real estate finance & investment
The newsweekly of the commercial property and capital markets

May 28, 2010

Current Conditions in the Real Estate Mezzanine Market

By **Todd Soloway** and **Luisa Hagemeier**

Current conditions in the real estate market may force an unpleasant dilemma upon the many mezzanine lenders secured only by ownership interests in their borrowers, rather than by junior mortgages on the borrower's real estate, when those borrowers fall into default. Specifically, if the value of the real estate is insufficient to satisfy the loans it secures, mezzanine lenders holding only equity in the borrower have to choose between (i) foreclosing on the shares or participation interests in the borrower or (ii) doing nothing, and watching a sizeable investment evaporate when lenders secured by the real estate foreclose and leave the borrower entity an empty shell.

Depending on how poor the value-to-debt ratio has become, this is not an easy choice for the mezzanine lender. While the first option has initial appeal, foreclosing on ownership interests in the borrower, thereby stepping into the borrower's shoes, may actually leave the mezzanine lender saddled with debts and obligations (such as the under-collateralized mortgages), and none of its assets. In such cases, a walk-away might look good.

Necessity being the mother of invention, however, many such mezzanine lenders have found their way around this lose-lose dilemma by negotiating with the priority-holding secured lenders to restructure the existing debt, enabling the mezzanine lender both to enforce its security interest by foreclosing on the borrower's equity and avoid, or at least control the extent to which its investment turns into a liability. To preserve this option, however, it is important to be aware of the mechanisms and requirements for successfully foreclosing on ownership interests in the borrower, particularly the keystone requirement that a disposition of the borrower's collateral must be commercially reasonable. Given the variations in court's interpretations of what satisfies that requirement, discussed below, it may be wise to consider reducing uncertainties at the moment of truth by building terms into the initial loan documents defining the methods and price standards deemed by both parties to be commercially reasonable in the event of default, foreclosure and disposition.

Remedy in the Event of Default on a Mezzanine Loan

In the era of ever-increasing real estate values, mezzanine loans secured by shares in the borrower entity, rather than by a mortgage interest in its real estate, became more commonplace. Such collateral is personalty, not real estate, and thus the mechanism for enforcing the lender's security interest is found in Article 9, Section 6 of the Uniform Commercial Code, not the Real Property Actions and Proceedings Law. Foreclosure under UCC Article 9 has considerable advantages over foreclosure under the RPAPL, most notably expedience and simplicity due to the absence of the requirement of judicial supervision. The collateral may even be disposed of in a private sale if it "is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotation."

It did not escape the notice of the Code's drafters that that kind of freedom can engender abuse. Thus, while it is relatively simple to foreclose on the collateral for a mezzanine loan in the event of default, to have the disposition stick, mezzanine lenders must be sensitive at the outset (and, as we discuss herein, even when the loan documents are being negotiated and drafted), to the requirement that the disposition be "commercially reasonable." The New York Court of Appeals has characterized as the "touchstone of the secured party's obligations."

Section 9-610(b), which sets forth the rights of a secured creditor to dispose of the collateral securing its loan, provides among other things that "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms must be commercially reasonable." The requirement that the disposition of collateral be commercially reasonable is so fundamental that the UCC prohibits the debtor from waiving or "varying" it. If the disposition is challenged, the secured lender bears the burden of proving that the disposition was commercially reasonable.

Commercial Reasonableness under the UCC

The underlying purposes and policies of the UCC, codified in Article 1, § 103(a), are: "(1) to simplify, clarify, and modernize the law governing commercial transactions; (2) to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and (3) to make uniform the law among the various jurisdictions." Consistent with the Codes' motivating purpose of deferring to organically evolving practices of given commercial industries, it comes as no surprise that, despite the primacy of the commercial reasonableness requirement, the term is not defined the Code.

Instead, the Code stops short at articulating two scenarios in which a disposition *will* be deemed commercially reasonable *per se* (judicially approved dispositions and dispositions made "(1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition"), and two that *do not preclude* a finding of commercial reasonableness (non-judicial sales or sales in which "a greater amount could have been obtained by a collection, enforcement, disposition or acceptance at a different time or in a different method from that selected by the secured party").

The rest, it appears, has been left to the courts.

Commercial Reasonableness in New York Courts

Courts presented with the question whether a disposition of collateral was "commercially reasonable," in accordance with UCC Article 9, § 6 maintain that they look at the "totality of the circumstances" and that no single element controls this determination. Off the bat, therefore, a mezzanine lender attempting to follow rules that will yield a secure result are face the uncertain task of complying with the cardinal element of (i) a statute that gives that element no definition and (ii) a body of case law that's only discernible rule appears to be that determinations are made on a case-by-case basis.

While no hard-and-fast rules can be devised, some general parameters have been set. According to the New York Court of Appeals in *Bankers Trust Co. v. J.V. Dowler & Co.*, for instance, a disposition may be found to be commercially reasonable as a matter of law *either* based on the proceeds it yields *or* based on the method followed in disposing of the collateral, using as a guide "consideration of accepted business practices . . . to what is most likely to protect both debtor and creditor." In *Dowler*, the price obtained on dissolution of bonds, the collateral as issued, passed muster as a matter of law even they were sold below their face and actual values, where both parties admitted that those values were inflated. The "method" of disposition - sale on a recognized market - was held to be commercially reasonable by virtue of the statute itself. That finding remained true even though the debtor argued that a smaller deficiency would have resulted if the lender had presented the bonds to a third party, who had undertaken to pay their full price, because, the Court held, the lender "had the right to perceive such tolerance as contrary to its legitimate self-interest. Certainly, the code was not intended to place a secured party at a borrower's mercy by permitting it to speculate with pledged collateral at will."

Of course, not all cases present such tidily resolvable factors. In the context of scenarios that can arise in this area, however, a case like *Dowler* - where the parties agreed that the price on disposition accounted for an inflated market factor, and the method followed was commercially reasonable per se under the Code - is something of a 'gimme.' The decision in *Sackman Mortgage Corp. v. European Am. Bank*, for instance, calls into question whether commercial reasonableness can be established either by the price or the method, or whether the proper test is whether the sale can be vitiated if either element is found to be unreasonable, given that the "prime objective of the codes' mechanisms is optimizing resale price." Still, depending on the totality of the circumstances, sales yielding proceeds of only 12% of the collateral's value may be held commercially reasonable as a matter of law.

Building Standards for Foreclosure Into Mezzanine Loan Documents

In the atmosphere described above, and considering the underlying purposes of the UCC, it would seem to behoove all parties to build terms defining the agreed procedures for a "commercially reasonable" disposition into the mezzanine loan documents themselves. Assuming sophisticated parties on both sides, doing so would not run afoul of the prohibition against waiving or varying the requirement of commercial reasonableness, because parties are expressly permitted "by agreement to determine the standards by which the performance of obligations is to be measured if such standards are not manifestly unreasonable." It would enable the parties to contemplate the demise of the loan, and the terms under which it may be foreclosed, in the clear light of day, rather than in the heat of litigating a default. And, of benefit to all concerned, it would introduce (at least a measure of) certainty into the process of foreclosing on mezzanine loan collateral.

Todd Soloway *is a partner at law firm* ***Pryor Cashman*** *and is chairman of its real estate litigation group and* ***Luisa Hagemeier*** *is of counsel.*