Forbes.com

Sep 24, 2021, 10:00am EDT | 257 views

Risk Reduction For Mezzanine Loan Borrowers

Joshua Stein Contributor

Real Estate

I write about commercial real estate negotiations, deals and legal issues.

A subway is seen in front of skyscrapers in Long Island City on February 18, 2019 in the Queens borough of New York City. - Seattle-based online retailer Amazon said they are cancelling plans to build a second corporate headquarter in Long Island City after encountering opposition from some local politicians and residents. (Photo by Johannes EISELE / AFP) (Photo credit should read JOHANNES EISELE/AFP via Getty Images) [-] AFP VIA GETTY IMAGES

Real estate financing often includes something more than an ordinary mortgage loan. A borrower often obtains additional funds through a separate mezzanine loan, secured by a pledge of ownership interests in the entity that owns the mortgaged real estate. Because those ownership interests are not real estate, the lender's rights are governed by the Uniform Commercial Code rather than real estate law. The UCC states that if the

mezzanine loan defaults, the lender can foreclose relatively quickly and easily – at least in comparison to mortgage foreclosures in many states, including New York. This is because, unlike New York mortgage foreclosures, UCC foreclosures don't require the lender to go to court.

Quick and streamlined mezzanine loan foreclosures are great for mezzanine lenders. But they expose mezzanine borrowers to the risk of losing their equity so quickly that they can't possibly have enough time to find new investors, new lenders, or some other way to recapitalize their project and save their investment. Even if a mezzanine lender generously gives the borrower 60 days' notice of a foreclosure auction, the borrower still might not have enough time.

All of this has become abundantly and painfully clear to some mezzanine borrowers during the pandemic. Aggressive or impatient lenders held UCC foreclosure sales with relatively little notice. Those sales wiped out hundreds of millions of dollars of equity value, or at least equity value that existed before the pandemic. In some cases, the courts intervened to slow down the process, but that's hardly a great source of comfort for future mezzanine borrowers.

Perhaps when mezzanine borrowers negotiate new mezzanine loans they should not accept the "standard" rights and remedies that the UCC offers lenders, or that typically appear in standard pledge agreements for mezzanine loans. Perhaps borrowers should refuse to accept the risks of mezzanine loan foreclosures that can move with blinding speed.

Of course, mezzanine lenders think that the entire UCC foreclosure process is completely satisfactory, standard, and set in stone. "Everyone does it this way" and always has. Lenders will offer a predictable collection of arguments against any change. Whether or not a borrower can demand improvements will depend largely on the state of the market and the desirability of the borrower's transaction. If multiple mezzanine lenders compete to make an economically attractive mezzanine loan, then they might decide they can accommodate a borrower's concern about the mezzanine loan foreclosure process.

See next page

If a borrower has enough leverage to open this conversation, it should start by asking for comfort that a UCC foreclosure auction won't occur so quickly that the borrower has no hope of doing anything to save its position. The UCC and most pledge agreements say the mezzanine lender needs to give the borrower only 10 days' notice before any foreclosure sale. That is, of course, nowhere near enough time for the borrower to find new capital to repay the mezzanine loan and stave off the sale.

As a practical matter, mezzanine lenders often give 30 to 45 days' notice before a foreclosure sale. That isn't really enough time either.

Maybe a borrower should insist on receiving 120 days' notice of the sale, to try to give them enough time to save their investment. The lender might reasonably attach a price tag, payable in cash, as a condition of any such extension.

A borrower might also think about other parts of the UCC foreclosure sale process. For example, the terms of any UCC foreclosure sale often require the winning bidder at the sale to post a deposit of 10% of the high bid. Then, within 24 hours, the winning bidder must pay the remaining 90% and close the purchase of the collateral. Maybe 5% or less should suffice. And maybe the closing should take place at least 30 days after the auction sale. Those changes would make it easier for the borrower to place the winning bid and actually close.

The lender would also, of course, need to agree that the borrower or its representative can bid at the foreclosure sale. Lenders often prohibit that. The borrower should also try to assure that the winning bid can be freely transferred if necessary.

As a final suggestion but not necessarily the last word, the borrower might want the lender to agree to never use a particularly powerful weapon – the "strict foreclosure" process. That mechanism allows the lender to automatically acquire its collateral if it sends a notice to the borrower and the borrower doesn't object within a certain time.

Changes like these would help a mezzanine borrower reduce the risk of sudden loss of its investment. Although the vast majority of mezzanine lenders would resist such measures, a desirable borrower with a desirable transaction might prevail. A slightly higher interest rate might help.

If a mezzanine lender accommodates a borrower's request for kinder and gentler foreclosure procedures, the mezzanine lender would also need to look at the other side of the capital stack. It would need to make sure that any concessions did not create new problems in dealing with the mortgage lender. That's a separate discussion.

Joshua Stein

I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

Published on Forbes.com September 24, 2021