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Mezzanine Finance: The Lender's Exit Strategy

In recent years mezzanine financing has become increasingly used to finance commercial real estate projects. A mezzanine loan is one in which the lender borrows on the strength of its equity interest in the company owning the real property, either directly or indirectly.

The company is typically either a limited liability company or a limited partnership, whose equity interest may either constitute a security under Article 8 of the Uniform Commercial Code (UCC), if the company has elected to have its membership interests so treated,¹ or a general intangible under Article 9 of the UCC.

Default and foreclosure are frequently afterthoughts when the documentation is being drafted. During an economic downturn, however, it makes sense to plan ahead and consider the lender's options if default should occur. This article explores the steps the lender may take prior to default.²

Some Initial Considerations

The first step a lender should take when default is threatened is to consult any intercreditor or subordination agreement by which it may be bound to see whether the approval of any other party is required to modify the security agreement entered into by the debtor. If such modification is still possible, it may be worthwhile to offer a troubled borrower financial or other accommodations in return for modifications in the security agreement that would reduce the secured party's potential exposure to liability in the event of foreclosure.

The secured party's largest exposure in enforcing its remedies is a claim by the debtor for damages arising from the secured party's failure to hold a commercially reasonable sale. The UCC requires that every aspect of a foreclosure sale be commercially reasonable.

Given that there is little precedent or history of what exactly constitutes a commercially reasonable sale in connection with a mezzanine loan, it is difficult for a secured party to be certain that it can



insulate the sale from attack. Although the parties may have initially failed to provide for the characteristics of a sale that would be deemed "commercially reasonable," an amendment to the security agreement can so provide. Under New York UCC §9-603, the parties may by agreement establish the standards measuring the fulfillment of the duties of the secured party (including the N.Y. UCC §9-610(b) duty of holding a commercially reasonable sale) if the standards are not "manifestly unreasonable."

The second reason for consulting the intercreditor or subordination agreement to determine whether the mezzanine lender has the right to cure defects in the mortgage loan. It is likely that if default is threatened or deemed likely to occur on the mezzanine loan, default on the mortgage loan is also threatened or has already occurred.

The chief reason why it is helpful to the secured party to be able to cure a default is that it may take time for the secured party to arrange a commercially reasonable sale of the equity interest. First, advertisements may have to be placed in trade journals or other specialized media whose lead time may be longer than the lead time for a newspaper of general circulation, and second, parties expressing interest will want to perform due diligence as to both the equity interest and the real property. Therefore, the secured party should have the opportunity to time the sale as circumstances dictate. This timing goal is more easily accomplished if the secured party is not operating under the threat of imminent foreclosure on the mortgage.

Review Loan Documentation

After reviewing the intercreditor or subordination agreement, the lender should review the loan documentation and filed financing statements to see whether its security interest was and remains a perfected, first-priority security interest. UCC insurance, insuring the attachment, perfection, and priority of security interests in personal property, has been available during the period that mezzanine finance was growing in popularity, and has been required by the majority of lenders. If such insurance was purchased, the lender can be assured that there was a first priority security interest on the day of closing, (or on a later date, if the policy was dated down to that date).

Even if the secured party's lien is a first priority lien, it would also be a good idea to run a search against the debtor to determine whether any junior liens have arisen since the closing date. Because a junior creditor has a right to foreclose, the senior creditor should know if a junior creditor exists. Additionally, if there are any financing statements that are within the six month window for filing a continuation statement, they should be continued now.

The most important item of collateral, the certificate representing the membership interest (if the entity has elected to have its equity interest treated as a security) should already be in the secured party's possession. If the certificate was taken into possession but subsequently lost, the secured party should notify the issuer³, and follow the steps outlined in Article 8 of the UCC for obtaining a replacement certificate.⁴ If the collateral is to be sold after default, the lender will have to transfer the certificate to the purchaser.

Although the equity interest is the most important item of collateral, the security agreement may also claim a security interest in the entity's books and records (tangible or electronic). It may be useful to the secured party to obtain and review them prior to the sale to determine the state of finances of the entity and what changes, if any, have occurred in the organizational documents since the closing. Under N.Y. UCC §9-609(c), the debtor is required to assemble the collateral after default, even in the absence of an agreement, but many security agreements provide that the collateral will be assembled and delivered to the secured party upon demand.

Next, any control agreement among the bank,

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the debtor, and the secured party covering a deposit account should be reviewed to see whether it requires that a specific form of notice be given to the bank or the broker, or whether the secured party is free to draft its own form. If there is no specific form of notice, the secured party might draft a sample form and present it to the bank or broker for prior review, so that the secured party will know in advance of default that its form is acceptable.

Property-Ownng Entity

The most common incorrect assumption is that a membership interest in an LLC or limited partnership is like shares in a corporation, so that if the lender has obtained a security interest in a 100 percent membership interest, upon default it can step into the shoes of the debtor, become a member of the entity, and vote those shares. On the contrary, it is necessary to consult the LLC operating agreement (or partnership agreement) to determine what the secured party's rights may be. If the relevant agreement is silent, do not assume that there are no restrictions on becoming a member, as the applicable jurisdiction's governing law will likely contain default provisions addressing such rights.

Since many mezzanine finance transactions involve the use of Delaware limited liability companies, a look at the relevant provisions of the Delaware limited liability act are instructive.

For example, see 6 Del. Code §18-702:

Assignment of limited liability company interest

(a) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement and upon:

(1) The approval of all of the members of the limited liability company other than the member assigning the limited liability company interest; or

(2) Compliance with any procedure provided for in the limited liability company agreement.

(b) Unless otherwise provided in a limited liability company agreement:

(1) An assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member....

What, then, does the secured party receive? In Delaware, for example:

(1) An assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and

(2) A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of the member's limited liability company interest. Unless otherwise provided in a limited liability company agreement, the pledge of, or granting of a security interest, lien or other encumbrance in or against, any or all of the limited liability company interest of a member shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member.⁵

These provisions raise the possibility that the secured party will be left with limited enforcement rights if it cannot become a member. The operating agreement or partnership agreement and transaction documents should be reviewed to see what provision, if any, has been made for the secured party to become a member. For example, there may be signed, undated consents of the existing members to the admission of the secured party, or express provision for the admission of the secured party upon default.

The Article 9 Overrides

It is sometimes assumed that §§9-406 and 9-408 of the New York UCC, which generally override certain restrictions on assignment, enable the secured party to disregard transfer restrictions. However, it is necessary to parse these sections carefully. If the operating agreement is silent and the restriction on assignment comes from the governing jurisdiction's LLC statute, note that, New York did not enact the override to statutory restrictions on assignment. Furthermore, if the entity has elected to have the membership interest represented by a security, neither of these sections overrides restrictions on transfers of securities. These sections relate to payment intangibles and general intangibles (i.e., membership interests not represented by a security).

Finally, if the entity is organized in Delaware, these anti-assignment provisions do not apply to the entity because Delaware has enacted a statute that overrides these "override" sections for limited liability companies. It provides:

Sections 9-406 and 9-408 of this title do not apply to any interest in a limited liability company, including all rights, powers and interests arising under a limited liability company agreement or this chapter. This provision prevails over §§9-406 and 9-408 of this title.⁶

A similar provision addresses limited partnerships.⁷

Finally, the secured lender should consider the effect of a bankruptcy filing by the debtor. Hopefully, the various entities (if more than one) involved in the mezzanine financing have all been structured so as to be bankruptcy remote. If they have not, it is possible that if bankruptcy ensues a provision in an agreement that entitles the secured party to become a member upon the occurrence of an event of default may be considered an "executory contract," and thus vulnerable to rejection by the bankruptcy trustee under §365 of the Bankruptcy Code. Also, enforcement action

may be subject to the automatic stay of §362.

Conclusion

The last consideration is perhaps the most obvious: has there been an event of default? N.Y. UCC §9-625 provides damages for noncompliance with Article 9. Each of the remedies provided in the default sections may be exercised "upon default" or "after default." If there has not actually been a default as determined by the loan and security agreement, the secured party may recover damages, including "loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing."⁸ Comment 2 to this section notes that the secured party is required to proceed in good faith. Thus, declaration of a default for a minor or trivial breach of a representation, for example, may give rise to damages. This section is a reminder that although "lender liability" litigation may have diminished in recent years, the good faith enforcement requirement is preserved by statute.



1. See N.Y. UCC §8-103(c).
2. A subsequent Outside Counsel article in NYLJ will address disposition of the collateral once a default has been declared.
3. See N.Y. UCC §8-406.
4. See N.Y. UCC §8-405.
5. See 6 Del. Code §18-702(b).
6. See 6 Del. Code §18-1101(g).
7. See 6 Del. Code §17-1101(g).
8. See N.Y. UCC §9-625(b).