What's A 'Commercially Reasonable' Mezzanine Loan Foreclosure?

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Joshua Stein February 22, 2023

An owner of commercial real estate will typically record a mortgage to secure its financing. In many cases, however, mortgage lenders won't provide as much financing as the real estate owner wants or needs. To solve that problem, the owners of the entity that owns the real estate (i.e., the owners of the mortgage borrower) will sometimes pledge their partnership interests (or other forms of equity, such as limited liability company membership interests) in the borrower to secure an additional layer of financing. This is called a mezzanine loan.

A mezzanine loan isn't secured by a mortgage or governed by mortgage law. Instead, it's governed by the same law, the Uniform Commercial Code, that governs pledges of inventory, equipment, valuable contract rights, and other forms of personal property, i.e., almost anything that isn't real estate. All these things and more can be collateral for a loan secured by a UCC security interest.

Traditionally, it was thought that mezzanine lenders could enforce their UCC pledges rather quickly. Through a foreclosure sale, they could take over ownership and control of a mortgage borrower with blinding speed. This terrified mezzanine borrowers, but they had to live with it. Recent litigation, especially during the Covid pandemic, has made it clear that the law actually doesn't allow mezzanine lenders to foreclose as quickly as people had thought. This is true at least where the underlying real property is substantial or complicated—which commercial real estate developments and investments usually are.

Section 9-610(b) of the Uniform Commercial Code commands that every aspect of a UCC foreclosure, "including the method, manner, time, place, and other terms, must be commercially reasonable." The UCC goes into no further detail, leaving it to the courts to determine what "commercially reasonable" means, through litigation over UCC foreclosure sales. Quite a few mezzanine borrowers initiated such litigation during the pandemic. As a result, some court decisions offer limited guidance, along with confusion and inconsistency.

The law in this area teaches mezzanine lenders that they need to figure out what's commercially reasonable for their foreclosure auction sale and then do it. That means giving possible auction bidders due diligence information and time to review it. Lenders also need to publicize foreclosure sales in a reasonable way. They need to give the world reasonable advance notice of the sale. They can't unilaterally exclude bidders. They need to figure out what someone would do if they wanted to attract buyers and make them want to bid.

All of this is somewhat murky, though. Any lender should remember that whatever they do, the mezzanine borrower may claim they didn't do enough, so the foreclosure sale was not commercially reasonable. Therefore, a cautious lender should bend over backwards to be reasonable.

Lenders often try to define "commercially reasonable" in their loan documents. They figure that if the borrower has agreed on what's reasonable, then it's safe to do whatever the borrower agreed needed to be done. That sounds great. It has given mezzanine lenders an opening to hard-wire perfectly unreasonable foreclosure procedures into their loan documents. But any smart lender won't believe its own documents. That's because a patently unreasonable definition of "commercially reasonable" just won't work.

Section 1-302(b) of the UCC states (minus some extraneous words): "The obligations of reasonableness 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." In other words, even if the loan documents try to define commercial reasonableness, that definition itself cannot be manifestly unreasonable—whether or not the lender likes that.

Nevertheless, lenders typically insist on retaining in their loan documents their manifestly unreasonable definitions of commercial reasonableness for foreclosure sales. This issue is rarely negotiated in mezzanine loans, perhaps because it's bad karma for a borrower to even raise the subject of loan default or foreclosure. A thoughtful lender might be well advised to open the conversation. A thoughtful loan originator might not like the idea that some future staff member of the lender might read the loan documents and believe what they say.

Can we clarify the meaning of "commercial reasonableness" by amending the Uniform Commercial Code? It sounds like a great idea. It would require someone to think about the wide range of possible collateral for UCC security interests. The meaning of commercial reasonableness will vary with the type of collateral and other circumstances. A UCC foreclosure sale of an equity interest in a limited liability company that owns 20 apartment buildings and five shopping centers in 12 states will require a different type of reasonableness than a UCC foreclosure sale of 10 boxes of hairbrushes.

Some commentators say it would be impossible to define commercial reasonableness in any more detail than the UCC already does. That means mezzanine lenders will just have to figure out what it means and then comply. Either that, or figure out a way to make it impossible for mezzanine borrowers to object. That's another discussion.