as the owner of the troubled asset. And then the fun really begins!

Endnotes

[1] Article 9 of the UCC establishes very few hard rules to guide mezzanine lenders through the foreclosure process. The UCC requires that every aspect of a disposition of collateral be "commercially reasonable" with regard to the method, manner, time, place and other terms of the sale. The UCC leaves it to the courts to determine what constitutes a commercially reasonable sale. A court is likely to evaluate each step of the foreclosure process by comparing it to the process that the foreclosing lender would customarily follow if independently marketing and selling similar property for its own account.

[2] Tranche warfare (or skirmishes among lenders with differing interests in a real estate asset) is beyond the scope of this article. The prospect of significant disputes among members of an asset's debt capital stack, however, should be considered at an early stage and carefully evaluated.

[3] Non-recourse carveout guaranties generally provide for recourse liability to a creditworthy guarantor in the event any "bad boy" acts occur, such as a voluntary bankruptcy filing, an unpermitted transfer of the collateral, the misappropriation of cash flow, waste of the collateral and the like. Such guaranties often provide that certain categories of actions (misapplication of rents, for example) will result in recourse to the guarantor only to the extent the lender is damaged, whereas other categories of actions (a voluntary bankruptcy, for example) will result in full recourse to the guarantor for the entire loan.

[4] Section 9-627(b)(3) of the UCC states that a disposition is commercially reasonable 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." The UCC offers greater protection for dispositions on a recognized market, but the definition of a recognized market is limited to markets with standardized price quotations for property of a fungible nature (such as securities markets). Accordingly, courts will have the last say with respect to whether a foreclosing mezzanine lender acted "in conformity with reasonable commercial practices". General guidelines that can be derived from case law support a lender's decision to (i) advertise the property in appropriate media or trade publications, (ii) provide potential purchasers with adequate information and time to evaluate the property, (iii) hold the sale in a manner and place that increases the likelihood of bidder participation, and (iv) give the debtor adequate notice of the sale.

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