

*Presenting a live 90-minute webinar with interactive Q&A*

## Mezzanine Loan Foreclosure in Real Estate Transactions

Protecting Borrowers' and Lenders' Interests Under UCC Article 9

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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**CONSIDERATIONS FOR BORROWERS AND GUARANTORS CONFRONTED  
WITH MEZZANINE LOAN FORECLOSURE ON EQUITY INTERESTS**

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**A. Typical Goals of Borrowers and Guarantors**

1. Prevent the sale of the collateral if possible;
2. Ensure that the sale price of the collateral is maximized;
3. Avoid or minimize deficiency claim (if loan is recourse);
4. Other goals – including tax reasons to defer sale.

**B. Potential Lender Concerns Regarding Article 9 Foreclosure Process**

1. Generally – uncertainty, cost of litigation and delay in completing sale;
2. No established market for LLC interests;
3. No generally recognized procedures for marketing and sale - and few reported cases;
4. No UCC safe harbors (other than for notice of disposition);
5. Obtaining judicial approval of marketing and sale is likely to be time-consuming and expensive;
6. Uncertainty and lack of information available to potential buyers regarding the value of the LLC interest offered for sale;
7. Potential for trial regarding “commercial reasonableness” (and jury trial unless waived);
8. Sale process tends to be judged in hindsight with knowledge of the outcome.

**C. Substantive Issues for Challenge by Borrower and Guarantors**

1. Is mezzanine lender’s secured claim valid and enforceable?

- a. Are the loan and security interest properly documented?
  - b. Proper perfection against the collateral – is LLC interest a “general intangible” with perfection by filing, or did the entity elect to change the interest into a “security” under UCC Article 8, with other means of perfection?
  - c. Challenges to lender’s conduct - UCC standards are relevant (including potential application of UCC §1-304 requirement of good faith and UCC §1-303 course of performance and course of dealing).
2. Notice requirements:
- a. UCC §9-611 requires written notification of disposition of collateral to:
    - (i) debtor;
    - (ii) any secondary obligor;
    - (iii) any party that has sent lender an authenticated notification of a claim of an interest in the collateral;
    - (iv) any other secured party or lienholder with respect to the collateral;
  - b. UCC §9-612 provides a 10 day safe harbor for notices;
  - c. UCC § 9-613 provides for required content of notices;
  - d. Longer notice periods for federal and state tax liens.
3. Requirement of Commercial Reasonableness - UCC §9-610:
- a. Commercial reasonableness is required in “every aspect” of a disposition of collateral;
  - b. Uncertain what a court will later consider to be commercially reasonable marketing efforts and sale terms with the benefit of hindsight;
  - c. Commercial reasonableness of a sale is an intensely factual issue and the lender has the burden of proof, see Ford & Vlahos v. ITT Commercial Finance Corp., 825 P. 2d 877(Cal. 1994);
  - d. The leading case providing guidance on marketing such assets in a commercially reasonable manner is Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P., 821 A. 2d 296 (Del. Ch. 2002);
  - e. Did lender fail to disclose to all material information in its possession to other buyers? The Vornado court excused such a failure by credit-bidding lender, but this was an unusual situation where the partnership interest being offered for sale was convertible to a publicly-traded security. The public market price was a

reference point for the partnership interest, and the lender's credit bid was based on the prior day's price. The failure to disclose material information did not appear to be significant there.

f. Standard intercreditor agreement limitation on transfer of LLC interest - only to a "qualified transferee"

(i) This is generally limited to an institutional buyer or a fund manager with a specified minimum amount of committed capital;

(ii) Is such a limitation on permissible buyers consistent with a commercially reasonable sale, especially if Borrower and Guarantors are not parties to the intercreditor agreement?

#### **D. Means of Challenging Article 9 Foreclosure Process**

1. Availability of injunctive relief prior to a sale – UCC §9-625(a);
2. Borrower's objection (or failure to consent) to strict foreclosure or other lender proposals – but could a wholly unreasonable objection from borrower potentially convert a non-recourse loan into a full recourse loan under some contractual non-recourse carve-out provisions?
3. Borrower may object to lender's marketing and sale process on commercial reasonableness grounds – but could an objection that provides affirmative guidance on how lender should market and sell the collateral be deemed satisfied or moot if lender then adopts those suggestions?
4. UCC §9-615(f) - provides for adjusting deficiency claim if lender or affiliate is the successful bidder and price is "significantly below the range of proceeds" that would have been realized from a sale to an unrelated third party;
5. UCC §9-625(b) – statutory claim for damages for lender's failure to comply with Article 9 requirements.

#### **E. Potential Problems For a Lender That Acquires the LLC Interest**

1. Fiduciary duties owed to any other members of LLC and others, with special concerns if LLC is in the zone of insolvency;
2. If the collateral is only a partial interest in a LLC, purchaser may only be able to obtain an economic interest in distributions from the LLC and not full membership rights, such as voting and access to books and records, without consent of other members.

3. Additional issue for Delaware entities – Delaware has adopted statutes which override UCC §§9-406 and 9-408. In effect, this allows the operating agreement or partnership agreement of a Delaware LLC or limited partnership to impose restrictions on the grant and enforcement of a security interest in an LLC or partnership interest.

4. Burdens to lender or other buyer of owning and operating the LLC:

- a. operations and management of LLC;
- b. obtaining working capital;
- c. keeping project development on schedule;
- d. dealing with mechanic lien claims;
- e. priority of all debts of the LLC over the equity interest acquired;
- f. transfer taxes on the underlying real estate may be triggered by a transfer of the controlling interest in the entity that owns it (e.g. N.Y.).

5. Fraudulent conveyance concern where value of collateral arguably exceeds amount of lender's claim and there was no competitive bidding – but see BFP v. Resolution Trust Corp., 511 U.S. 531 (1994) (consideration received in a regularly conducted, non-collusive real estate mortgage foreclosure sale that conforms to applicable state law is reasonably equivalent value under the fraudulent conveyance provisions of the Bankruptcy Code).

## **F. Overview of Relevant Bankruptcy Issues**

1. Timing of filing of bankruptcy by the borrower;

2. Typical lender response - motion to modify the automatic stay to complete the sale – 11 U.S.C. §362(d);

3. Alternative lender response – seek of dismissal of case as “bad faith” filing – does the case serve a legitimate bankruptcy purpose?

4. Dealing with multiple related entities as debtors:

- a. Joint Administration;
- b. Substantive Consolidation.

5. Special adequate protection requirements that need to be satisfied by a “single asset real estate” debtor in 11 U.S.C. §362(d)(3);

6. Possible use of the bankruptcy proceeding to complete the sale of the LLC interest or to sell the underlying property, pursuant to 11 U.S.C. §363;
7. The Supreme Court has narrowly construed the Bankruptcy Code exemption from transfer taxes in its decision in Florida Department of Revenue v. Picadilly Cafeterias Inc., 128 S. Ct. 2326 (2008) – a sale must be made pursuant to a confirmed plan of reorganization in order to qualify for this exemption.

*Stephen Bobo is a partner in the Chicago office of Reed Smith LLP, a global law firm with offices in Europe, the Middle East and Asia as well as 13 offices in the United States. He has over 25 years of experience with corporate restructuring, bankruptcy and creditors' rights and related litigation. He regularly represents a variety of parties in financially-troubled situations, including secured lenders, creditors' committees, other significant creditors, debtors and trustees in bankruptcy. He is experienced with Article 9 foreclosures, including real estate mezzanine foreclosure sales of LLC interests. He also has been appointed as equity receiver on 10 occasions in fraud cases brought by federal agencies.*