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Traps And Pitfalls In Mezzanine Loans

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Rate creep, loss of control in bankruptcy, and unexpected recourse liability are just some of the hazards. [-] GETTY

Today's debt stacks often include a lower-interest mortgage loan secured by real estate and a higher-interest mezzanine loan secured by a pledge of all the equity interests in the mortgage borrower. Each piece of the stack gives

each lender a risk-reward ratio that it likes. And it probably gives the borrower a lower all-in cost of funds, or at least more funds than otherwise.

This structure is so common that even if a financing starts out as a single mortgage loan, the documents sometimes allow the lender to slice off a mezzanine loan later. All of this seems intuitively reasonable and sensible. It can, however, create lethal problems, especially when combined with modern nonrecourse carveout guaranties.

The problems start with the minor detail of the interest rate. Although the borrower probably likes the combined interest rate at the outset, the loans sometimes require any amortization – especially unscheduled amortization such as prepayments – to be applied against the lower-interest mortgage loan. This way, the total combined interest rate rises over time. This phenomenon is known as “rate creep.”

Either lender might ultimately foreclose. If that happens, the other lender’s loan documents might deem that foreclosure to constitute a prohibited transfer. That might in turn make a guarantor personally liable for the entire loan under a nonrecourse carveout guaranty.

A mezzanine loan foreclosure can create other problems for anyone who signed a nonrecourse carveout guaranty for the mortgage loan. After the mezzanine loan foreclosure, the guarantor presumably no longer controls the mortgage borrower, because the mezzanine lender (or whoever bought the limited liability company interests at foreclosure) now controls the

mortgage borrower. Nothing stops the new owner of the mortgage borrower from having the mortgage borrower file bankruptcy or commit other "bad acts," any of which can make the carveout guarantor personally liable for the entire mortgage loan.

Conversely, the guaranty covering the mortgage loan may contain provisions that allow the guarantor to terminate its liability by surrendering the real estate collateral to the mortgage lender. Any such conveyance of the collateral to the mortgage lender, even if it makes total business sense, could trigger liability under the mezzanine loan if done without the mezzanine lender's consent. And once the mezzanine lender has foreclosed out the previous ownership of the mortgage borrower, the guarantor has no ability to cause the borrower to surrender the real estate to the mortgage lender.

Much less dramatically, anyone who acquires the equity in the borrower by foreclosure under the mezzanine loan can misapply income from the property and fail to use it to pay, for example, real estate taxes. Those misapplications might trigger personal liability for the guarantor, the former principal of the mortgage borrower – but the guarantor can no longer do anything to prevent it. Similar problems can arise if either lender obtains the appointment of a receiver.

Once any mezzanine lender (or the successful bidder at a mezzanine loan foreclosure) takes control of the mortgage borrower, that party also owns all the books, records, files, and email history of the mortgage borrower, including communications with the mortgage borrower's former counsel.

The principals of the mortgage borrower might not want anyone else to see some of those communications. If they've lost control of the mortgage borrower, though, they've also lost control of its history and its right to assert the attorney-client privilege.

If the mortgage encumbers a ground lease, then a mezzanine loan foreclosure can create another problem, this time for the lender. Many ground leases say the ground tenant and its leasehold mortgagee cannot be affiliated or related in any way. If a mezzanine lender is related to the mortgage lender and acquires all the equity in the mortgage borrower through a mezzanine loan foreclosure, or if an unrelated mortgagee acquires the equity (cheaply) at the mezzanine loan foreclosure sale, then the ground tenant and its mortgagee will suddenly become affiliates or related parties. How does that play out under the ground lease?

Lenders also need to consider two other possible traps.

First, any nonrecourse carveout guaranty will typically trigger liability if certain events occur affecting the underlying real property. Those events make a lot of sense for a mortgage lender. A mezzanine lender should, however, also worry about a whole second group of possible nonrecourse carveouts: actions that the mezzanine borrower or its members can take that impair or destroy the mezzanine lender's collateral, which doesn't consist of real estate but instead consists of membership interests in an LLC.

For example, the mezzanine lender should worry about prohibited amendments of the LLC agreement, misapplication of distributions made by the mortgage borrower, dilution of the pledged membership interests, and admission of additional members into the mezzanine borrower. The mezzanine lender should tailor its nonrecourse carveouts accordingly.

Second, if a mortgage lender wants the right to later slice off part of the mortgage loan as a mezzanine loan, the mortgage loan documents will often require the mortgage borrower to grant the lender a power of attorney to

sign all the necessary documents. But it's not enough for the mortgage borrower to give the lender that authority. Instead, the lender also needs to obtain similar authority from the members of the mortgage borrower, as those members will ultimately need to sign any mezzanine loan documents. Without that extra layer of authority, the lender can't accomplish the restructuring if the borrower doesn't want to cooperate.

All these traps and pitfalls can readily be prevented if counsel to borrowers and lenders take the appropriate steps in negotiating the loan documents. To do that, though, they first need to know about the traps and pitfalls and how to prevent them. Recent litigation suggests that not everyone who closes these loans has that knowledge.

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I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 400 articles and five books so far, including the 2024 three-volume New Guide to Ground Leases (www.groundleasebook.com). I occasionally serve as an arbitrator or expert witness in complex real estate disputes.