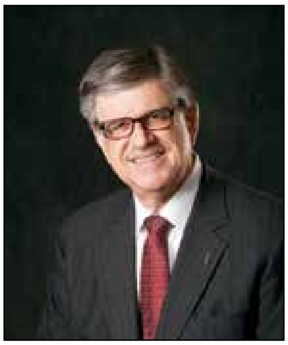
Have We Learned Anything From Foreclosing On Pledged Equity Collateral In Real Estate Mezzanine Lending?



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James D. Prendergast and James S. Cochran

"Pay attention" is a simple rule to state, but not to follow.

GIVEN THE RUSH to return to covenant light deals (the ones that lack some of the usual covenants that protect lenders) and increasing leverage in commercial real estate transactions, it is tempting to say "no" to the question posed in the title of this article. That said, as lawyers we probably have nothing valuable to add to the discussion of the current state of the lending market. However, as lawyers who have been very involved in commercial real estate mezzanine loan transactions, we have some very definite opinions about the overall state of documenting and closing such transactions. (Jim Cochran's from the perspective of representing both mortgage and mezzanine lenders in such transactions and Jim Prendergast's from the perspective of providing UCC insurance insuring the mezzanine lender's "secured creditor" status in the pledged equity collateral under Article 9 of the Uniform Commercial Code (the "UCC") and the mezzanine lender's "protected purchaser" status under Article 8 of the UCC.) This article will not consider how to financially structure a mezzanine loan. Rather, this article will consider a few of the recurring problems we have encountered both in the up-front lending and in the back-end foreclosure process that lawyers now structuring mezzanine loans should take into consideration.

Notwithstanding the real estate collapse of 2008, the mezzanine structure is here to stay as a better financing structure than the alternatives in borrowing against the remaining equity in the underlying real estate after the mortgage tranche. The mezzanine structure, to many analysts, provides both an equity and debt play and allows more effective exit strategies than preferred equity, another class of common equity, an A/B note or a subordinate mortgage (if the senior mortgagee will concur).

By way of background, in early 2007, Moody's Investors Service issued a new Rating Methodology: US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans(the "Moody's Report," available at [www.firstam.com/assets/ucc/articles/moodys-3-2007.pdf)](www.firstam.com/assets/ucc/articles/moodys-3-2007.pdf). The Moody's Report acknowledged that real estate mezzanine lending had a natural capital markets outlet and indicated that Moody's would rate such credits in their own right. In response to this market, the Moody's Report outlined Moody's view of a baseline "credit neutral" mezzanine loan structure and then described how Moody's would apply that view in rating mezzanine loans. Among other things, the Moody's Report stated:

- Moody's expects that 100 percent of the beneficial ownership interests in the property-owning entity will be pledged as collateral, so that any foreclosure of the mezzanine loan will produce a transfer of all the equity interests in the property owner, directly or indirectly held, leaving behind no minority interests;
- Therefore, Moody's expects that mortgage loan borrowers will irrevocably "opt-in" to Article 8 of the UCC and will certificate the partnership or LLC membership interests that will be pledged to the mezzanine lender to facilitate prompt foreclosure. UCC-1 financing statements should additionally be filed, as "fail-safe" protection with respect to the pledged equity collateral and to perfect the mezzanine lender's security interest in other collateral often included with the equity pledge, such as contract rights with the issuer;
- The mortgage borrower's organizational documents should have provisions prohibiting both the issuance of additional interests and opting-out of UCC Article 8 without the lender's written consent; and
- Therefore, Moody's generally expects that mezzanine loans presented for rating will have the benefit of… in all cases … a "UCC insurance policy" where available.

In short, according to the Moody's Report there is a "right" way for a secured creditor to legally structure a real estate mezzanine loan transaction under the UCC, particularly in light of the complex interplay between Articles 8 and 9 of the UCC. Assuming that the requisite bargaining power is with the mezzanine lender, a few conclusions can be reached:

- The secured lender should require that the issuer of the pledged equity collateral, typically consisting of interests in limited liability companies or limited partnerships, to opt-in to Article 8;
- The secured lender should file a financing statement against the pledgor/borrower even if the only reliance collateral for the mezzanine loan is the pledged equity interest;
- The secured lender should require that the pledged equity be certificated by the issuer and the lender should perfect by "control" of the certificated equity (possession plus indorsement);

- The secured lender should require that the inability to issue additional equity and opt-out of Article 8 be specifically set forth in the organizational documents of the issuer and that the organizational documents preclude amendment of these provisions without the consent of the lender; and
- The secured lender should require UCC insurance.

These efforts should do more than provide the lender with a valid and perfected security interest under Article 9 of the UCC; they should also put the lender in the position of a "protected purchaser" under Article 8 of the UCC. However, the issues involved are complex and need to be considered by competent commercial practitioners well versed in the UCC. Notwithstanding the fact that a portion of commercial lending may still be local in scope, the relevant law of the transaction is not local and the lawyer's standard of care is that of an expert in a sophisticated area of the law. That is where the UCC insurance underwriters operating on a national scale as well as experienced UCC counsel can be of significant assistance to the real estate practitioner. (Given this need for a basic understanding of the UCC, it is important to consider the admonitions of the Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions — Revised Article 9. The TriBar Report was published in the August 2003 issue of The Business Lawyer, Volume 58, Number 4. The TriBar Report clearly advises that an attorney who ventures into the area of providing a security interest opinion under Article 9 is assuming the mantle of a specialist in the UCC, or at least to Article 9 and related sections of other Articles, such as Article 1 on scope and choice-of-law, Article 3 on instruments and Article 8 on securities and the relationship of Article 8 and Protected Purchaser to the issue of perfection and priority of security interests in investment property.)

With the foregoing in mind, following are some of the areas in which we have seen significant problems in the past and hope to see major improvements in the future.

1. Duplicative Original Certificates

Although when this problem is mentioned in sophisticated legal circles (the laughter is deafening) this problem is neither rare nor limited to general practitioners with little experience in handling complex commercial real estate transactions. Major mezzanine loans have seen duplicative original security certificates executed at closing. Why this is done continues to be mystifying. The same lawyers who do this would be aghast at having duplicative original promissory notes signed at closing. How they draw a distinction between multiple originals of a promissory note that qualifies as a negotiable instrument under Article 3 of the UCC and multiple originals of a certificated equity interest, each of which constitutes a transferable security under Article 8 of the UCC, is intriguing. However, the results from such a practice can be anything but funny. Try to refinance a mezzanine loan with multiple original security certificates floating around and not being able to account for all of them. The best result will probably be a requirement from the UCC insurance company for an indemnity from a creditworthy indemnitor to hold the UCC insurance company harmless from any loss or damage resulting from the "extra" original certificates popping up in the hands of an Article 8 protected purchaser. Such an indemnity will probably also be required in a foreclosure sale because the buyer of the certificated securities will require a legal opinion or UCC insurance that the purchaser is a protected purchaser under Article 8 of the equity being acquired. It is not the purpose of this article to discuss what might happen in the unlikely but not impossible situation in which the duplicate original certificate lands in the possession of a protected purchaser, e.g., dilution of the outstanding equity value of the pledgor, an overissuance by the issuer/real estate owner, or other problems. Instead, this article offers a simple “take away”: just make sure that the mortgage borrower or other issuer of the pledged equity interests does not issue duplicative original security certificates.

2. Lost Certificates

This may also state the obvious and is often encountered in deals involving multiple originals of the same security certificate. We have encountered many a horrific fight between a mezzanine lender and its counsel over who has the original security certificate that serves as its primary collateral. A bond to cover the potential liability for the surfacing of a lost certificate can be significant, say, five percent of the face amount of the loan. For a billion-dollar loan, a law firm could lose a significant client (to say the least). Treat the certificated security as you would an original negotiable promissory note. (For more on this significant and recurring problem, see Brad Gibson’s article titled *My Dog Ate the (Security) Certificates…What’s the Big Deal?* published in the September/October 2008 issue of Business Law Today. Brad, who is associate counsel of the UCC Division of First American Title Insurance Company, co-chairs the Investment Securities Subcommittee of the American Bar Association’s Uniform Commercial Code Committee.)

Again, do not lose the certificate. Sometimes it is useful to restate the obvious.

3. Qualified Transferee Issues With The Standard Form Of Intercreditor Agreement

A little over two years ago, Judge Richard Lowe handed down his “industry-rattling opinion” in Bank of America, N.A. v. PSW NYC LLC, 2010 WL 4243437 (2010) (“PSW”). In PSW, the court enjoined a mezzanine lender from foreclosing on its direct and indirect equity interests in the mortgage borrower until after the mezzanine lender cured all defaults under the senior mortgage loan, which included paying the entire accelerated balance of the loan (totaling more than $3.6 billion). (Although PSW involved multiple mortgage loans and multiple mezzanine loans, for simplicity the discussion that follows will describe these loans and the related loan parties in the singular.) As discussed below, this case totally upended the bargaining power between the senior lender and the mezzanine lender by effectively eliminating the utility of foreclosure on the equity of the mortgage borrower as an effective strategy for the mezzanine lender.

Many commentators disagreed with the outcome of PSW and believe the intercreditor agreement in that case merely provided that after a foreclosure by the mezzanine lender, any defaults still existing under the senior mortgage loan created an issue that would need to be addressed by the “Qualified Transferee” acquiring the collateral at the foreclosure sale. Few commentators interpreted the relevant provision in the intercreditor agreement as requiring the mezzanine lender to cure all defaults under the senior mortgage loan prior to a foreclosure or, for that matter, as making payment in full of the senior mortgage loan the only acceptable method of cure after acceleration of the loan. By requiring “cure” (meaning payment in full) prior to foreclosure, the court in PSW effectively eliminated the option of the mezzanine lender to foreclose on the pledged equity and possibly acquire the equity at the UCC foreclosure sale. If PSW were the only case of its type, one might be tempted to dismiss it as an outlier, albeit a significant one. Unfortunately, however, PSW is now not alone. On December 6, 2011, Judge David C. Bury of the United States District Court for the District of Arizona granted a preliminary injunction to stop a foreclosure sale by a mezzanine lender on arguments similar to those advanced by the senior lender in PSW. The case is *U.S. Bank Nat’l Assoc. v. RFC CDO 2006-1, Ltd.*, Case No. 4:11-cv-664, Doc. No. 41 (D. Ariz. 2011) (“RFC”), available at www.ballardspahr.com/

alertspublications/legalalerts/2012-01-13_judge_blocks_mezzanine_lenders_UCC_sale.aspx. As in PSW, the court in RFC enjoined the mezzanine lender from foreclosing on its equity interest in the mortgage borrower because the mezzanine lender failed to cure all defaults under the senior loan.

What is most problematic about PSW and RFC is that both cases turn on the intercreditor agreement between the senior lender and the mezzanine lender and, in both cases, the relevant intercreditor agreement was (or was largely based on) the form of intercreditor agreement often referred to as the "Dechert Form," available at www.firstam.com/assets/ucc/articles/intercreditor-form.pdf. Originally proposed in 2002 by two attorneys practicing with Dechert LLP, David W. Forti and Timothy A. Stafford, in an article they wrote titled *Mezzanine Debt: Suggested Standard Form of Intercreditor Agreement*, the form was widely accepted by the CMBS and CDO industries. As stated by the authors of the Dechert Form toward the end of their introduction to the form:

"Widespread use of the form by market participants should ultimately benefit all CMBS participants by creating a higher level of consistency in intercreditor agreements and reducing the time, expense and uncertainty associated with negotiating mezzanine loan intercreditor agreements."

Widespread use did occur; in fact, almost every significant mezzanine transaction used the Dechert Form. As a result, if the interpretation of the Dechert Form set forth in these cases becomes the accepted judicial view, widespread damage from the perspective of the mezzanine lender will occur.

The *PSW* court's reading the relevant cure provision in the intercreditor agreement (based in large part on the Dechert Form) is tortured at best: it makes a hash of the timing and tense of the verbs and confuses who has a duty to do what when. This provision reads in part as follows:

"To the extent that any Qualified Transferee acquires the Equity Collateral pledged to a Junior Lender [the mezzanine lender] … such Qualified Transferee shall acquire the same subject to (i) the Senior Loan and the terms, conditions and provisions of the Senior Loan Documents … for the balance of the term thereof, which shall not be accelerated by Senior Lender … solely due to such acquisition and shall remain in full force and effect; provided, however, that (A) such Qualified Transferee shall cause, within ten (10) days after the transfer, (1) Borrower [the mortgage borrower] … to reaffirm in writing … all of the terms, conditions and provisions of the Senior Loan Documents ... on Borrower's … part to be performed and (B) all defaults under (1) the Senior Loan … which remain uncured or unwaived as of the date of such acquisition have been cured by such Qualified Transferee or in the case of defaults that can only be cured by the Junior Lender following its acquisition of the Equity Collateral, the same shall be cured by the Junior Lender …."

The provision concerned quite clearly imposes obligations upon the Qualified Transferee who acquires the pledged equity collateral through a UCC foreclosure sale or other enforcement action. Except for the last part of the provision (which suggests that the mezzanine lender may have a limited post-acquisition cure obligation even if it is not the Qualified Transferee that acquires the pledged equity collateral), the provision imposes no obligation on any person who does not acquire the pledged equity collateral. By requiring the mezzanine lender to pay the accelerated senior loan in full prior to any foreclosure sale, the PSW court departed from the clear language of the provision concerned. Moreover, it appears that the PSW court failed to see the forest for the trees. In the PSW court's view, the cure obligations concerned apply to all acquisitions of pledged equity collateral under all circumstances rather than only when the Qualified Transferee's intention is to keep the senior mortgage loan in place "for the balance of the term." As a result, the court in PSW ultimately concluded that in order for the mezzanine lender to dispose of its collateral in a UCC foreclosure sale when the senior loan has been accelerated, the mezzanine lender first had to pay off the senior loan and then, following the foreclosure, the mezzanine lender had to require the Qualified Transferee acquiring the collateral to cause the mortgage borrower to reaffirm the senior loan and the senior loan documents and, with respect to certain defaults under the senior loan that could only be cured by the mezzanine lender, cause such defaults to be cured. Why a Qualified Transferee acquiring the pledged equity collateral would need to cause the mortgage borrower to reaffirm an obligation that was fully discharged prior to the acquisition or why the mezzanine lender would need to cure any defaults at all under that obligation, particularly when the intercreditor agreement would have terminated by its terms upon payment in full of the senior loan, seems not to have been a question that the court in PSW considered. If it had, presumably it would have re-examined its initial conclusions and come up with an interpretation that was more in line with the original expectations of the parties.

All that said, the fact that the Dechert Form can be so easily misinterpreted presents a problem for those who are documenting mezzanine loan transactions now and in the future. In the face of the unexpected results described above, the only thing that makes sense is to re-work mezzanine loan intercreditor agreements based on the Dechert Form so that they once again make foreclosure a certain remedy on which the mezzanine lender can rely while at the same time protecting the legitimate interests of the senior mortgage lender.

Even if the cure provisions in the Dechert Form are appropriately revised, there remains the issue of how "Qualified Transferee" is defined. Under the Dechert Form, a mezzanine lender that seeks to foreclose on its pledged equity collateral must either sell the pledged equity to a Qualified Transferee (as specially defined, a fairly narrow class of potential buyers plus the mezzanine lender and its affiliates) or obtain a "Rating Agency Confirmation" prior to consummating the sale (time and money without certainty of outcome). Because of the uncertainties surrounding the second option, ordinarily the first option will be preferred. The problem with the first option, however, is that except for the mezzanine lender and its affiliates, the criteria for becoming a Qualified Transferee were set so high (e.g., as to net worth or other financial minimum standards) that there are few third parties interested in acquiring the distressed equity collateral , often regardless of price, around that meet the criteria. This was a serious problem during the bottom of the crash. Now, with the markets recovering and, in some areas, at record highs, the problem of meeting rigorous criteria may be solving itself. Still, mezzanine lenders should give their intercreditor agreements with senior mortgage lenders a reality check and determine as a practical matter how feasible it would be to find multiple Qualified Transferees who might be interested in buying distressed pledged equity collateral a foreclosure sale.

Even if the standard is not set so high as to preclude finding multiple Qualified Transferees, another question, given the difficult financial condition of many properties, is whether a third-party financial institution that does meet the standards for a Qualified Transferee will be interested in acquiring indirect interests in such properties. Perhaps as a practical matter the only potential third-party buyers of the mezzanine lender's pledged equity collateral at a foreclosure sale will be less well-capitalized ventures that cannot clear the hurdle for Qualified Transferee in the Dechert Form. Again, parties should review their intercreditor agreements to see if the provisions on foreclosure provide a realistic exit strategy in today's world and, if necessary, revise those agreements. Further, severely restricting the pool of potential buyers at a foreclosure sale could have an adverse effect on the conclusion that the foreclosure sale was conducted in a commercially reasonable manner.

4. Qualified Transferee Issues With The Typical Pledge Agreement

A more subtle issue in most mezzanine loan transactions is that few pledge agreements between the mezzanine borrower and the mezzanine lender include a provision in which the pledgor acknowledges the limitation of possible transferees at foreclosure to Qualified Transferees (a term that typically includes the mezzanine lender and its affiliates) and agrees that a post-default disposition in which the universe of potential buyers is limited to Qualified Transferees is "commercially reasonable." Such a provision, if drafted properly, ought to pass muster under section 1-302(b) of the UCC, which provides in part:

"The obligations of good faith, diligence, reasonableness, and care prescribed by [the Uniform Commercial Code] may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable."

If this issue of commercially reasonable foreclosure sale is not addressed in the pledge agreement and the foreclosing mezzanine lender limits the potential buyers to Qualified Transferees, the mezzanine lender creates an immediate issue that the pledgor and its affiliates (e.g., a carve-out guarantor) can use to defend against a possible deficiency or other claim by the mezzanine lender. On the other hand, if the mezzanine lender does not include such a restriction in its sale procedures, it runs the risk of violating the terms of its intercreditor agreement, potentially exposing itself to a claim by the senior mortgage lender. Once the problem is understood, however, the solution is simple: draft a provision containing the requisite acknowledgment and agreement and include the provision in the applicable pledge agreement.

5. Defective Opt-In to Article 8

Assuming attachment of the security interest, the most important step in analyzing the applicability of the UCC to a mezzanine loan transaction is to categorize the collateral. The issue here that needs to be addressed is whether the pledged equity collateral in the commercial real estate mezzanine loan transaction constitutes a "general intangible" or "investment property" under Article 9 of the UCC. Much turns on this determination, including the effective perfection of the mezzanine lender's security interest in the pledged equity collateral. Although the equity interests pledged in a commercial real estate mezzanine loan transaction sometimes consist of interests in a limited partnership, in the vast majority of cases the applicable equity interests consist of interests in a limited liability company. Accordingly, even though the legal rules are similar, in the interests of both simplicity and relevance the discussion below will assume that the issuer is a limited liability company rather than a limited partnership.

The securing of obligations with equity collateral potentially brings into play both Article 8 and Article 9 of the UCC. However, for many lawyers, especially lawyers who do not practice commercial law on a regular basis, Article 9 remains a mystery and Article 8 is totally off the screen, meaning little more than a space saver between Article 7 and Article 9. However, not understanding Article 8 and its implications for equity collateral transactions can have a detrimental effect on a lawyer's malpractice coverage premiums.

We have had many discussions with attorneys involved in mezzanine loan transactions, and they seem quite pleased with themselves in preparing a certificate evidencing the collateral equity interests in a limited liability company, having this certificate indorsed to the lender at a closing, and then having the lender take possession of the certificate to perfect its security interest. Many of the right steps are there. The problem, however, is that without more, an equity interest in a limited liability company is a general intangible and Article 9 provides only "one" method of perfecting a security interest in general intangibles — filing a financing statement at the appropriate filing office in the jurisdiction where the debtor is deemed located under the UCC. Taking possession of a beautiful certificate evidencing a general intangible is of no legal effect with respect to the perfection of a security interest in the general intangible.

To repeat, without more, an equity interest in a limited liability company is a general intangible and not a "security" for purposes of Article 8 or "investment property" for purposes of Article 9. Section 8-103 of the UCC provides that, except for certain rarefied situations that need not concern us here, equity interests in a limited liability company are not securities unless the issuer explicitly "opts in" to Article 8 by specifying that the equity interests are securities governed by Article 8. (By contrast, stock in a corporation is a security under Article 8 and investment property under Article 9 without any need for further action.)

Opting in is not very difficult. The limited liability company agreement needs to contain certain "magic" language to the effect that the equity interests in the issuer are governed by Article 8 of the UCC. Additionally, if the equity is certificated, each certificate should carry a legend that, at a minimum, says effectively the same thing. One act does the work and the other puts potential purchasers on notice. That is it, although a lender might also want covenants in the pledge agreement to ensure that the issuer will not "opt out" of Article 8 and other protective provisions. Not very difficult, but a whole lot happens when the magic is performed.

If the above actions are taken, the equity interests in the limited liability company morph from a general intangible to a security under Article 8 and investment property under Article 9. As mentioned above, a security interest in a general intangible can only be perfected by filing, and priority among security interests will be determined by the "first to file" rules of Article 9. However, a security interest in investment property can be perfected by filing, possession, or "control" (normally, possession of the certificate evidencing the equity together with an indorsement, usually in blank, of the certificate). As investment property, a security interested perfected by control or possession would, in most cases, have priority over a competing security interest that had previously been perfected only by filing (even if the subsequent secured party had knowledge (as defined under Article 9 — actual knowledge) of the competing security interest. As is obvious, if a secured party obtains control or possession of a certificated security, no other party can usually obtain control of the security because such control also requires possession of the certificate. Again, if you certificate the equity collateral, treat the certificate as a negotiable document and do not lose it!

With the above as background, section 8-102(a)(15) of the UCC tells us, in the context of equity interests in closely held limited liability companies of the type commonly used in mezzanine loan transactions, very clearly how to opt in to Article 8:

(15) "Security," except as otherwise provided in Section 8-103, means an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:

(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;

(ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and
(iii) which:
(A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or
(B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.

While not very elaborate, this definition is more than a mere trifle. Care must be taken to ensure that the limited liability company interest "by its terms expressly provides that it is a security governed by [Article 8]." Doing so also satisfies section 8-103, which (as noted above) generally provides that a limited liability company interest is not a security unless its terms expressly provide that it is a security governed by Article 8. In the context of a limited liability company interest, the language required to opt in to Article 8 seems pretty straightforward, yet you would be surprised how often you see organizational documents and/or security certificates that fail to incorporate this simple statutory language and instead provide merely that the interest concerned is a "security" within the "meaning of" (rather than "governed by") section 8-102 of the UCC.

While the mezzanine lender could mount an argument that this general reference works, it is certainly not at all clear that the mezzanine lender would win. The immediate and potentially catastrophic adverse consequence of not winning the argument is that the mezzanine lender has not obtained "control" because by definition you cannot get control of a general intangible and, therefore, the mezzanine lender has not achieved "protected purchaser" status under Article 8. Further, and perhaps even more catastrophic, the mezzanine lender may not be a perfected secured creditor under Article 9 unless the mezzanine lender filed a back-up financing statement.

What needs to be done is: (i) to have the limited liability company whose interests are being pledged resolve by organic entity action (e.g., written consent of the members) that the interests in the limited liability company are securities governed by Article 8 and take the steps necessary to amend the limited liability company agreement accordingly; and (ii) legend the securities if they are certificated with a statement such as "The Membership Interest represented by this Certificate is a security governed by Article 8 of the [Delaware] Uniform Commercial Code." Not much to do, but do it!

6. Post-Disposition Transfer Procedures That Involve Pledgor-Related Parties

Although it is again stating the obvious, a mezzanine lender or its counsel needs to read not only the mezzanine loan documents but also various other legal documents affecting the mezzanine loan transaction: any applicable intercreditor agreement with the senior mortgage lender as discussed above, the organizational documents of the pledgor, and, perhaps most importantly, the organizational documents of the issuer of the pledged equity collateral (typically, the mortgage borrower and the owner of the underlying real property). Strangely, many mezzanine lenders seem to pay little attention to the transfer procedures under the organizational documents governing their collateral. Often, a limited liability company agreement will contain transfer procedures that require the signature or other involvement of an individual (e.g., a manager or officer) who is controlled by the pledgor in order for the transfer to be effective or the transferee to be admitted as a member. Needless to say, the prompt and full cooperation of such individuals following an Article 9 disposition is not something that the mezzanine lender should be counting on. In fact, a prudent mezzanine lender should expect just the opposite.

This problem can easily be solved when the mezzanine loan is being made by requiring: (i) appropriate amendments to the organizational documents that allow the mezzanine lender (or a third-party purchaser) to complete a transfer of interests and be recognized as a member or partner without having to involve individuals who have no interest in cooperating with the transfer; and (ii) appropriate acknowledgments and consents by the issuer and, if necessary, by other members. If this is done and the mezzanine lender ends up foreclosing, the mezzanine lender will have a streamlined and dependable process enabling it (or a third-party purchaser) to succeed to the interests concerned rather than a muddled process that leaves the mezzanine lender's rights in doubt and its ability to effect a transfer of the underlying real estate in a way that satisfies a title insurer in question. (The authors want to thank Norman M. Powell, a partner in the Delaware law firm of Young Conaway Stargatt & Taylor, LLP., for much of the following).

It is also important to remember that the laws of the several States do differ. Often the mezzanine lender and borrower describe the intended collateral equity security for the mezzanine loan as 100 percent of the "membership interest" in the limited liability company, which they assume is very much like 100 percent of the stock in a corporation, which is to say, ultimately, total economic participation in profits, losses, and distributions ("Economic Rights") and total voting and managerial control ("Control Rights"). The term "membership interest" often appears in the granting clauses of security agreements, in the collateral descriptions in related UCC1 financing statements, and in control agreements by which security interests in uncertificated securities may be perfected. But the term "membership interest," as applied to a Delaware limited liability company, is fraught with ambiguity — the term does not appear anywhere in the Delaware Limited Liability Company Act, Del. Code Ann. tit. 6, §§18-101 — 18-1109 (the "Delaware LLC Act"). Rather, the Delaware LLC Act carefully distinguishes among what are here termed Economic Rights, Control Rights, and the status of being a member ("Member Status"). Why, then, do many secured parties describe their collateral as "membership interest"? Perhaps because the term is widely used and well defined in the limited liability company acts of many jurisdictions other than Delaware, such as California, New York and Florida. This issue is important because many attorneys pick Delaware as the jurisdiction in which to form their limited liability companies for mezzanine loan transactions because their corporate partners said it was the customary place to form corporations. Well, all limited liability companies are not created equal.

Further, and consistent with Delaware's policy to give "maximum effect to the principle of freedom of contract and to the enforceability" of limited liability company agreements, Delaware permits and enforces restrictions on the alienability of rights and statuses relating to limited liability companies. These restrictions apply to Economic Rights, Control Rights, and Member Status.

Under section 18-702(a) of the Delaware LLC Act, Economic Rights are "assignable in whole or in part except as provided in a limited liability company agreement." Thus, prohibitions and conditions to the assignment of Economic Rights are generally enforceable. Many would point to the provisions of sections 9-406 and 9-408 of the UCC, which generally override restrictions on assignment of certain rights to receive payments. Contemporaneously with its enactment of non-uniform text to sections 9-406 and 9-408, which rendered these provisions inapplicable to interests in limited liability companies and partnerships, the Delaware General Assembly also amended the Delaware LLC Act to like effect. Thus, the very law under which the Delaware limited liability company is formed and exists explicitly provides that anti-assignment provisions will be enforced.

Further, the Delaware LLC Act provides that the assignee of a member's Economic Rights "shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement" and upon satisfaction of certain other conditions (emphasis added). The point is further made by section 18-702(b)(1) of the Delaware LLC Act, which provides that unless the limited liability company agreement provides otherwise, "[a]n assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member." Lastly, section 18-704(a) of the Delaware LLC Act provided (at time of writing) as follows:

"An assignee of a limited liability company interest may become a member as provided in a limited liability company agreement and upon: (1) the approval of all of the members of the limited liability company other than the member assigning limited liability company interest; or (2) compliance with any procedure provided for in the limited liability company agreement."

Thus, while a secured party can freely enjoy Economic Rights, subject to compliance with restrictions or waiver of prohibitions, if any, contained in the limited liability company agreement, a secured party can enjoy Control Rights and achieve Member Status only to the extent provided in the limited liability company agreement or otherwise approved by the limited liability company's members.

The outcome seemingly mandated by the Delaware LLC Act, at least in instances where the parties have not taken advantage of their contractual freedom to facilitate a different outcome, is that the secured party succeeds to all Economic Rights while all Control Rights and Member Status remain in the debtor. As a result, in the best case, the debtor, who has no further Economic Rights, has sole and exclusive power to decide when, if ever, to make distributions, sell assets, wind-up the company, etc. In the worst case, due to an unusual feature of the Delaware LLC Act, the issuer (typically, the mortgage borrower and property owner) will be deemed dissolved. In either case, the foreclosing mezzanine lender, who has neither Control Rights nor Member Status but does possess all Economic Rights, is relegated to hopeful impotence. It is well to remember that this outcome is not mandated by the Delaware LLC Act, but merely follows from application of its default rules where the parties have not facilitated a different outcome by inclusion of appropriate contractual provisions in the limited liability company agreement. The proximate cause of the problem, if we can call it that, is not the statute, but the limited liability company agreement.

The Delaware LLC Act affords the contractual flexibility necessary to facilitate a secured party's succeeding to Economic Rights, Control Rights, and Member Status, but requires that care be taken in drafting the limited liability company agreement and security agreement to facilitate that outcome. A statutory amendment to change this default setting would likely facilitate the outcomes most often intended by parties to mezzanine loan transactions. Absent such an amendment, however, existing transactions should be reviewed and appropriate steps taken to assure that limited liability company agreements and security agreements use the appropriate terminology, and include the necessary contractual provisions, to facilitate the intended outcome following default and a secured party's exercise of remedies. A routine audit, or pre-workout documentation review, would be a good time for such review and rehabilitation.

7. Selecting The Appropriate Pledge Agreement

Briefly, there is a real difference between a principal obligor and a secondary obligor. A secondary obligor is a surety bringing into play the need for suretyship waivers in a pledge of equity collateral. The mezzanine borrower pledging the equity in the real property owning subsidiary is a principal obligor. In the latter case, it is not a problem if you leave out the suretyship waivers. However, if you have a transaction where the owner of the equity is not a borrower of mezzanine debt but a guarantor guarantying the mortgage debt, then you do have a secondary obligor transaction requiring suretyship waivers. Grab the right form then, by thinking about the transaction. For more information on this topic, see Bradley Gibson, *Surety Defenses in Mezzanine Lending, Commercial Insight* (Nat'l Com. Services Div. First Am. Title Ins. Co., Santa Ana, Cal., Spring 2008). For more information on the difference between principal obligors and secondary obligors, the utility of UCC insurance in equity pledges and the correct way to structure a mezzanine loan transaction, see *Secured Real Estate Mezzanine Lending (With Form),* The Practical Real Estate Lawyer; *UCC Insurance: Cost-Effective Alternative to Borrower's Counsel Legal Opinion,* ACC Docket; and *The Utility of UCC Insurance,* The Secured Lender.

CONCLUSION • Perhaps the overarching theme of this article is this: pay attention! Whether it is understanding local law, reading the UCC, avoiding losing security certificates, not generating duplicate original certificates, or reading the organizational documents of your issuer, this article does little more than state the obvious. However, maybe it is necessary now and then to state the obvious. One of the benefits of UCC insurance is a "second set" of eyes, someone knowledgeable reading over your shoulders noticing the mistakes. However, not every issue is covered. No one is going to remind you of suretyship waivers, or that the operating agreement of the issuer limits the ability to effectively foreclose on the pledged equity collateral. Be careful, read the documents setting the stage for the transaction, and remember that the laws of the several States vary. The problems noticed above are not limited to practitioners with limited experience in sophisticated commercial real estate transactions. We have seen these problems in very significant transactions involving major national firms. In the end, then, the moral of the story may be to keep the real estate lawyers near the corporate and commercial lawyers.