



Outside Counsel The Lender's Exit Strategy In Mezzanine Financing

Expert Analysis

A mezzanine loan is one in which the lender borrows on the strength of its equity interest in a company owning real property, either directly or indirectly. The company may be either a limited liability company or a limited partnership.

The equity interest may either constitute a security under Article 8 of the Uniform Commercial Code, if the company has elected to have its membership interests so treated,¹ or a general intangible under Article 9 of the Uniform Commercial Code.²

This article explores the secured party's options for enforcing its security interest and disposing of the collateral after it has declared an event of default.

The secured party's first decision is whether it should proceed by judicial or nonjudicial foreclosure. Typically, secured parties proceed by "nonjudicial enforcement," i.e., simply by following the self help rules in Part 6 of Article 9 of the UCC.

Judicial enforcement, however, provides several clear advantages to the secured party. In a sale pursuant to an execution, the secured party may buy in and obtain the collateral, a right not available if the collateral is sold in a nonjudicial enforcement that constitutes a private sale. It may thereafter hold the collateral free of the requirements of Article 9.³

Also, a disposition pursuant to a judicial proceeding is deemed commercially reasonable,⁴ whereas in a nonjudicial proceeding a sale may be challenged as to its commercial reasonableness. Since the debtor can sue the secured party and recover damages for an asserted failure to hold a commercially reasonable sale,⁵ and since there is little judicial or statutory guidance on the criteria for a commercially reasonable sale of membership interests, secured parties dealing with debtors known to be litigious may well prefer the security of a judicial foreclosure.

A judicial sale, however, carries with it greater burdens of time and expense. In a mezzanine loan, where the value of the membership interest and the underlying real property may be declining

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A further consideration is that the use of judicial sales to dispose of collateral is less familiar than exercise of Article 9 remedies, and there may be greater uncertainty about its parameters. New York's Lien Law §206 ostensibly provides such a remedy, although the reported cases predate the enactment of Article 9.⁶

The secured party's second option is either strict foreclosure or partial strict foreclosure. Retention of collateral after default is called "strict foreclosure" if it effects a complete satisfaction of the debt and "partial strict foreclosure" if it effects a partial satisfaction of the debt.

In a mezzanine loan, where the value of the membership interest and the underlying real property may be declining in tandem, immediate sale may be the most important consideration.

There is a significant difference in the acts that must be performed prior to exercise of this remedy, depending on whether strict foreclosure or partial strict foreclosure is sought. If partial strict foreclosure is sought, the secured party must have the debtor sign an agreement so stating after default, NY UCC 9-620(c)(1).

Under NY UCC §9-621(a), the notice must also be sent to: (1) persons that have notified the secured party that they claim an interest in the collateral; (2) other secured parties of record; and (3) secured parties perfected under federal law; and (b) such persons must fail to object.

How does the secured party get the debtor to sign after default? One could try to rely on any appointment of the secured party as attorney-in-

fact for the debtor that is present in the loan and security agreement. It is not clear, however, whether this may be regarded as an unenforceable end-run around the Article 9 requirement of debtor consent post-default. An additional option may be providing for a springing right of recourse if the debtor does not consent after default, subject to the same potential argument concerning enforceability.

If the secured party seeks strict foreclosure, however, it has another option for obtaining the debtor's consent. It may also secure consent by sending its proposal to the debtor and failing to receive notification of objection within 20 days.⁷

How long can the secured party simply hold on to the collateral before taking any action? Comment 5 to NY UCC §9-620 is intended to reject case law holding that the acts of the secured creditor in keeping the collateral for an unreasonably long time before attempting sale constitutes constructive strict foreclosure. The comment suggests, however, this is a factor in whether the sale was commercially reasonable.

Once the collateral has been accepted by the secured party, whether in partial strict foreclosure or strict foreclosure, it may be transferred to a purchaser. Acceptance of collateral in full or partial satisfaction of the debt: (1) discharges the obligation to the extent of the debtor's consent (i.e., completely or in part); (2) transfers all of the debtor's rights in the collateral to the secured party; (3) discharges the security interest that was the subject of the debtors consent, as well as subordinate security interests and liens; and (4) terminates any other subordinate interest.⁸

Comment 2 to NY UCC §9-622 notes, however, that these consequences arise only if the debtor's acceptance was an effective acceptance under §9-320. The purchaser from the secured party must, therefore, be assured as to the regularity of the consent. If the purchaser does not wish to investigate the bona fides of the consent or is unable to do so, it can purchase one of the "buyer's" or "owner's" policies available from insurance companies issuing UCC insurance.⁹

The debtor's right to arbitrarily refuse to agree to strict foreclosure (whether or not that refusal is reasonable) is likely to be a significant bargaining chip in any workout discussion. If the debtor does not agree, the secured party will have to conduct a sale.

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Commercially Reasonable

The secured party is required to hold a commercially reasonable sale.¹⁰ The sale may be public or private. The term “public sale” is not defined in Article 9, but a comment 7 to §9-610 offers the following guidance:

[A] ‘public disposition’ is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. ‘Meaningful opportunity’ is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition).

There is little guidance on what constitutes a “commercially reasonable sale” of the equity interest in an entity. However, the concept of “commercial reasonableness” would encompass both advertisement of the foreclosure sale in specialized real estate trade journals and possibly also identifying and notifying persons known to invest in properties similar to the underlying real property.

Securities Laws

Whether or not the membership interest is represented by a security certificate, it may constitute a security for purposes of the federal securities laws. These laws may impose additional restrictions on the sale.

Many lenders expressly state in the security agreement that the lender is not required to register the securities. Comment 8 to §9-610 states that the requirement of a public disposition should not compel the secured party to register previously unregistered securities. Therefore, such securities may be offered under circumstances that qualify the sale as a “private placement” under the federal securities laws.

Comment 8 to §9-310 also states that a sale that constitutes a private placement for purposes of the federal securities laws may nevertheless constitute a “public sale” for purposes of Article 9.

The secured party should also consider the effect of other restrictions on the transfer of the equity interest. It is common for intercreditor and subordination agreements in mezzanine finance transactions to provide that the membership interest can be transferred only to a “qualified transferee.” These parties may include: REITS, financial institutions, pension funds, or a “qualified institutional buyer” or an institution that is an “accredited investor” within the meaning of the federal securities laws that possesses assets in excess of a specified amount.

Independently of these requirements, the “change of control” requirement in the mortgage may make it necessary to seek the mortgagee’s approval of any potential bidder. This requirement may further limit the number of otherwise eligible bidders.

These restrictions raise the question whether Comment 8 to NY UCC §9-610, providing that a sale that meets the private placement requirements can be a “public sale,” would be

extended by analogy to a private placement in which only a qualified transferee approved by the mortgagee could be a bidder, or whether the sale conforming to these additional requirements would be considered a private sale.

This distinction is crucial to the ability of the secured party to buy in at the sale. It is to be hoped that courts would extend the rationale of Comment 8 to these situations as well.

Before conducting the sale, the secured party should consider whether it should attempt to buy in at the sale. This can be done only at a public sale, NY UCC §9-610(c). Furthermore, there is a risk that the secured party may be second guessed if the secured party’s winning bid appears to be less than fair market value.

Under NY UCC §9-615(f), sale of the collateral to the secured party or an affiliate or related party may be judicially scrutinized as to the price received. If this sale is “significantly below the range of proceeds that a complying disposition to...[another person] would have brought,” the surplus or deficiency is calculated on the basis of the hypothetical complying sale, not the sale that occurred.

Comment 10 to NY UCC §9-610 adds that a lower than fair market value price should also invite judicial scrutiny of the commercial reasonableness of the sale.

The secured party that intends to bid and knows there is a significant chance it will be the only bidder should consider both the benefits and the risks of obtaining independent appraisals of the real property and the enterprise.

The benefit is obvious: A bid at or above the appraised value will be difficult to challenge, particularly if the sale was otherwise procedurally regular. The detriment, however, is that the secured party may be compelled to bid the amount of the appraised valuation for fear of triggering a challenge.

Advanced Notice

One of the most important debtor protections in Article 9 is the right to be notified in advance of the sale. Under NY UCC §9-611(d), however, it is permissible to dispense with a notice to the debtor of the sale when the collateral is threatening to decline speedily in value. An argument may be made that this section applies when the mortgage loan is in foreclosure, or when foreclosure on the mortgage loan is threatened, as either of these events would reduce or eliminate the value of the membership interest or shares.

If foreclosure is not proceeding or threatened, a prior notice to the debtor is required. NY UCC §9-612(b) provides a 10-day safe harbor for this notice.

Under §9-611, there are parties other than the debtor that should be notified of the sale. They are: (1) any secondary obligor (guarantor); (2) any other person that has notified the debtor that it claims an interest in the collateral; (3) any other secured party that, 10 days before the notification date, held a security interest in the collateral perfected by a filing against the debtor;

and (4) any other secured party that held a security interest in the collateral perfected by a federal filing.

The form of notice is specified in §9-613. Since there is a safe harbor for a notification that uses the form, there is no reason to vary from the form.

The purchaser at either a public or private sale normally takes all of the debtor’s rights in the collateral, §9-617. The foreclosure sale discharges the security interest under which the disposition is made; and discharges any subordinate security interest or other subordinate lien, other than liens arising under state statutes expressly preserved by the enacting jurisdiction.

In the uniform version of this section, a bracket was inserted to indicate that an enacting jurisdiction that wished to preserve liens should list the specific statutes under which the liens are created. New York removed the brackets and referred generally to liens that are entitled to be preserved, leaving it a mystery as to what those liens might be.

Under §9-617(b), a transferee that acts in good faith takes free of the security interest under which the disposition was made, as well as subordinate security interests and liens, even if the secured party failed to comply with the default provisions of Article 9. Thus, the purchaser need not inquire as to the regularity of the sale or whether a statutorily correct notice was given.

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1. See NY UCC §8-103(c).

2. Generally, the secured lender will be able to tell whether it holds a security or a general intangible. There may be a question, however, if the membership interest is represented by a security certificate but the operating agreement or the partnership agreement does not refer to an election to have the membership interest be represented by a security.

3. See NY UCC §9-601(f) and Comment 8 thereto.

4. See NY UCC §9-627(c)(1).

5. See NY UCC §9-625(b).

6. “An action may be maintained to foreclose a lien upon a chattel, for a sum of money, in any case where such a lien exists at the commencement of the action. The action may be brought in any court, of record or not of record, which would have jurisdiction to render a judgment, in an action founded upon a contract, for a sum equal to the amount of the lien. For the purposes of this section and of sections two hundred seven to two hundred ten inclusive a chattel mortgage to secure the payment of a loan of money or other debt, or the purchase price of chattels, a contract of conditional sale of personal property, a hiring of personal property where title is not to vest in the person hiring until payment of a certain sum and a security interest created by a security agreement in personal property, shall be deemed a lien upon a chattel. The procedure in an action to foreclose a mortgage on real property, in so far as it may be applicable, shall apply in actions to foreclose a mortgage or other lien on chattels or other personal property.”

7. See NY UCC §9-620(c)(2).

8. See NY UCC §9-622.

9. Currently, these companies are Chicago Title Insurance Company and the First American Title Insurance Company.

10. See NY UCC §9-610.