Strategic Thinking for the Mezzanine Lender

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Feature

Mezzanine loans were designed for borrowers seeking additional capital for real estate projects believed to have values exceeding the mortgage debt encumbering them, while offering lenders higher returns than first-mortgage loans. Following the savings-and-loan crisis of the late 1980s, and cognizant of the problems that subordinate mortgagees could create for them in cases of default and bankruptcy, many first-mortgage lenders refused to permit their borrowers to take out secondary mortgage financing. The spectacular growth of the commercial mortgage-backed securities industry beginning in the 1990s spawned the popular use of "mezz loans," which largely replaced junior mortgages. Nationally-known rating agencies ranking debt and securities offerings secured by commercial real estate dramatically influenced the origination of commercial mortgage loans.[1]

The Common Structure

Guidelines promulgated by the rating agencies produced the following common structure that covers both mezz lending and the bowore:

- The mortgage borrower (the "property owner") would be a bankruptcy-remote special-purpose entity (SPE) owning only one real estate property or project;
- The property owner would grant a senior mortgage encumbering the property to a mortgage lender, and no other mortgage on the real estate would be permitted;
- The property owner would be owned by another SPE (the "mezz borrower"), a holding company that takes out the mezzanine loan, which is secured by a pledge of the mezz borrower's ownership interests in the property owner.
- The lender to the mezz borrower (the "mezz lender") would not hold a direct claim against the property owner or its assets.

This structure has also been utilized by lenders intending to sell participations in their loans without securitizing them. It has been estimated that between $50 billion and $75 billion in mezz loans have been made to fill the gap between borrowers' equity and first-mortgage loans.[2] From 2004-07 in particular, mezz financing remained a favored financing tool, as capital was abundant, loan underwriting standards were relaxed and mortgage and mezz lenders aggressively competed for deals. Given the ongoing freeze of credit markets, the virtual collapse of the mortgage loan securitization industry, the dramatic slowdown in commercial real estate markets and the filing of major real estate bankruptcy cases, mezz lenders need to consider how they will protect their position should their borrower's project become distressed.

Fundamental Concerns of a Mezz Lender

The mezz lender has structural priority ahead of the property's equity owner but stands behind the senior mortgage lender. The relationship between the mezz lender and the senior mortgagee is typically governed by intercreditor agreements, which typically provide that a default under the mezz loan does not cause a default under the mortgage loan. The mezz lender must verify that this feature is actually in place. Moreover, the loan documents may provide that a default under the mezz loan triggers a "cash sweep" under the mortgage loan that permits the mortgage lender to trap all cash flow from the property to pay its debt, property expenses and fund reserves, leaving little or no money to pay the mezz lender. The mezz lender must be on guard for this.

The mezz lender must also ascertain whether the mortgage loan is in default or dangerously close to a default even if the mezz loan is not. Intercreditor agreements usually grant the mezz lender the right to cure the property owner's defaults while the mortgage lender temporarily forbears. If the property's value clearly exceeds the sum of all outstanding liens encumbering it, the mezz lender will likely be interested in exercising that right, but the mortgage borrower and property owner may agree on a resolution of a troubled project that effectively leaves the mezz lender with little or no recovery. Should the mortgage lender conduct a foreclose sale, the mezz lender would be left with a pledge of interests in a borrower that no longer holds any interest in the property. In addition, should the property owner commence a chapter 11 case, the mezz lender would not ordinarily hold a claim in the property owner's case and would not have the right to vote on or object to a proposed plan of reorganization, even one that calls for a transfer of the property from the property owner. This would leave the mezz borrower as nothing more than an empty shell. Accordingly, the mezz lender must act promptly and decisively when a loan goes into default before the actions of others decide its fate.

During workout negotiations, if the mezz lender is willing to advance additional funds into a particular project, it will want to obtain a security interest in an asset of the property owner, such as a pledge of cash accounts—but it should expect resistance from the mortgage lender. The mortgagee will want to prevent the mezz lender from becoming a direct, secured creditor of the property owner because it does not want the mezz lender to have standing, in a chapter 11 of the property owner, to take positions adverse to it regarding issues such as debtor-in-possession financing or plan confirmation.

Recent situations have shown that a mezz lender cannot assume that a borrower structured as a bankruptcy-remote SPE will not be able to commence a bankruptcy case.[3] Unreported bench rulings in *RiverAir LLC*[4] suggest a strategy that a mezz lender may wish to pursue:

1 Andrew R. Berman, "Once a Mortgage, Always a Mortgage—The Use (and Misuse) of Mezzanine Loans and Preferred Equity Investments," 11 *Stan. J.L. Bus. & Fin.* 76, 99 (Autumn 2005).

2 Lingling Wei, "Mezzanine Debt Loses Its Shine with Investors," *Wall St. J.*, Feb. 18, 2009, http://online.wsj.com/article/SB123491174266103567.html. While this estimate does not appear to be based on specific empirical data, it at least provides a general indication of the widespread use of mezzanine financing during the period preceding the recent economic downturn.

3 *See In re Gen Growth Props. Inc.*, 09-11977, 2009 WL 2448423 (Bankr. S.D.N.Y. Aug. 11, 2009); Kris Hudson and Lingling Wei, "Move by General Growth Rattles Malls' Investors," *Wall St. J.*, May 8, 2009, http://online.wsj.com/article/SB124163910180492861.html.

4 *In re RiverAir LLC*, Case No. 04-17586 (SMB) (Bankr. S.D.N.Y. Nov. 29, 2004).

preventing the mortgage borrower from pursuing a bankruptcy case. As a technical matter, this case did not involve the typical mezz loan, and there was no cooperation between the mortgagee and the property owner regarding the bankruptcy filing or a proposed restructuring. The approach of the lender holding the pledge of interests in the property owner whose loan went into default prebankruptcy merits a mezz lender's consideration.

In re RiverAir LLC: *A Case Study*

Background

The lender formed the debtor as a New York limited liability company (LLC) to develop certain valuable air rights for a condominium construction project and owned all the membership interests. The lender sold the membership interests in the debtor to a holding company in return for a purchase-money promissory note. The holding company executed a pledge agreement under which it pledged all the membership interests in the debtor as security for the note.

Under the pledge agreement, the holding company assigned all of its voting rights[5] to the lender, but the holding company was permitted to exercise those rights as long as no default occurred under the note or pledge agreement. The pledge agreement provided that if an event of default were to occur and be continuing, then the pledged membership interests, at the lender's option, "shall be registered in the name of the" lender or its nominee, who "may thereafter exercise (i) all Voting Rights, all membership and other rights pertaining to the Pledged Interests and (ii)...any other rights, privileges or options pertaining to the Pledged Interests as if it were the absolute owner thereof."

The pledge agreement further provided that, upon the occurrence of an event of default, the pledgor (holding company) irrevocably directs the debtor on receipt of written notice from the lender to "deem and treat Pledgee [Lender] or such nominee in all respects as the sole member of the Debtor (and not merely as an assignee of Pledgor) entitled to exercise all the rights, powers [and] privileges (including without limitation, all Voting Rights)... and to have all other rights, powers and privileges appertaining to such limited liability company membership interest." The debtor executed an acknowledgement and consent, pursuant to which it agreed that all terms and conditions of the pledge agreement were binding upon it.

Events Leading to the Bankruptcy Filing

A payment default occurred under the note. The lender then sent the debtor and holding company a default notice, and demanded that the membership interests in the debtor be reregistered in its name. The notice declared that under the terms of the pledge agreement, the lender had become entitled to exercise all voting rights.

Simultaneously, the lender commenced two lawsuits in New York state court: an action to collect on the note, and an action for a declaratory judgment that the lender owned all the membership interests in the debtor by virtue of strict foreclosure[6] and could exercise the voting rights. The holding company's counsel objected to the strict foreclosure and advised the lender's attorneys that the debtor would be filing a bankruptcy case. The lender's attorneys responded that the holding company no longer had the right to authorize any such filing.

Nevertheless, the holding company, its parent company and the debtor (collectively, the "RiverAir debtors") filed chapter 11 petitions, with the holding company executing a resolution authorizing the filing of the petition for the debtor.

The lender promptly filed a motion to dismiss the debtor's case, arguing that the bankruptcy court lacked jurisdiction over it because the filing was not properly authorized. The RiverAir debtors contended that the the lender's demand letter was not self-executing. They argued that in order to acquire membership interests in the debtor, the lender was required to call a meeting of the members of the debtor to replace management to effectuate the reregistration, and the membership interests had to be reregistered in the lender's name, either voluntarily by the debtor or pursuant to a court order. The RiverAir debtors claimed that the lender was nothing more than a creditor holding a security interest in the membership interests, which the debtors argued still belonged to the holding company. The debtors further asserted that the lender had not accomplished strict foreclosure because a judicial procedure was required under N.Y.U.C.C. §9-610 due to the RiverAir debtors' refusal to consent. The RiverAir debtors alleged that they had substantial equity in their properties, and that the lender was improperly seeking to dismiss the bankruptcy so that it could seize it.

Ruling on a Dismissal Motion

In an oral decision, Chief Judge **Stuart M. Bernstein** granted the lender's motion to dismiss, finding that the holding company lacked the authority to cause the debtor to sign or file the petition. The bankruptcy court reviewed the pledge agreement, which provided that the holding company assigned its voting rights in the debtor to the lender, but permitted the holding company to continue to exercise those rights until an event of default occurred. It determined that once the event of default occurred and the lender sent the default notice, the lender acceded to those voting rights as if the lender were the owner of those interests.[7]

The bankruptcy court reasoned that the person filing a chapter 11 petition for a corporation must be authorized to do so under state law. *Price v. Gurney,* 324 U.S. 100, 106 (1945). Under New York law, unless the articles of organization provide otherwise, management of an LLC is vested in the company's members.[8] The bankruptcy court found that given the undisputed event of default, the lender had the right to cause the membership interests to be registered in its name and exercised that right. It held that under the pledge agreement, the lender succeeded to all rights of a holding company as the sole member of the debtor.

The bankruptcy court concluded that the RiverAir debtors were seeking to capitalize on—and be rewarded for—their own breaches by arguing that the membership interests had not been transferred into the lender's name. Judge Bernstein stated that the "bankruptcy court is a court of equity and 'equity regards as done that which ought to be done.'"[9] The holding company and the debtor had agreed to recognize the lender's rights and to cooperate with the lender to ensure that those rights could be enforced. Accordingly, the membership interests should have been registered in the lender's name, and the bankruptcy court deemed this to have been done. Notably, the court found that it did not have to decide whether a foreclosure had occurred, because the pledge agreement entitled the lender to become the absolute owner of the debtor without the need for foreclosure.[10]

The RiverAir debtors moved for reconsideration, arguing that a secured

5 The pledge agreement defined "voting rights" as "all rights of the Pledgor under the Debtor's operating agreement to vote and give approvals...in respect of the pledged interests."

6 *See* New York U.C.C. law §9-620.

7 *In re RiverAir LLC,* Tr. of Hr'g on Feb. 3, 2005 (the "Feb. 3, 2005, Hearing Trans.") at 18.

8 New York Limited Liability Company Law §401 (McKinney 2005).

9 Feb. 3, 2005, Hearing Trans. at 22.

10 *Id.* at 24.

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creditor cannot take ownership of its collateral simply by sending a default notice to its borrower. The debtors further argued that since the court's initial ruling, the holding company had exercised its right of redemption under the UCC by tendering to the lender full payment of the amounts due under the note, which the lender had refused to accept.

Upon reconsideration, the court adhered to its original holding but clarified that it had only held that the holding company did not have the authority to file the petition on behalf of the debtor without deciding who owned legal title to the membership interests in the debtor. The bankruptcy court characterized the lender as the "sole managing member in equity, if not in law," who had directed the holding company not file the debtor into bankruptcy.[11]

The RiverAir debtors argued that they had filed a joint plan of reorganization that would pay all of their creditors in cash in full. They pleaded that the bankruptcy court allow their cases to proceed so they could confirm their proposed plan and pay their creditors, but the court rejected the request, stating that "equity is the trash heap of loose legal thinking. You have to get in here first before I get to invoke any equity jurisdiction."[12]

Conclusion

In situations similar to the case study, a mezz lender will not be able to adopt the strategy employed in *RiverAir* unless (1) its loan documents provide that voting rights of the mezz borrower belong to the mezz lender once it issues a default notice, and (2) the mezz lender timely invokes the provision before the property owner files for bankruptcy. Once the mezz borrower files for bankruptcy, the mezz lender would be stayed from taking such action, and would be treated as a creditor of the mezz borrower.

The *RiverAir* court did not answer the question of whether the holding company could have recovered voting rights by exercising its right of redemption under §9-623 of the UCC by tendering payment of all obligations secured by the collateral and the mezz lender's reasonable attorneys' fees. The RiverAir debtors did not raise that issue until they made their motion for reconsideration, and the bankruptcy court left that question for the state court. Ironically, the lender in *RiverAir* was not seeking payment in full since it believed the value of the mortgage borrower's property vastly exceeded the aggregate amount of the mortgage debt and the lender's note. In today's environment, most mezz lenders would be happy to receive payment in full instead of dismissal of the property owner's bankruptcy case. *RiverAir* illustrates the need for the mezz lender to be fully aware of its rights, as well as the rights of the mezz borrower, mortgage borrower and mortgagee under their respective loan documents, and to be prepared to move swiftly when a potential default appears on the horizon.[13] ■

11 *In re RiverAir LLC*, Tr. of Hr'g on Feb. 15, 2005, at 24-25 [Docket No. 55].

12 *Id.* at 10.

13 This is a case study citing how one situation affects mezz lenders. It is highlighted to stress points of concern that mezz lenders should be aware of, in the opinion of the author of this article.