

### UCC FORECLOSURE

# Statute Benefits Lenders, But Protects Borrowers



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As real estate financings completed over the last several years reach maturity in a climate of tight credit and economic recession, the real estate industry is expecting an increasing number of defaults, restructurings and foreclosures. Many of these financings were structured as mezzanine loans, which are typically secured by the equity interests owned by the direct or indirect parent company of the mortgage borrower and under which the lender has no direct interest in the underlying real property. In the article entitled "Foreclosing on a Mezzanine Loan Under UCC Article 9" published in the May 7, 2008 edition of the New York Law Journal, Peter E. Fisch, Steven Simkin and S.H. Spencer Compton discussed the remedies of a mezzanine lender under Article 9 of the Uniform Commercial Code (UCC). This article will focus on the rights and remedies of a mezzanine borrower under Article 9.

#### Extra-Judicial Remedies

A mezzanine lender has no rights with respect to, and therefore no ability to foreclose upon, the real property underlying the loan. Instead, after a mezzanine borrower defaults under the mezzanine loan documents, a mezzanine lender's rights with respect to the equity interests held as collateral will be governed in large part by Article 9.

Article 9 provides a secured party with the right to take possession of the collateral after a debtor's default and to dispose of the collateral in order to satisfy its claims against the debtor. Unlike a mortgage lender, which will typically (at least in New York) be required to resort to judicial remedies if its loan goes into default, a mezzanine lender can typically possess and dispose of the equity interests it holds as collateral without ever setting foot in court. In pursuing the extra-judicial remedies afforded to it by Article 9, however, a mezzanine lender is nonetheless subject to numerous requirements

with respect to the method in which it obtains possession and disposes of its collateral. Principal among these requirements are that the mezzanine lender proceed in good faith, deliver proper notice of the disposition to the mezzanine borrower (and certain secondary obligors), and conduct the disposition in a commercially reasonable manner. After first summarizing these requirements, the discussion below will explore the various rights and remedies afforded to a mezzanine borrower under Article 9 in the event that a mezzanine lender fails to comply with these requirements.

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#### Procedural Requirements

##### A. Good Faith

Every action taken by a secured party under Article 9 must be taken in good faith. While this requirement is not specifically set forth in Article 9 itself, UCC §1-203 imposes upon every contract or duty governed by the UCC "an obligation of good faith in its performance and enforcement" and Official Comment 11 to UCC §9-620 specifically states that the provisions of UCC §1-203 apply to a secured party's enforcement under Article 9.

##### B. Default

As an initial matter, under UCC §9-601(a), a secured party's right to enforce its security interest in collateral under Article 9 only arises "after default." Article 9 does not define "default," instead leaving to the parties' agreement, as supplemented by law other than Article 9, the determination as to whether a default as occurred.<sup>1</sup> New York courts have held that a default is whatever the security agreement, or other applicable loan document, says it is.<sup>2</sup>

##### C. Disposition of Collateral

Following the determination by a mezzanine lender that a default has occurred under the mezzanine loan documents and the acceleration of the loan (and assuming that any attempts to reach an agreement on a workout or restructuring fail), the mezzanine lender will seek to exercise its rights and remedies and realize on its collateral (typically only after navigating restrictions set forth in the intercreditor agreement with the mortgage lender). A mezzanine lender's rights with respect to the disposition and sale of the equity interests it holds as collateral will be limited to the rights afforded to a secured party under Article 9, which primarily consist of (1) foreclosure by disposition of the collateral under UCC §9-610 and (2) strict foreclosure under UCC §9-620. Since a UCC "strict foreclosure" cannot proceed if the borrower objects and is therefore only relevant in a consensual context, we will focus solely on the procedures governing foreclosure by disposition of the collateral pursuant to UCC §9-610.

UCC §9-611 provides that before a secured party may dispose of collateral under Article 9 a debtor and any secondary obligor (i.e., guarantors) are each entitled to a reasonable authenticated notification of disposition (subject to certain exceptions, such as collateral that is of the type customarily sold on a recognized market). Although Article 9 does not definitively state what constitutes "reasonable" notice (and in fact notes that it is a question of fact), a statutory safe harbor contained in UCC §9-612(b) provides that a notice of disposition sent after default and 10 days or more before the earliest time of disposition set forth in the notification is considered reasonable.<sup>3</sup>

Article 9 provides that a disposition of collateral can be effected by either a "public disposition" or a "private disposition."<sup>4</sup> Generally, a secured party may only dispose of the collateral at a private disposition if the collateral is "of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations." Mezzanine loan collateral will almost always be sold in a public disposition, both (a) because it usually consists of privately held limited liability company or partnership interests or shares of stock in a closely held corporation and (b) because the lender cannot make a "credit bid" for privately held equity interests in a private disposition.

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Every aspect of either type of disposition, including the method, manner, time, place and other terms, must be "commercially reasonable."<sup>5</sup> New York courts have formulated two tests to determine whether the disposition of collateral satisfies the UCC's requirement of commercial reasonableness: the "procedural" test (which focuses on the method used to market and complete the sale) and the "proceeds" test (which focuses on the price achieved for the collateral).<sup>6</sup> Some New York courts have held that the primary focus of commercial reasonableness is the procedures employed, not the proceeds received, for the sale.<sup>7</sup> Nevertheless, it is plausible to think that if the borrower can demonstrate that the proceeds received were low, the court will examine the procedures used with greater scrutiny.

### Borrower's Remedies

If a mezzanine lender fails to comply with the requirements of Article 9 with respect to the disposition of its collateral, including the principal requirements summarized above, the mezzanine borrower and certain related secondary obligors can look to the following specific set of remedies under Article 9.

#### A. Equitable Remedies

If a mezzanine borrower wishes to assert that the mezzanine lender is not proceeding in accordance with Part 6 of Article 9, the mezzanine borrower may bring an affirmative action under UCC §9-625(a) requesting that the court order or restrain, by means of an injunction or temporary restraining order, the "collection, enforcement or disposition of collateral on appropriate terms and conditions." This is a significant remedy because it means that a mezzanine borrower is not limited solely to challenging the mezzanine lender's compliance as a defense in a deficiency action.

It should be noted that if a mezzanine borrower alleges that a mezzanine lender is proceeding under Article 9 in bad faith (e.g., if the mezzanine borrower feels that a mezzanine lender's determination that a default has occurred was not made in good faith), it appears that the borrower may be able to bring a claim under UCC §9-625 (in addition to any breach of contract claims and lender liability claims, each of which are outside the scope of this article) to enforce the provisions of UCC §1-203. While there is no relevant New York case law on this issue, because the UCC specifically imposes the obligation of good faith on a secured party's enforcement under Article 9, it is likely that a failure of a mezzanine lender to comply with UCC §1-203 is actionable under UCC §9-625.8

It should also be noted that the Article 9 requirements requiring that a secured party proceed in good faith, with reasonable notice and in a commercially reasonable manner are not described with specificity, and in the context of underlying real estate assets there is very little case law, in New York or elsewhere, interpreting these requirements. This could allow a mezzanine borrower's counsel to bring a variety of challenges to a mezzanine lender's compliance with Article 9 that are particular to real estate mezzanine financings (e.g., by claiming that the typical requirement found in the intercreditor agreement with the senior lender requiring that the buyer at the foreclosure sale be a "qualified transferee"

(i.e., meeting credit, experience and other tests) chills the bidding process and therefore is not commercially reasonable).

#### B. Damages Claims

Pursuant to UCC §9-625(b), a mezzanine borrower can also bring a claim for damages resulting from the mezzanine lender's noncompliance with Article 9. UCC §9-625(b) provides that a person is liable for damages in the amount of any loss caused by a failure to comply with Article 9, which may include loss resulting from a debtor's inability to obtain, or the increased costs of, alternative financing. Official Comment 3 to UCC §9-625 provides that damages for a violation of the requirements of Article 9 are those reasonably calculated to put an eligible claimant in the position that it would have occupied had no violation occurred.

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#### C. Deficiency Proceedings

In those cases where there is recourse liability to the mezzanine borrower (or, more likely, to a guarantor of the mezzanine borrower), additional protection is afforded by UCC §9-626 where the mezzanine lender brings a deficiency action against the mezzanine borrower (or guarantor) seeking satisfaction of the difference between the proceeds received by the mezzanine lender in an Article 9 foreclosure sale and the amount owed by the mezzanine borrower under the loan. In the event a deficiency action is brought by the mezzanine lender, a mezzanine borrower or guarantor may challenge the compliance of the foreclosure sale with the provisions of Article 9 relating to "collection, enforcement, disposition or acceptance" by placing such compliance in issue under UCC §9-626, which shifts the burden of proving compliance to the secured party. If the secured party fails to meet its burden of proof that it conducted the sale of the collateral in accordance with Part 6 of Article 9, UCC §9-626(a)(4) creates a "rebuttable presumption" that the amount of proceeds that would have been realized if the secured creditor had complied with the requirements of Part 6 of Article 9 is equal to the sum of the secured obligation (plus expenses and attorney's fees). Because this is a rebuttable presumption, if the noncomplying secured party can prove that a complying disposition of collateral would have resulted in an amount less than the amount due from the debtor, the secured party will have rebutted the presumption and will be entitled to seek the resulting deficiency.

UCC §9-615(f) further protects the mezzanine borrower in the event the mezzanine lender is the purchaser of the collateral at its own foreclosure sale, recognizing that a secured party that purchases the collateral at its own foreclosure sale may lack the incentive to achieve the highest price. UCC §9-615(f) provides a special method for calculating a deficiency if the transferee is

the secured party, a person related to the secured party, or a secondary obligor and the amount of proceeds of the disposition is significantly below the range of proceeds that a complying disposition to a person other than the secured party, a person related to the secured party, or a secondary obligor would have brought. UCC §9-615(f) provides that, in such event, the deficiency is calculated based on the amount of proceeds that would have been realized in a disposition complying with Part 6 of Article 9 to a transferee other than the secured party, a person related to the secured party, or a secondary obligor.

#### Additional Considerations

One additional consideration that is particularly relevant, given the current state of the real estate market and the resulting potential lack of bidders, is whether a mezzanine lender is obligated to proceed within a certain timeframe with the enforcement of its remedies under Article 9. Official Comment 3 to UCC §9-610 addresses this issue directly, noting that Article 9 "does not specify a period within which a secured party must dispose of collateral" further stating, "[i]t may, for example, be prudent not to dispose of goods when the market has collapsed." The same comment does go on to state, however, that "if a secured party...holds collateral for a long period of time without disposing of it, and if there is no good reason for not making a prompt disposition, the secured party may be determined not to have acted in 'a commercially reasonable' manner."

One option that is always available to a borrower is to file for bankruptcy in order to take advantage of the automatic stay and halt the foreclosure sale. This remedy may be of limited value in the context of a real estate mezzanine loan, however, since mezzanine loans often have non-recourse carve-out guarantees pursuant to which the loan becomes recourse to a guarantor if the mezzanine borrower files for bankruptcy.

#### Conclusion

While Article 9 provides many benefits to a mezzanine lender foreclosing upon its collateral, Article 9 also offers the mezzanine borrower significant protections against a mezzanine lender's noncompliance with the requirements of Article 9. By understanding the various rights and remedies afforded to it under Article 9, a mezzanine borrower will be better prepared to protect itself in the event its mezzanine lender declares a default under the mezzanine loan and proceeds with a disposition of its equity interests under Article 9.

1. Official Comment 3 to UCC §9-601.

2. See *Jefferds v. Ellis*, 127 Misc.2d 477, 483 N.Y.S.2d 649 (Sup. 1985), rev'd on other grounds, 122 A.D.2d 595, 505 N.Y.S.2d 15 (4th Dep't 1986).

3. See Official Comment 3 to UCC §9-612.

4. UCC §9-610(c).

5. UCC §9-610(b).

6. See *In re Sackman Mortg. Corp.*, 158 B.R. 926, 936 (Bankr. S.D.N.Y. 1993) and *Vornado PS, LLC v. Primestone Inv. Partners, L.P.*, 821 A.2d 296, 316 (Del. Ch. 2002).

7. See *In re Zsa Zsa Ltd.*, 352 F.Supp. 665, 671.

8. See Official Comment 11 to UCC §9-620.