What Happens If A Mezzanine Loan Foreclosure Is Unreasonable?

forbes.com/sites/joshuastein/2024/09/26/some-new-ammunition-for-mezzanine-loan-warfare

Joshua Stein September 26, 2024

Mezzanine loan foreclosures must be commercially reasonable, but what does that mean? And what can a court do if they're not commercially reasonable?

getty

Real estate capital stacks often have two pieces. First, there is a traditional mortgage loan secured by real estate. Second, there is a less traditional, but recently quite common, mezzanine loan secured by a pledge of membership interests in the limited liability company that owns the same real estate.

In New York, mortgages can take years to foreclose because New York is in the minority of states that always require judicial proceedings to foreclose. Those proceedings often move with glacial speed. In contrast, if a mezzanine lender wants to foreclose on a pledge of membership interests, it can do this without involving a court. The lender just needs to

comply with a law called the Uniform Commercial Code, which provides for nonjudicial foreclosure proceedings that are relatively quick, at least in comparison with New York mortgage foreclosures.

The UCC requires any mezzanine lender to conduct its foreclosure proceedings in a way that is “commercially reasonable” throughout. Mezzanine borrowers who face foreclosure will sometimes try to assert that the lender’s foreclosure procedures are not “commercially reasonable.” For example, the borrower might say the lender didn’t advertise the sale adequately, hire a suitable broker to expose the sale to the market, allow enough time, or give bidders enough information (including access to the underlying real property) to make an informed decision on whether and how much to bid.

These claims have led some New York courts to enjoin UCC foreclosure sales, causing delay and consternation for some mezzanine lenders. On the other hand, mezzanine lenders often don’t really want to acquire their collateral, so they are often ambivalent about actually holding a sale. They will often prefer to repeatedly delay their sale or sell their loan.

In the litigation on commercial reasonableness of mezzanine loan foreclosures, the courts have offered some clues and suggestions, sometimes inconsistent, that may help a mezzanine lender understand how to comply with UCC requirements on reasonableness of a sale. Most but not all of those judicial ideas are practical and reasonable. Lenders just have to figure out how to comply.

When mezzanine borrowers have tried to stop foreclosures because they are commercially unreasonable, lenders have sometimes persuaded courts not to suspend the process – i.e., not to issue an injunction against the mezzanine loan foreclosure. The lenders and the courts have reasoned that if the lender violated UCC requirements, the mezzanine borrower can always sue the lender after the fact – when the mezzanine borrower has lost its entire indirect interest in the property – and recover a judgment for the borrower’s losses.

The option of suing after the fact holds little appeal for a borrower. The lawsuit could be long, difficult, and expensive. Memories will fade, facts will become harder to determine, witnesses will go away, and entropy will set in. The court will require the borrower to prove the amount of its damages, which can raise complicated factual issues and disputes over hypotheticals. The requirement to prove damages may end up producing a minimal number anyway in part because uncertainties often get resolved in favor of the defendant. It’s not always easy to collect a judgment for damages, even against an institutional lender that misbehaved. After many mezzanine lenders foreclose on their collateral, they are single-purpose entities with no assets except ownership of a mortgage borrower that has little or no remaining equity in its mortgaged real property. That makes it even harder to enforce a judgment against a lender that violated the UCC. Finally, a post-foreclosure lawsuit gives the borrower much less leverage than a pre-foreclosure injunction.

The permanent editorial board of the UCC recently issued a commentary that may make it easier for borrowers to convince a judge to temporarily block a mezzanine loan foreclosure sale on the ground that it's not commercially reasonable. In that commentary, the editorial board considered the argument that injunctions against foreclosure sales are disfavored if the mezzanine borrower can recover a collectible judgment against the lender. The board found that argument unpersuasive, concluding that the UCC gives courts broad authority – broader authority than they may think – to enjoin commercially unreasonable sales.

Net result: the editorial board gave the courts a roadmap to more easily enjoin UCC foreclosure sales, assuming the mezzanine borrowers and their counsel know about that roadmap and persuade the courts to apply it. That new tool can make it easier than otherwise for mezzanine borrowers to convince a court to block a UCC foreclosure sale because it's "commercially unreasonable." That's good for borrowers who want to try to protect their investment or at least torment their lenders. As a practical matter, however, current market conditions leave many mezzanine borrowers with no investment value left to protect. They may be disinclined to invest more money in legal fees under the circumstances.

If mezzanine lending comes back into vogue in the next cycle of real estate lending exuberance, future mezzanine lenders may respond by making sure their loan documents make it difficult or impossible for borrowers to seek injunctions against UCC foreclosure sales, thus vitiating whatever help the permanent editorial board gave them. As part of that strategy, when lenders prepare nonrecourse carveout guaranties for mezzanine loans, they may want to make the guarantor liable for the entire loan if the borrower seeks an injunction against a UCC foreclosure sale, especially if the borrower's efforts fail. And that could spawn another series of negotiations, litigations, and court decisions.

.