REAL ESTATE & CONSTRUCTION LAW MONITOR
MONITORING THE LATEST DEVELOPMENTS IN REAL ESTATE & CONSTRUCTION LAW
PUBLISHED BY
COLE SCHOTZ
COLE, SCHOTZ, MEISEL, FORMAN & LEONARD, P.A.

The Plight of the Unwary - Mezzanine Loan Foreclosures

Posted at 9:11 AM on September 22, 2009 by John S. Stewart

In the wake of the economic crisis and distress of the real estate markets, issues related to the foreclosure of mezzanine loans have become the subject of much discussion. A mezzanine loan put simply is a loan given to a business entity which is secured by the ownership interests in that business entity. In real estate transactions, the most frequent structure involves a pledge of the membership interests in a limited liability company. This limited liability structure is primarily the result of special purpose entity requirements imposed by commercial lenders to conform to securitized lending guidelines. Mezzanine loans provide an opportunity for an entity which owns commercial real estate to leverage its equity in instances in which the entity's real estate lender does not allow subordinate mortgage financing.

As a result of the current economic climate and percipitous decline in real estate values, many mezzanine loans are now in default due to reduced cash flow or the inability to refinance the loans. Many mezzanine lenders assume that if they foreclosed on the ownership interests in the entity they could assume management control of the real estate asset including the right to dispose of the asset. That assumption is not necessarily correct.

If the foreclosure is contested, the lender must concern itself with the requirements of the applicable Uniform Commercial Code ("UCC") and other applicable laws. Section 9-610 of the Uniform Commercial Code requires that a mezzanine foreclosure be conducted in a "commercially reasonable manner." Every aspect of a disposition of collateral must be commercially reasonable. This requirement explicitly includes the method, manner, time, place and other terms of the disposition. However, the UCC does not define what type of sale is commercially reasonable.

The law of the jurisdiction in which the business was formed, together with the organization documents of the business entity, control what rights a transferee of an ownership interest acquires. Many partnership agreements and operating agreements of limited liability companies limit the rights of a transferee of a partner or member's interest to an assignment of economic rights including a right to share in the profits and losses. However, many partnership agreements and operating agreements of limited liability companies prohibit a transferee the right to participate in the management of the entity or to take actions which legally bind the entity. Many lenders are aware of this but don't consider it a problem because the UCC, as adopted in most states, overrules such anti-assignment provisions, so that you can take assignment of economic rights notwithstanding a prohibition in the organizational document. However, the UCC as adopted in some jurisdictions would not protect the lender under the anti-assignment provisions. For example, Delaware, the governing law for many of these agreements, is different. Under Delaware's UCC, as well as its Partnership Act, Limited Partnership Act and Limited Liability Company Act, if an entity's organizational documents prohibit assignments of economic interests, the provisions in those documents will control. This means that you need to ascertain which state's law will govern the assignment of the economic interests. The UCC contains mandatory choice of law rules governing the perfection and priority of security interests, which do not apply to the granting of an assignment of economic interests. Moreover, it is uncertain whether a choice of law clause contained in loan documents will be effective on this question, even though such clauses are generally enforceable. This is because it is doubtful that a lender and a borrower can dictate which law will apply to govern the relationship between the borrower and the entity in which the borrower is invested. Therefore, a lender may not be able to avoid the application of Delaware law, because the applicable law may well be determined by choice of law rules which generally require a rational nexus analysis as well as other factors many of which are outside of the control of a lender.

Whether a mezzanine loan can been foreclosed such that the foreclosing mezzanine lender can gain control of the real estate controlling entity and have proper authority to operate and transfer the assets is not always apparent from an examination of the applicable loan collateral documents, entity organizations or formation documents, public records and applicable laws. In addition to reviewing the laws of the jurisdiction governing the loan collateral documents to ensure the foreclosure is done properly and the organization or formation documents of the transferring entity to be certain that proper authority for the transfer exists, you need to have a thorough understanding of the applicable laws relating to real estate transfers by the particular type of entity. The foreclosing mezzanine lender should also determine if the foreclosure including the control and/or ownership of the entity owning the real estate will result in transfer tax or other tax consequences to the foreclosing mezzanine lender.

In light of these restrictions and impediments, title companies are reluctant to insure any real estate transaction involving a transfer of property by a conveyance from the foreclosing mezzanine lender and will scrutinize the loan collateral documents as well as the entities corporate governance documents and the laws of the jurisdiction of formation. Accordingly, great care must be exercised any time a foreclosing mezzanine lender attempts to exercise its rights under the mezzanine loan documents or agrees to accept an assignment or other transfer in lieu of foreclosure. And, if the mezzanine lender intends to insure the transfer it is recommended that the mezzanine lender get the title company involved early in the process to confirm the transfer is insurable and before any of the lender's rights are compromised.

Cole, Schotz, Meisel, Forman & Leonard, P.A.

Court Plaza North
25 Main Street
Hackensack, NJ 07601
Phone:
(201) 489-3000

900 Third Avenue
16th Floor
New York, NY 10022
Phone:
(212) 752-8000

500 Delaware Avenue
Suite 1410
Wilmington, DE 19801
Phone:
(302) 652-3131

300 East Lombard Street Suite 2000
Baltimore, MD 21202
Phone:
(410) 230-0660