

Demystifying the Out-of-Court Foreclosure Process

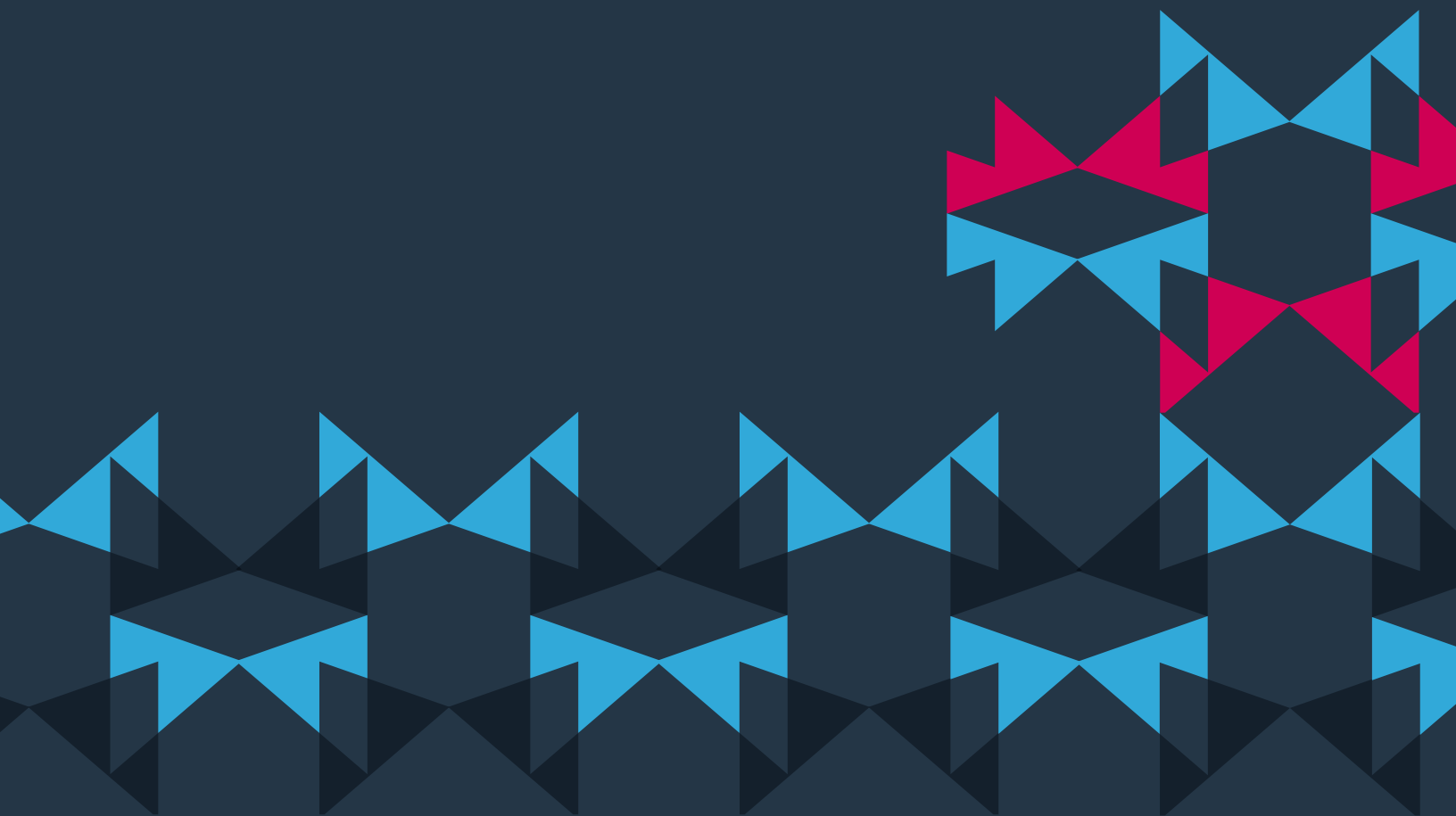
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Introduction

Mezzanine lenders looking to foreclose on their collateral have the advantage of being able to pursue remedies outside of court. But the process, which is described in the Uniform Commercial Code (UCC), is often ill understood and can seem daunting. In this article, we aim to simplify the process, explain the roles of lawyers and other professionals, and highlight some common strategies and pitfalls.

What are Mezzanine Loans

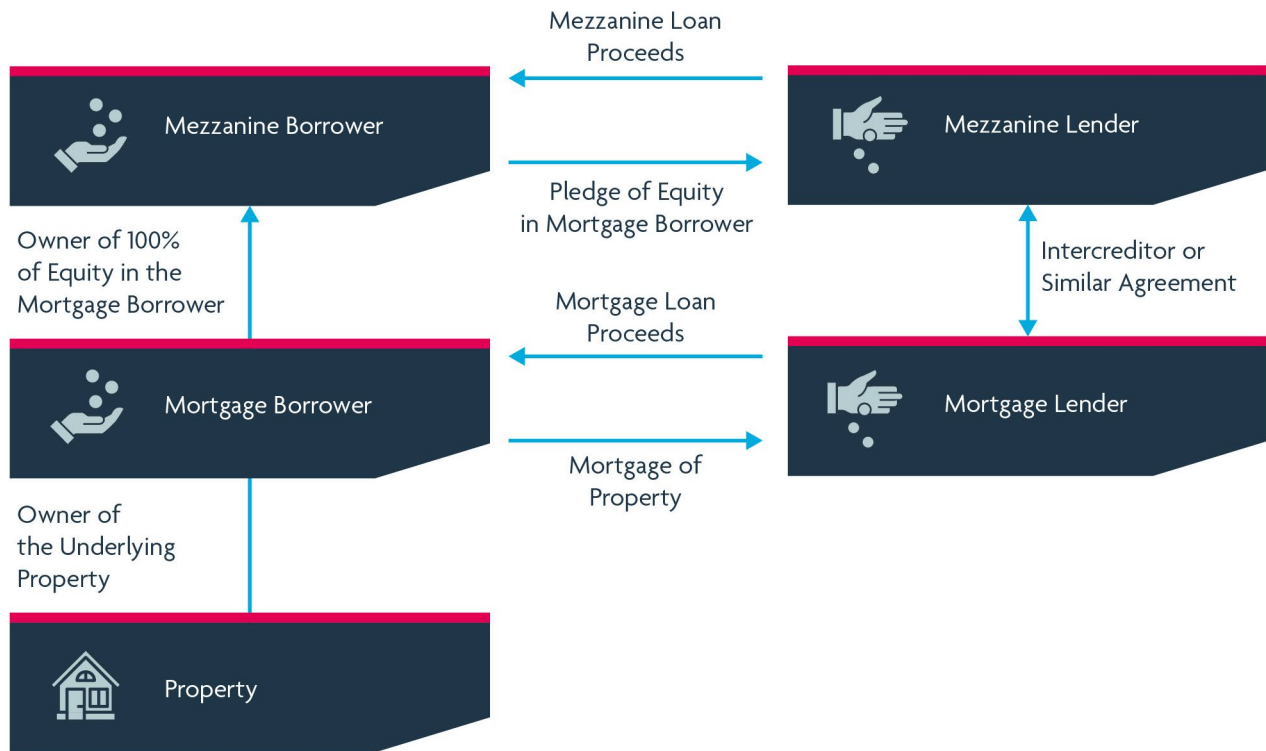
It's helpful to generally understand the types of loans typically subject to a UCC foreclosure. Generally, these are loans that are secured by assets that are not direct interests in real estate, including equity interests such as stock, shares or units in a limited liability company.



Mezzanine loans are typically secured by equity interests in a special purpose entity set up to be the borrower of the mortgage.

Loans secured by equity interests in companies that own real property are typically referred to as mezzanine loans — a form of debt used in addition to the mortgage loan on the underlying property. Whereas the mortgage loan is secured by the real property, mezzanine loans are typically secured by equity interests in a special purpose entity set up to be the borrower of the mortgage. Because these loans are secured by a pledge of 100% equity interests in the mortgage borrower, rather than by a lien on the underlying property, they fall under the UCC.

How a Mezzanine Loan Works



Source: JS Supra

So, when a lender forecloses on a mezzanine loan, it is foreclosing on 100% of the equity interests in the mortgage borrower, not on the underlying real estate. That allows the lender to avoid court proceedings and take advantage of the

UCC foreclosure process. It also allows the lender to credit bid on the pledged equity — to forgive all or part of its debt — instead of using an actual cash bid.

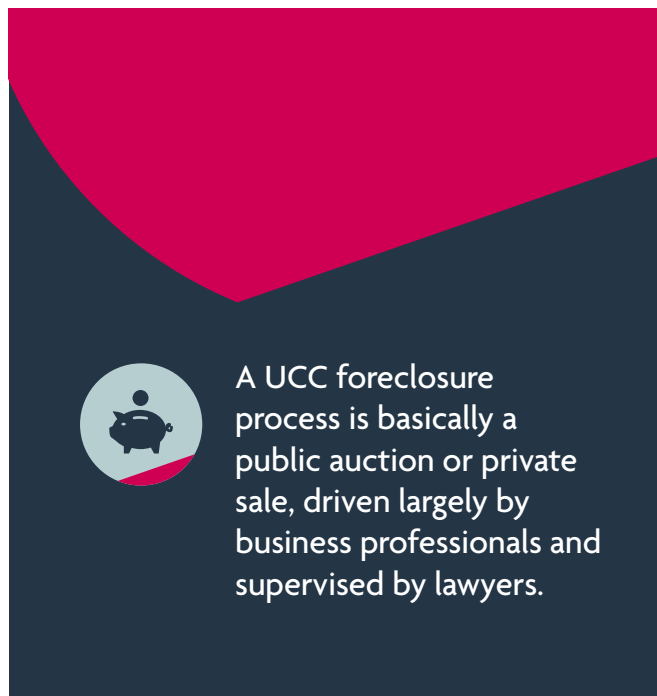
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The UCC Foreclosure Process

So what is the UCC foreclosure process? Many believe that it is just like a judicial foreclosure, driven by lawyers and courts, but that's not the case. Instead, the process is basically a public auction or private sale, driven largely by business professionals and supervised by lawyers.

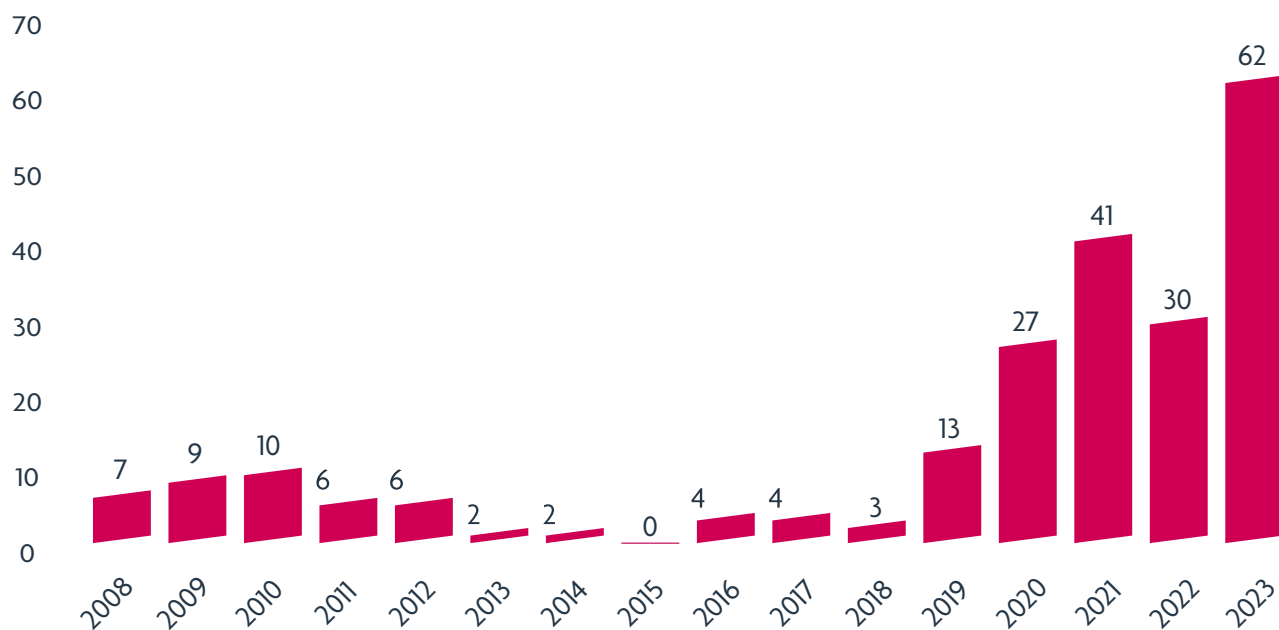
In a nutshell, the foreclosing lender hires a broker to market the property and find potential buyers of the assets pledged as collateral. If it's set up as a public auction, the lender also hires an auctioneer to handle the actual sale. In a private sale, which is less common, the lender may also hire valuation professionals to provide an independent appraisal of the pledged assets.

Lawyers and courts play a role, but it is more of an oversight function. In a foreclosure, the UCC provides protection to the mezzanine borrower by requiring that "every aspect of a disposition of collateral, including the method, manner, time, place and other terms, must be commercially reasonable." There is no more guidance beyond this vague concept, and that is where the law comes into play.



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Number of UCC Foreclosure Sale Notices for Commercial Property Loans



Source: Wall Street Journal

What is Commercially Reasonable

Because the UCC does not define what exactly is commercially reasonable, the meaning of this concept has evolved through the courts and loan agreements.

Loan agreements (or related documents) often set out the disposition process that the parties agree to be commercially reasonable. These include specifications concerning how and when notice of the disposition should be sent, how and where the sale should be advertised, and how and where the sale should take place. Generally, this process requires notice to the borrower and any other affected parties, advertisement in national or local newspapers, and an auction on the courthouse steps of a court chosen by the parties. Auctions can also take place at the office of the lender's lawyers.

The foreclosure period will vary depending on the type of asset that comprises the collateral — while it is possible for the process to conclude in a matter of weeks, it usually takes several months. That's generally the time required to prepare the marketing materials, identify potential buyers and give the potential buyers sufficient time to evaluate and perform the requisite due diligence on the underlying real estate. A broker will advise on a realistic timeline based on their experience with similar assets.

If the disposition takes the form of a public auction, an auctioneer will oversee the sale. The auction generally takes place on the courthouse steps and remotely and concludes in a matter of hours.



Legal Considerations



The main way for lenders to avoid or prevail in any challenges is to respect the borrower and avoid gamesmanship.

The main way for lenders to avoid or prevail in any challenges is to respect the borrower and avoid gamesmanship. That means ensuring that the marketing process is robust, providing ample time and opportunity for potential buyers to conduct their diligence and avoiding unnecessarily excluding potential bidders from the auction process. It also means paying attention to the case law that has developed to avoid other potential pitfalls.

The efforts made to locate buyers, the amount of time given for potential buyers to conduct their diligence, and the price or amount of the credit bid obtained for the auctioned assets can all come under scrutiny as these processes play out.

Recent Case Law

Recent decisions provide some additional guidance on what courts perceive as commercially reasonable. In a recent case in Texas (*In re: Strudel Holdings LLC*), the borrower sued the lender for failing to sell the borrower's pledged stock and other property (a farm and a sailboat) in a commercially reasonable manner. The borrower argued that the value of the collateral was destroyed because, among other things, the sale took place when the value of the stock was at a low point.

The court disagreed and ruled that the lenders had acted in a commercially reasonable manner because they hired professionals to sell the collateral, took pains to negotiate with the borrower and proceeded with the sale when the negotiations broke down. The court held that, "The law does not require punishing lenders who work in good faith."

The court noted that the fact that a better price could have been obtained by a sale at a different time or in a different method from the one used by the lender was not in and of itself sufficient to establish that the sale was not done in a commercially reasonable manner.

In another case heard in New York (*Atlas MF Mezzanine Borrower LLC v. Macquarie Texas Loan Holder*), the borrower argued that the lender rushed through a sale and had a predatory intent given its own interest in acquiring the borrower's properties at a discounted price.



These decisions highlight the need for lenders to stay above board, avoid cutting corners and avoid exploiting the UCC foreclosure process.

The court also found the lender conducted a commercially reasonable sales process because it "marketed the properties widely; gave sufficient time for potential bidders to decide whether to bid; set reasonable parameters for the bidding process; and generated a sales price that — based on credible expert testimony — does not cast doubt on the rigorosity of the process."

These decisions highlight the need for lenders to stay above board, avoid cutting corners and avoid exploiting the UCC foreclosure process to gain an unfair advantage over the borrower.

Conclusion

In sum, a UCC foreclosure offers secured lenders the means to recover on the collateral without potentially lengthy and expensive court proceedings. It is much simpler than it may seem at first blush, but it calls for careful planning and diligence, and the right professionals, to avoid challenge and litigation down the line.

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