MEZZANINE LOANS IN THE CREDIT CRUNCH ENVIRONMENT. AN ADDITIONAL THEORY TO CURE THE ARTICLE 9 PERFECTION ISSUE

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This brief article is intended to accomplish two tasks. First, it will outline present thinking of mezzanine lenders and the criteria they apply to underwriting new mezzanine loans in the present credit environment. Second, it will present a theoretical solution to a problem that recently has arisen in connection with the propensity of large financial institutions to perfect a security interest in certificated securities by filing a financing statement under Article 9 of the Uniform Commercial Code (the "UCC") rather than by taking possession of the certificates pursuant to Article 8 of the UCC or entering into a control agreement. The problem occurs because a subsequent pledge or control agreement defeats the Article 9 filing.

MEZZANINE LOAN UNDERWRITING UNDER PRESENT CONDITIONS

The difficulty with analyzing capital market opportunities at this juncture is that the attitude of lenders is still evolving. It goes without saying that the first hallmark of a well-underwritten mezzanine loan is the availability of a first loan. Right now, first loans are as scarce as the proverbial hen's teeth. Mezzanine loans are made by two kinds of lenders: those that also make first loans and those that primarily make mezzanine loans. Often the originator of a first loan that prefers to confine the first loan to a stated low loan to value ratio for securitization purposes will split the loan into a first loan with a loan to value ratio of 50% to 70% and a mezzanine loan for the remaining 20% to 40% of the investment. The first lender may retain the mezzanine loan or sell it to an investor regularly engaged in the business of

making mezzanine loans. In other cases, the first lender will simply make a first loan leaving the borrower to find a mezzanine loan to fill out the capital stack.

In order to originate the first loan, the first lender will have to clear certain hurdles. The originator often will warehouse the loan with a credit line lender that provides funds to the originator and takes the loan as security for the funds. This ensures the liquidity of the originator and enables the originator to make future loans. If the warehouse lender does not believe that the loan will be able to be placed into a securitized pool, either because the loan does not meet agreed upon criteria or because it believes that the market will not accept the sale of the pool, it may refuse to take the loan. At the present time, credit line lenders are anticipating that loans that otherwise would have been perfectly acceptable will not be able to be securitized. In addition, it is not clear whether there will be a sufficient volume of credit to purchase the existing inventory of loans to be securitized let alone new loans yet to be originated. Thus, the first loan availability is not made and the mezzanine loan becomes moot.

There are still a considerable number of mezzanine loans coming through the system. Loans that were made prior to the liquidity crisis have been structured to retain the capacity to have a portion of the debt converted to a mezzanine financing. Mezzanine lending became lax in its own respect prior to the liquidity problem. In order to make new loans, there are a number of issues that have become more prominent from the mezzanine lender's point of view. Bear in mind, however, that a number of mezzanine loans originated by the first lender have been poorly documented. A significant part of the liquidity crunch comes not only from poor underwriting but also from deviations from good lending practice. These deviations include poor documentation that emphasizes the first loan obligations but pays little attention to the basics of the mezzanine loan relationship.

The following paragraphs contract past and current practices:

A. *Identity and Strength of the Sponsor.* Although a strong sponsor should have been a pre-requisite to the making of the loan, especially in the case of limited recourse loans, the hurdle for sponsorship was substantially lowered. At this juncture, however, strong sponsorship is one of the factors mezzanine lenders consider vital to the loan characteristics. Simply stated, strong loan sponsors think twice before incurring a default or letting a property go to foreclosure. The risk is not obviated but it is significantly mitigated.

B. *Realistic Loan to Value (LTV) Ratios are Restored.* Although lip service has been given to the belief that first loans and mezzanine loans taken together should not exceed 85% to 90%, income and expense realization was gauged in an optimistic fashion by both the first lender and the mezzanine lender. Today, the mezzanine lender will be more likely to test and stress the numbers provided by the borrower in order to keep the LTV within normal boundaries.

C. *Interest Rate Expectations.* The return required by mezzanine lenders is generally higher than that required by first loan lenders. However, when the mezzanine loan is originally structured by the first lender rather than independently originated outside of the first loan process, the risk/reward is set by the first lender. In those cases, the criteria will be more strict because the reward to the mezzanine lender is lower. In the case of direct mezzanine loan origination, borrowers can expect significantly higher interest rates to reflect the perceived risk.

D. *Borrower Covenants, Reserves and Cash Management.* The mezzanine lender should insist on budget approvals, leasing approvals (if not dealing with multi-family properties), and strict adherence to reserves for the benefit of the mezzanine lender as well as the first lender. Cash management will be required and the soft lockbox will only be permitted if the other loan

factors give the mezzanine lender a high degree of comfort. Financial covenants will be required and enforced including overall debt to value ratios and debt service coverage requirements.

E. *Recourse Carve-Outs*. Before the liquidity crisis, mezzanine lenders believed that they could solve most ills by making deficiencies in loan underwriting the subject of limited or full recourse carve-outs. Unfortunately, by overlooking sponsor strength, recourse carve-outs are chimerical at best. They are no substitute for proper underwriting. While they are still useful, the mezzanine lender in today's world will do the proper underwriting and only accept carve-outs when there is adequate capitalization.

F. *Inter-Creditor Agreements*. If the first lender has already closed the first loan and mezzanine loan (often the case in the market that provoked the liquidity issues) and the mezzanine loan is not properly documented to meet the safety criteria required by the mezzanine lender in today's market, there are two options available to rectify the problem. The mezzanine lender can request that the originator ask the borrower for concessions in the documentation. The loans often contain a covenant that will permit limited renegotiation. However, renegotiation often will require more than the limited scope of the covenant will permit. Obviously, the borrower has no incentive to engage in expensive renegotiations nor to limit rights it thought it had obtained. In these cases in which renegotiation is not feasible, some of the rights can be derivatively granted by the first lender by means of the intercreditor agreement. For example, if the mezzanine documentation does not give the mezzanine lender budget approval, the first lender can agree to approve the budget only if the mezzanine lender concurs. Often, first lenders are only willing to grant consultation to the mezzanine lender. This may not be enough in the present environment.

G. Use of Preferred Equity in Lieu of the Mezzanine Loan. Lenders frequently took a preferred equity position instead of making a mezzanine loan. This involved the entry by the lender into the ownership structure by becoming a zero percent member of the LLC (thus not affecting the tax treatment of the remaining members), receiving a preferred return equal to the interest rate to be charged, prohibiting certain actions by the entity without the preferred equity member's permission, taking control of management immediately when a default occurs (as opposed to the occurrence of an Event of Default which ripens after the passage of time), receiving a default preferred return that effectively steered the project economics to the preferred member, and ultimately taking control as the general partner through a single purpose entity. This structure provided a much simpler method to secure the benefit of the bargain to the lender although there were potential latent securities issues in the structure. It now appears that utilization of this method of entering the capital stack is on hold. The liquidity crisis has made the use of such advanced techniques by lenders a less preferred way to proceed. This structure should be revived when the present conditions are alleviated.

H. Perfection of Security Interests in the Ownership Interest of the Borrower. The only safe way to perfect a security interest in the ownership interest of the mezzanine borrower is to require that the borrower opt into Article 8 of the UCC, certificate the ownership interests, agree not to opt out of Article 8 and deliver the certificated interests to the mezzanine lender along with a blank power. The agreement not to opt out should be backed up with a recourse event in a guaranty by the sponsor, which hopefully is capable of backing up the guaranty. Major financial institutions do not prefer Article 8 perfection. As with notes, they have a propensity to lose the certificates because of the volume of pledged loans. Therefore, they prefer to secure the ownership interest with an Article 9 filing. As previously noted, this

leaves the mezzanine lender in a precarious position because possession trumps filing and the possessor does not take subject to a previous filing. Likewise, a control agreement regarding certificated interests also is trumped by a pledge with possession. The mezzanine lender should avoid this situation if at all possible, recognizing that defeating a filing by certificating and delivering possession is a breach of contract on the part of the borrower and probably a fraud. If such occurs, the mezzanine lender only has a cause of action in contract and fraud and cannot get at the membership interest. It has been all of our experience that a borrower willing to perform these acts usually does not have the financial resources to make the lender whole. This brings us to a theory for counteracting the potential negative effects of an Article 9 perfection.

ARTICLE 9 VS. ARTICLE 8

Perfection of a security interest in investment property by a mezzanine lender by filing pursuant to Article 9 leaves the lender open to loss of priority in the event the borrower, whether inadvertently or by design, later grants a security interest by granting third-party control (by possession or the execution of a control agreement). The lender with priority by control does not take subject to the Article 9 interest. Section 9-328 of the UCC governs the priority of perfection in investment property and makes it clear that possession trumps filing.

Although one would hope that a subsequent lender would perform the obvious searches for prior interests, the fact that the interest is taken by a subsequent lender leaves the holder of the filed interest with little recourse. A loan agreement that prohibits the defeat of the grant of the security interest has been breached; perhaps there will be a cause of action for fraud; and, if the loan agreement is properly drafted, there will be recourse to a guarantor of substance.

However, there may be a solution which lies within the provisions of the Delaware Limited Liability Company Act (the "Act"). Mezzanine lenders should be more

emphatic in insisting that Delaware be the state of choice for entity formation purposes. While many mezzanine borrowers are formed in other states, in these uncertain times lenders will take comfort in the way Delaware has interpreted LLC law as well as the uniqueness of certain provisions of the Act.

Lenders should require that the mezzanine borrower's LLC agreement provide that the entity will not opt into Article 8 of the UCC without the permission of the mezzanine lender. The operating agreement should also provide that the agreement shall not be amended in any respect without the consent of the mezzanine lender. Section 18-302 (e) of the Act provides as follows:

> If a limited liability company agreement provides for the manner in which it may be amended, including by requiring the approval of a person who is not a party to the limited liability company agreement or the satisfaction of conditions, it may be amended only in that manner or as otherwise permitted by law (provided that the approval of any person may be waived by such person and that such conditions may be waived by all persons for whose benefit such conditions were intended).

Thus, the operating agreement will not be capable of being amended without the consent of the mezzanine lender and any amendment may indeed be an *ultra vires* act by the entity. The mezzanine loan agreement should also provide for a similar "no opt in" covenant and the guaranty should provide for a recourse event.

In order to complete the picture, the mezzanine lender should insist on one additional step, which does not have the force of law but creates a notice situation to any future prospective lender. The certificate of formation for a Delaware LLC permits the entity to place comments on the face of the form. A comment should note that the operating agreement does not permit the LLC to opt into Article 8 of the UCC. While this has no effect of law, it is

compelling notice to any party that has an interest in requiring the entity to opt into Article 8 of the UCC.

There is no assurance that this theory will work to prevent an LLC from opting into Article 8. However, if the mezzanine lender prefers to perfect under Article 9, it is worthwhile to consider insisting that the borrower follow these steps when preparing the formation documents of the mezzanine borrower.

In some states, the use of an LLC causes significant state tax problems, which necessitates the use of a limited partnership. The suggested technique can still be utilized in such a situation, however, because the general partner of the limited partnership is always an LLC and the prohibition can be applied in the general partner's operating agreement.

It should be noted that this solution works with Delaware limited liability companies and Delaware limited partnerships. In other states, the provisions of the UCC trump the organic formation statutes for LP's and LLC's.

In any event, there is no substitute for the use of Article 8 to perfect a security interest in ownership interests. The use of the Article 9 solution is a band aid at best and not a substitute for the methodology provided by Article 8 of the uniform Commercial Code.

CONCLUSION

The mezzanine loan as a lending technique is not likely to become extinct as a result of the credit crunch. Indeed, if properly underwritten, it is a valuable tool for both lenders and borrowers in developing the capital stack for a project. Rather, as in all real estate downturns, the standards will become more useful and realistic. At least until near the end of the next boom.