Commercial Real Estate Mezzanine Loan Foreclosures

A Practical Guidance® Practice Note by
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This practice note discusses mezzanine loan foreclosures, including methods of and defenses to foreclosure under Uniform Commercial Code (UCC) Article 9, as well as practical and strategic considerations for borrowers and lenders relating to UCC Article 9 enforcement actions and conducting a commercially reasonable mezzanine loan foreclosure sale in the midst of a global pandemic.

For more information about mezzanine financing, see Mezzanine Financing Resource Kit, Commercial Real Estate Mezzanine Financings, Mezzanine Financing, Mezzanine Lending, Intercreditor Agreements (Mortgage Lender and Mezzanine Lender), Mezzanine Loan Closing Checklist, Mezzanine Loan Structure Diagram (Real Estate Transaction), Mezzanine Workout Checklist, Irrevocable Proxy Agreement (Mezzanine CRE Loan), Intercreditor Agreement (Mezzanine Financing) (NY), and Control Agreement (Mezzanine CRE Loan).

For more on foreclosures, see Foreclosure of Real Property, Commercial Real Estate Loan Defaults and Remedies, Workouts of Commercial Real Estate Loans, and Mezzanine Workout Checklist.

A mezzanine loan is a loan made to the owner of the equity interests of a single-purpose property owning entity that is a borrower under a mortgage loan. The mortgage borrower must also be a single-purpose entity with real property as its sole asset. Unlike a mortgage loan that is secured by a lien on the real property itself, a mezzanine loan is secured by a pledge of the mezzanine borrower's 100% equity interests in the mortgage borrower. These equity interests are personal property; therefore, the pledge is governed by the UCC, rather than real property law. Upon a default under the mezzanine loan, which is cross-defaulted with the mortgage loan, the mezzanine lender will commence a foreclosure under the UCC. When a mezzanine lender forecloses on its mezzanine loan, the mezzanine lender is foreclosing on the pledged equity interest in the mortgage borrower, and not the real property itself. A UCC foreclosure of a mezzanine loan indirectly secured by real property could take as little as 10 days but is typically a 45- to 90-day process. On the other hand, in states like New York where a foreclosure of a mortgage on real property requires a judicial process, a mortgage foreclosure can take well over a year to complete.

Advantages of Mezzanine Loan Foreclosure

While the relative speed of a mezzanine loan foreclosure is a definitive advantage to a mezzanine lender, a mezzanine loan foreclosure requires the foreclosing mezzanine lender

to take title to the collateral subject to all intervening liens. As the collateral is the ownership and control of the mortgage borrower, the mezzanine lender not only becomes the 100% owner of the mortgage borrower, it also effectively becomes the owner of the underlying real property. It should be noted that the underlying real property will remain subject to all liens and encumbrances (including the mortgage loan itself), which, by contrast, would have been extinguished in a mortgage loan foreclosure process.

Mezzanine loans are attractive to real estate owners as they provide the opportunity to borrow funds at a greater loan-to-value ratio than is typically available with mortgage financing alone; however, the speed of a mezzanine loan foreclosure can put the property owner at a disadvantage if it seeks to challenge it.

Intercreditor Agreements

In a financing transaction that involves both a mezzanine and mortgage loan, the lenders will enter into an intercreditor agreement at or around the time of the closing of the loans, which will govern their respective rights and obligations toward each other, including the strict conditions that the mezzanine lender must satisfy to complete a mezzanine loan foreclosure. These conditions include, but may not be limited to the following:

- Curing all mortgage loan defaults either before or simultaneously with foreclosure
- The equity transferee being a qualified transferee meeting certain financial and experience requirements
- The appointment of a qualified property manager
- The posting of a replacement guarantor (for any nonrecourse carve-out guaranty, environmental indemnity, completion guaranty, carry guaranty, or payment guaranty) –and–
- The establishment of a hard cash management system

For additional discussion of mezzanine loan intercreditor agreements, see Intercreditor Agreements (Mortgage Lender and Mezzanine Lender), Mezzanine Financing Resource Kit, and Intercreditor Agreement (Mezzanine Financing) (NY).

UCC Foreclosure Procedures

Article 9 of the UCC provides a process for foreclosing on secured collateral outside of a judicial process. Mezzanine lenders are customarily required to take to actions to exercise their remedy to foreclose on equity collateral under the terms of most market mezzanine loan documents and intercreditor agreements. Mezzanine lenders should review and comply with the specific foreclosure requirements in the applicable loan documents and intercreditor agreement. Mezzanine lenders will have other rights and obligations under an intercreditor agreement not related to its foreclosure rights and obligations, such as the right to consent to loan document modifications and mortgage loan purchase rights.

Default Notice

To commence a UCC foreclosure, the mezzanine lender must send the mezzanine borrower and any guarantor a default notice under the mezzanine loan agreement. This default notice must include a reservation of rights and remedies by the mezzanine lender. The mezzanine lender must notify the mortgage lender, and any other senior or subordinate mezzanine lenders, of the event of default and the mezzanine lender's intention to foreclose on its collateral. In the event that there are holders of subordinate mezzanine loans, the mezzanine lender will also be required to provide such subordinate mezzanine lenders with the opportunity to cure the defaults under, and/or purchase, the mezzanine loan at issue.

Once the default notice has been sent, the mezzanine lender must keep the mortgage lender and any junior mezzanine lenders reasonably informed of the status of the foreclosure, including providing copies of all material notices, pleadings, motions, and briefings. If the mortgage lender or any senior mezzanine lender provides the mezzanine lender with a notice of default under such senior loan, the mezzanine lender must consider exercising its rights under the intercreditor agreement to cure such defaults under the senior loan until the mezzanine lender completes its foreclosure. Under the terms of most intercreditor agreements, a junior lender is afforded the right to cure defaults for nonpayment of monthly debt service under a senior loan for a stipulated period of time (e.g., four consecutive months) and to cure nonmonetary defaults. A mezzanine lender will not have the ability to cure a maturity default—although, in states where a mortgage foreclosure can be completed quickly, a mezzanine lender may try to negotiate a short standstill period upon a maturity default, providing the mezzanine lender sufficient time to foreclose on its mezzanine loan before a mortgage loan foreclosure. The mezzanine lender must cure defaults under any senior loan, or exercise its rights to purchase the senior loan, in order to prevent the holder of the senior loan from exercising its remedies (e.g., foreclosure or deed in lieu of foreclosure) which would leave the mezzanine lender with a pledge in an entity that no longer has any assets.

A mezzanine loan is evidenced and secured by loan documents that are similar to the mortgage loan and often also on similar forms. Instead of a mortgage or deed of trust, the lender's interests in the mezzanine loan are secured by a pledge and security agreement that pledges the mezzanine borrower's 100% equity interests in the mortgage borrower to the mezzanine lender. Pledge agreements usually require that the mezzanine lender provide at least 10 days' prior written notice to mezzanine borrower, as pledgor, of the time and place of any public or private sale of the equity collateral under the UCC. It is generally recommended that the mezzanine lender provide a minimum of 30 days' prior written notice of any public sale to provide potential bidders adequate notice and opportunity to conduct due diligence and participate in the auction to help demonstrate to a court—if the sale is challenged—that the sale was conducted in a commercially reasonable manner.

New York UCC

New York law is generally selected as the governing law for mezzanine loan documents, regardless of the location of the real property. Under the New York UCC, the mezzanine lender, as a secured party, may sell the equity collateral by public or private sale provided that the method, manner, time, place, and other terms of such sale are commercially reasonable. N.Y. U.C.C. Law § 9-610(b). It should be noted, however, that the mezzanine lender may acquire the equity collateral only at a public sale because equity collateral is not "customarily sold on a recognized market or the subject of widely distributed standard price quotations." N.Y. U.C.C. Law § 9-610(c).

In some instances, pledge agreements themselves may stipulate what procedures will constitute a commercially reasonable sale. Under U.C.C. § 9-603(a), "the parties may determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party under a rule stated in Section 9-602 if the standards are not manifestly unreasonable." For example, the mezzanine lender may require the mezzanine borrower to agree in the pledge agreement as to the governing law of the sale, time and location of the sale, the auctioneer and/or the auction process, notice procedures, and publication requirements. Notwithstanding this advance agreement, a mezzanine borrower may still raise a commercial reasonableness challenge even if the mezzanine lender strictly followed the agreed-upon procedures. For example, if a pledge agreement designates that an auction must occur on a business day in New York City, but the sale occurred on the day of a blizzard or during a global pandemic, the mezzanine borrower may have grounds to challenge the sale as commercially unreasonable.

Reasonable Authenticated Notice of Sale

The mezzanine lender must send reasonable authenticated notification of the sale to the following parties:

- The mezzanine borrower and any guarantors
- Any person from which the secured party has received, before the notification date, an authenticated notification of a claim of an interest in the equity collateral –and–
- Any other secured party or lienholder that, 10 days before the notification date, held a security interest in or other lien on the equity collateral perfected by the filing of a financing statement

N.Y. U.C.C. Law § 9-610(c)(1)–(3).

Reasonable authenticated notification means the notice must be reasonable as to the manner in which it is sent, its timeliness (i.e., a reasonable time before disposition is to take place), and its content. N.Y. U.C.C. Law § 9-611 comment 2.

Under the safe harbor provision, the mezzanine lender complies with the notification requirement if the following takes place:

- Not later than 20 days or earlier than 30 days before the notification date, the secured party requests information concerning financing statements indexed under the debtor's name in the office which to file a financing statement against the debtor covering the collateral as of that date. –and–
- Before the notification date, the secured party either:
    - Does not receive a response to the request for information –or–
    - Receives a response and sends an authenticated notification of disposition to each secured party or other lienholder named in that response whose financing statement covered the collateral

N.Y. U.C.C. Law § 9-611.

A notice of sale sent after default and 10 days or more before the earliest time of disposition set forth in the notification is deemed to be sent within a reasonable time before the sale (N.Y. U.C.C. Law § 9-612(b)); however, sending a 10-day sale notice, especially for a public sale of equity collateral in real property, is generally held by courts to be an insufficient period of advance notice. Generally speaking, however, the contents of the notice of sale are sufficient if the notice does the following:

- Describes the debtor and the secured party
- Describes the equity collateral that is the subject of the intended disposition

- States the method of intended disposition (e.g., public sale)
- States that the debtor is entitled to an accounting of the unpaid indebtedness and states the charge, if any, for an accounting –and–
- States the time and place of a public disposition

See N.Y. U.C.C. Law § 9-613(a).

Conducting the Foreclosure Sale

The mezzanine lender will take additional actions to prepare for and conduct a public foreclosure sale of the equity collateral. While these actions may not be expressly required under the relevant mezzanine loan documents—generally, the mezzanine loan agreement, pledge, and intercreditor agreement—or the UCC, custom shaped by New York case law dictates that the following steps are critical to protect the mezzanine lender's interests and to help ensure that the foreclosure sale is conducted in a commercially reasonable manner:

- **Due diligence.** The mezzanine lender will conduct due diligence on the underlying project, the mortgage loan, and mortgage borrower, and review the mortgage loan documents, including any guaranties relating to the mortgage loan, or any third-party consent rights, such as a ground lessor.
- **Formation of transferee.** The mezzanine lender will form an entity that satisfies the requirements of the intercreditor agreement and obtain rating agency confirmation if required. Such an entity is generally defined as a qualified transferee under the intercreditor agreement.
- **Replacement guarantors.** Replacement guarantors will need to be identified and will need to sign replacement guarantees as required by the intercreditor agreement. The replacement guarantor will further be subject to any liquidity and net worth requirements in the mortgage loan documents.
- **Auctioneer and marketing.** The mezzanine lender will engage a professional auctioneer and investment banker/broker to develop and implement a plan to market and sell the equity collateral at auction to qualified bidders.
- **Data room.** The mezzanine lender and its professionals will need to prepare bid package or set up a virtual data room to include, among other things:
    - A description of the equity collateral and the underlying real property
    - The mezzanine loan documents and mortgage loan documents
    - The organizational documents of mortgage borrower
    - Financial information relating to the real property, mezzanine borrower, and mortgage borrower, to the extent available
    - The terms of sale, bidder eligibility, and bidding procedures
    - A confidentiality agreement with prospective purchasers
    - A bill of sale and purchase agreement
    - Appraisals of the project –and–
    - Title, survey, leases, and other property level due diligence, such as any payment in lieu of tax (PILOT) agreements, ground leases, condominium documents, and/or hotel franchise agreements
- **Advertising.** The mezzanine lender must also advertise the sale of the equity collateral in industry journals/publications and/or send targeted mailings of the sale of the equity collateral to prospective purchasers.
- **Credit bid.** The mezzanine lender will credit bid its debt at public auction or require a third-party bidder to outbid the mezzanine lender and pay off the mezzanine loan.
- **Deposit.** A third-party bidder will need to post a deposit in connection with a winning bid, typically equal to 10% of the amount of the bid.
- **Closing.** The mezzanine lender and its professional advisors will conduct a closing shortly following the public sale of the equity collateral, at which the winning third-party bidder must pay the balance of its bid and satisfy all remaining requirements in accordance with the terms of the sale.
- **Communications with mortgage lender.** The mezzanine lender will communicate with the mortgage lender during the foreclosure process and negotiate amendments to the mortgage loan documents. Such amendments may include resetting milestone dates for performance obligations.
- **Organizational documents.** The mezzanine lender or a winning third-party bidder and the mortgage lender will also need to cooperate to amend the mortgage borrower's organizational documents following the equity foreclosure sale.
- **Title insurance.** The mezzanine lender or a winning third-party bidder may desire a new title insurance policy in connection with the foreclosure of the equity.
- **Transfer taxes.** If a transfer tax is imposed by the jurisdiction in which the underlying property is located, consideration must be given to whether the recourse carve-out guarantor is obligated to pay such transfer tax liability.

- **Property-specific concerns / other third-party agreements.** Additional documentation is likely to be required with respect to certain types of real property. For example, if the underlying real estate is a hotel property, the mezzanine lender will also need to review the franchisor documentation, comfort letters, and recognition agreements.

For more on foreclosure sales, see Foreclosure of Real Property.

Commercial Reasonableness and COVID-19

While the above guidance as to what constitutes a commercially reasonable sale gives mezzanine lenders an idea of the steps to follow, conventional wisdom provides little guidance on how the concept of commercially reasonableness may change in the instance of outside events beyond the parties' control—such as a global pandemic. As a result of COVID-19, mezzanine borrowers have begun to ask New York courts to enjoin scheduled public sales of equity collateral on the basis that the sales were not being conducted in a commercially reasonable manner. In one recent case, D2 Mark LLC v. OREI Investments LLC, 2020 N.Y. Misc. LEXIS 2978 (Sup. Ct. Jun. 23, 2020), the borrower challenged the reasonableness of the mezzanine lender's sale notice issued 36 days before the initial scheduled date of the public sale of equity collateral, the majority of such time occurring during the governor's stay-at-home orders preventing potential bidders from in-person inspection of the property. The mezzanine lender issued a notice of UCC foreclosure sale after only a single missed payment, and while the mezzanine lender and mezzanine borrower were actively engaged in workout negotiations. The court ordered the mezzanine lender to reissue notice of the sale for an additional month, holding that the COVID-19-related conditions, including the then-current lockdown, failed to provide potential buyers with sufficient time to conduct their due diligence and attend the auction, and therefore, rendered the proposed sale under the initial notice commercially unreasonable.

In another New York case, 1248 Associates Mezz II LLC v. 12E48 Mezz II LLC, 2020 N.Y. Misc. LEXIS 5099 (Sup. Ct. May 18, 2020), the court granted a temporary restraining order preventing a public sale of collateral securing a junior mezzanine loan, ruling that the borrower's request for relief in having its case considered by the court was essential in the current environment. The junior mezzanine loan at issue was secured by equity interests in the entity which owns and controls the owner of a 161-key hotel/time-share and retail property under construction in Manhattan. The junior mezzanine lender argued that the failure of the borrower to cause the mortgage borrower to achieve substantial completion of the project pursuant to the terms of the junior mezzanine loan documents no later than December 31, 2019, was an event of default thereunder. The mezzanine borrower argued, in part, that not only had the property achieved 80% of the substantial completion threshold cited in the loan documents, but that it had attempted to find replacement financing and had been actively engaged in discussions regarding same with the mezzanine lender.

The sale of the collateral was advertised in a subscription-only industry publication inviting potential bidders to the auction to be held at the offices of the junior mezzanine lender's counsel 14 days later. One factor cited by the borrower in disputing whether such a sale would be commercially reasonable was the lack of mention in the published notice of the possibility of participating in the sale without being physically present in an office at a time when all nonessential gatherings were banned and the offices of all nonessential businesses were closed in New York State. The sale notice did not contain mention of measures to protect health and safety including virtual bidding, as more recent sale notices do. The mezzanine borrower argued that in the COVID-19 environment, the planned manner of the sale was intended to prevent potential qualified bidders from having the meaningful opportunity to conduct customary due diligence and to bid on the collateral at a public auction for the highest possible price. The mezzanine borrower further alleged that the nature of the sale was constructed so that the junior mezzanine lender could ensure that it would be the only qualified bidder present, in order to gain control of the collateral (and as such, control of the underlying property).

Ultimately, in the 1248 Associates Mezz case, the court (declining to address a number of the borrower's arguments as to the commercial reasonableness of the sale) permitted the sale to go forward. The New York State Supreme Court has held that the standard for permanently halting a UCC foreclosure sale is for the junior mezzanine borrower to demonstrate that the holding of the sale would cause it irreparable harm which could not be cured by the payment of monetary damages. As a result, the junior mezzanine borrower would have to seek recourse following the UCC foreclosure in a cause of action to recover its monetary damages resulting from the sale.

In New York State, Governor Andrew Cuomo has issued a series of executive orders creating and subsequently extending a moratorium on commercial mortgage foreclosures and evictions, most recently under Executive Order 202.64, issued on September 18, 2020, and extending

the moratorium until October 20, 2020. As New York courts have held in several recent cases, including those discussed above, the foreclosure moratorium does not apply to sales governed by the UCC, allowing mezzanine lenders to continue to pursue their foreclosure rights in New York. Due to the fact that New York law is often selected in mezzanine loan documents regardless of the location of the property, the decisions of New York courts will continue to have far-reaching implications on these issues.

The COVID-19-related economic downturn has put pressure on mezzanine borrowers, causing defaults or imminent defaults absent their lenders agreeing to restructure the terms of their loans. Some sectors of real estate, such as hospitality and retail, have been hit much harder than other sectors, such as multifamily, industrial, and logistics properties. Courts are likely to continue to assess the commercial reasonableness of UCC foreclosure sale challenges on a case-by-case basis as the pandemic continues. Mezzanine lenders should take appropriate actions to ensure that their UCC foreclosure sales are difficult to attack as commercially unreasonable.

We further expect the courts' assessments of valuation under current market conditions to continue to play heavily into their review of challenges to future UCC foreclosure sales in New York and elsewhere. However, as the pandemic continues and resets the commercial real estate market in the long term, it will become increasingly difficult for courts to stay UCC foreclosure sales based on perceived current value reductions due to the pandemic. As a result, mezzanine lenders faced with a current or pending default under the mezzanine loans in their portfolio should engage qualified counsel and professional sales and marketing teams to engage in efforts to plan, market, advertise, and conduct their UCC sales so as to attract the attention of as many qualified bidders as possible and to afford them adequate time to perform due diligence in advance of the sale.

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Kristen E. Andreoli focuses her practice on commercial real estate transactions, including acquisitions and dispositions, financing transactions, leasing, development, and ownership matters ancillary to ongoing real property holding and management. She represents institutional lenders, developers, and other equity stakeholders in real property transactions. In this capacity, she also advises clients on real property ownership structures to fit their evolving needs, including the formation of entities and trusts to protect real property interests.

Ms. Andreoli has extensive experience in many types of commercial real estate finance matters, including traditional mortgages, CMBS loans, mezzanine and other forms of equity-based financing, construction loans, cross collateralizations, spreader agreements, loan modifications, and loan defeasance transactions. She regularly drafts and negotiates leases, financing documents, tenant estoppels and SNDAs, title-related agreements, as well as acquisition/disposition related agreements.

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As part of his general real estate practice, Steven represents real estate investors, developers, landlords and tenants in real property acquisitions and assemblages, dispositions, financing, leasing and subleasing in all asset classes (including hospitality, office, retail, multifamily and residential). As part of this practice, Steven frequently represents joint venture partners in negotiating joint venture agreements. He also represents clients in sale/leaseback transactions, master leases, ground leases, REIT based transactions, and is experienced in Sharia law compliancy.

Steven's corporate law experience includes representing clients on corporate acquisitions/M&A matters and general corporate law (including company formation, operating agreements, and joint venture agreements). Steven also routinely issues legal opinions, including nonconsolidation opinions, Delaware bankruptcy law opinions and state law enforceability opinions.

Steven creates long-lasting relationships with his clients through creative legal solutions and a deep understanding of his clients' business objectives. He has represented and advised major institutions, including Brookfield Asset Management, Penn National Gaming, The Georgetown Company, John Hancock Life Insurance Company, Walker & Dunlop, Deutsche Bank, Cantor Fitzgerald, Hunt Investment Management, Atalaya Capital Management, American Immigration Group, Citigroup, DLJ, and Fortress.