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# Risks and Realities of Mezzanine Loans

Andrew R. Berman\*

I presented an earlier version of this paper at the University of Missouri School of Law Festschrift in honor of Dale A. Whitman<sup>1</sup> – a great teacher, thinker, and legal scholar. As many already know, Dale Whitman is largely responsible for the creation of the new academic discipline focusing on real estate finance law – once primarily the province of business schools, accountants, and economists.

Dale's scholarship and writing has had a significant influence and impact on so many of us, including my own interest in teaching and researching in the area of property law and real estate finance. When I look over Dale's lifetime of scholarship, I see several important and recurring themes, including the following:

- (i) the interconnection between common law property principles and contract law and the necessity for legislative reform;<sup>2</sup>
- (ii) the uneasy and constantly changing dynamic between the mortgagor-borrower and mortgagee-lender;<sup>3</sup>
- (iii) writing effectively to both legal academics and practicing lawyers;<sup>4</sup>

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1. Andrew R. Berman, Presentation at the University of Missouri-Columbia School of Law Festschrift in honor of Dale A. Whitman: The Hazards of Mezzanine Loans – What Your Lawyer Is Not Telling You (April 13, 2007).

2. See, e.g., Grant S. Nelson & Dale A. Whitman, *Congressional Preemption of Mortgage Due on Sale Law: An Analysis of the Garn-St. Germain Act*, 35 HASTINGS L.J. 241 (1983) [hereinafter Nelson & Whitman, *Congressional Preemption*]; Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 BYU L. REV. 305 [hereinafter Nelson & Whitman, *Adopting Restatement*].

3. See, e.g., Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851 (1993); Grant S. Nelson & Dale A. Whitman, *Rethinking Future Advance Mortgages: A Brief for the Restatement Approach*, 44 DUKE L.J. 657 (1995).

4. See, e.g., GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE TRANSFER, FINANCE AND DEVELOPMENT* (7th ed. 2006).

(iv) respecting the enduring role of a real estate lawyer as, first and foremost, a “dirt lawyer” – and that is not a pejorative – with his focus on recording issues,<sup>5</sup> mortgage drafting,<sup>6</sup> and other similar core real estate issues; and

(v) in all of his articles, focusing sharply on the intersection of property law and real estate finance.<sup>7</sup>

With this in mind, this current article exploring the risks and realities of mezzanine loans is dedicated to the legacy of Professor Dale Whitman’s lifetime of work in real estate and property law.

## I. INTRODUCTION

The last decade has witnessed an astounding increase in the outstanding amount and new issuances of mortgage-backed securitizations.<sup>8</sup> In 2005 alone, there were issuances of mortgage securitizations exceeding \$1.5 trillion.<sup>9</sup> These securitizations, consisting of pools of both residential and com-

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5. See, e.g., Dale A. Whitman, *Digital Recording of Real Estate Conveyances*, 32 J. Marshall L. Rev. 227 (1999); Dale A. Whitman, *Are We There Yet? The Case for a Uniform Electronic Recording Act*, 24 W. NEW ENG. L. REV. 245 (2002).

6. See, e.g., Dale A. Whitman, *Mortgage Drafting: Lessons from the Restatement of Mortgages*, 33 REAL PROP. PROB. & TR. J. 415 (1998).

7. See, e.g., Nelson & Whitman, *Congressional Preemption*, *supra* note 2; Nelson & Whitman, *Adopting Restatement*, *supra* note 2.

8. The securitization market refers to the process in which entire pools of mortgage loans are sold typically to a securitization trust. This trust vehicle then usually sells to the public certificates or securities that are secured, and receives the cash flow generated, by the underlying pool of commercial and/or residential mortgages. There are many excellent sources relating to the historical development and growth of the mortgage-backed securitization market. See, e.g., Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519 (2001); Joseph C. Shenker & Anthony J. Coletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1372 (1991); Joseph Philip Forte, *Ratable Model for Main Street and Wall Street*, 31 REAL PROP. PROB. & TR. J. 489, 495 (1996).

9. For statistics relating to issuances in the RMBS market, see ROBERT POLLSEN ET AL., RATING TRANSITIONS 2005: U.S. RMBS VOLUME AND RATING ACTIVITY CONTINUE TO SET RECORDS, available at <http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/3,1,1,0,1139588867949.html#ID143> (for calendar year 2005, the total amount of rated RMBS issuances equaled \$1,191.3 billion). For statistics relating to issuance in the CMBS market, see COMMERCIAL MORTGAGE ALERT, CMBS MARKET STATISTICS, available at <http://www.cmalert.com/Public/MarketPlace/MarketStatistics/index.cfm> (the total value of CMBS issuances is approximately \$169 billion for calendar year 2005). See also COMMERCIAL MBS 2006 OUTLOOK/2005 REVIEW, available at <http://www.cmbs.org/research> (follow “CMBS.CRE 2006 Outlook and 2005 Review” hyperlink).

mercial mortgage loans,<sup>10</sup> now constitute over \$5 trillion in outstanding mortgages and account for over 20% of all outstanding mortgages in the United States.<sup>11</sup> The growth in mortgage securitizations has also led to the creation of new real estate financing techniques, including mezzanine loans.<sup>12</sup>

These new financings are not directly secured by real estate and do not even directly involve land. In the real estate industry, mezzanine financing, for example, “refers to a loan secured principally by the borrower’s equity in other entities. Unlike conventional mortgage financing where the [mortgage] borrower owns real estate, a mezzanine borrower doesn’t directly own any real property nor does it operate any business – it acts merely as a sort of holding company.”<sup>13</sup> A mezzanine borrower typically only owns limited liability interests in a limited liability company, and this intermediary entity owns the entity that actually owns the underlying real estate.<sup>14</sup> Both economically and legally, the value of the mezzanine borrower’s collateral derives solely from its indirect ownership of the underlying mortgaged property.

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10. Residential mortgage-backed securities (RMBS) are pass-through securities that are based on cash flows from a pool of underlying residential home loans. Commercial mortgage-backed securities (CMBS) are pass-through securities that are based on cash flows from a pool of underlying commercial loans.

11. NOMURA FIXED INCOME RESEARCH, COMMERCIAL MBS 2006 OUTLOOK/2005 REVIEW 1 (DEC. 15, 2005), available at <http://www.nomura.com/research/s16> (CMBS issuances in 2005 represented almost 20% of the entire outstanding amount of all commercial mortgages); Comment Letter from Vernon H.C. Wright, Chairman, Am. Securitization Forum et al., to Jennifer J. Johnson, Sec’y, Bd. of Governors of the Fed. Reserve Sys. et al. 2 (July 19, 2004), available at 871 PLI/COMM 345, 348 (total MBS outstanding was \$5.3 trillion in 2003); Joseph Forte, *Wall Street Remains a Key Player in Commercial Real Estate Financing Despite Capital Market Fluctuations*, N.Y. ST. B. J., July-Aug. 2001, at 34, 38 (CMBS and RMBS accounts for over 20% of the mortgage market).

12. For law review articles that discuss mezzanine loans, see Georgette Chapman Poindexter, *Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing*, 2 BERKELEY BUS. L.J. 233 (2005), and the author’s previous article, Andrew R. Berman, “*Once a Mortgage, Always a Mortgage*” – *The Use (and Misuse) of Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76 (2005). Certain portions of this article discussing the history and growth of mortgage-backed securitizations and mezzanine financings are based, in part, on *Once a Mortgage, Always a Mortgage*.

For articles written mainly for real estate practitioners, see Joseph Philip Forte, *Mezzanine Finance: A Legal Background*, SJ090 A.L.I.-A.B.A. 437 (2004); Steven G. Horowitz & Lise Morrow, *Mezzanine Financing*, SJ005 A.L.I.-A.B.A. 541, 544 (2004); William G. Murray, Jr., *Mezzanine Financing*, 489 PLI/REAL 247 (2003); Jeanne A. Calderon, *Mezzanine Financing and Land Banks: Two Unconventional Methods of Financing Residential Real Estate Projects in the 21st Century*, 29 REAL EST. L.J. 283 (2001).

13. Berman, *supra* note 12, at 79.

14. See *infra* note 30 and accompanying text.

Property owners have increasingly favored combining mortgage financing along with mezzanine loans as a method to obtain higher loan-to-value ratios and therefore higher proceeds.<sup>15</sup> Oftentimes, the addition of a mezzanine loan to the borrowing structure can bring the total loan-to-value ratio of a transaction to 90-95% (and sometimes as high as 105%) of the total value of the underlying real estate.<sup>16</sup> This is compared to a loan-to-value ratio of 85-90% with traditional junior mortgage financing.<sup>17</sup> As a result, mezzanine loans have been quickly replacing the junior mortgage as the principal means to provide real estate owners with additional financing.<sup>18</sup> In calendar year 2005 alone, the amount of new mezzanine loans soared almost 300% from the preceding year.<sup>19</sup> According to Moody's, the issuance of mezzanine loans included in collateralized debt obligations (CDO) has increased from approximately \$25 million in 2004 to over \$3.22 billion per year in 2006.<sup>20</sup> Given this large increase in CDO issuances, the size of the mezzanine debt may be close to \$135 billion, and some estimate that it may represent up to 10% of the entire \$4.5 trillion real estate sector.<sup>21</sup>

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15. Horowitz & Morrow, *supra* note 12, at 546 (if underlying mortgage is going into a securitization, it is increasingly common to combine traditional mortgage debt with mezzanine financing as a method to increase the borrower's loan-to-value ratio and obtain more loan proceeds).

The growth of mezzanine loans is due in part to the national rating agencies' belief that traditional junior mortgage financing increases the likelihood and severity of default with the first mortgage. As a result, the rating agencies cause the interest rate to be higher in CMBS and RMBS securitizations where there is junior mortgage financing. Since this increased rate results in a higher price, borrowers have an incentive to seek out alternative financing. *See* Berman, *supra* note 12, at 81.

16. Mario J. Suarez & Gregory E. Xethalis, *Mitigating the Risks in Real Estate Mezzanine Finance*, 12 No. 12 ANDREWS' BANK & LENDER LIABILITY LITIG. REP. 13 (2006); *see also* NOMURA, *supra* note 11, at 11 (leverage has been rising in the CMBS market and LTVs in fusion transactions are generally in the 95-105% range); JIM DUCA & TAD PHILIPP, MOODY'S INVESTORS SERVICE, US CMBS: CONDUIT LOAN UNDERWRITING CONTINUES TO SLIDE - CREDIT ENHANCEMENT INCREASE LIKELY (2007), available at <http://www.cmbs.org/navigator/2007/MoodysReport.pdf> (loan to value ratios determined under Moody's criteria have reached 111.6%, reaching an all time record high).

17. *See* Berman, *supra* note 12, at 114.

18. *See id.* at 80.

19. Matt Hudgins, *Mesmerized by Mezzanine*, NAT'L REAL EST. INVESTOR, Aug. 1, 2006, available at [http://nreionline.com/mag/real\\_estate\\_mesmerized\\_mezzanine/index.html](http://nreionline.com/mag/real_estate_mesmerized_mezzanine/index.html).

20. DANIEL B. RUBOCK, MOODY'S INVESTORS SERVICE, US CMBS and CRE CDO: MOODY'S APPROACH TO RATING COMMERCIAL REAL ESTATE MEZZANINE LOANS 2 (2007), available at <http://dirt.umkc.edu/attachments/MDYMezz%20Loans.pdf>.

21. Lesley Hensell, "Mezzanine" Financing Fills Commercial Gap, REALTY TIMES, available at [http://realtytimes.com/rtpages/20010719\\_mezzanine.htm](http://realtytimes.com/rtpages/20010719_mezzanine.htm) (according to Prudential Real Estate Fixed Income Investors, the mezzanine market

In my previous article, "Once a Mortgage, Always a Mortgage," I explored the historical development of mortgage financings, securitizations and these new non-traditional financing techniques. I argued that courts should use their equitable powers to recharacterize mezzanine loans and preferred equity investments as junior mortgages.<sup>22</sup> In that article I principally examined the benefits of recharacterizing mezzanine financing from the borrower's viewpoint. This article, however, examines the hazards of mezzanine loans for lenders at two different points of time. At the very beginning of the debtor-creditor relationship, lenders often find it difficult to ensure the creation, attachment, and perfection of a security interest in mezzanine loan collateral. Furthermore, later on in that relationship if the mezzanine borrower defaults, there are many limitations on the remedies available to mezzanine lenders.<sup>23</sup>

Lenders frequently attempt to mitigate some of these risks by requiring that borrowers are special purpose and bankruptcy remote entities, and lawyers deliver legal opinions on the enforceability of the loan documents. In addition, lenders purchase "mezzanine loan" title policies and/or endorsements, and enter into intercreditor agreements with the senior mortgage lender. Unfortunately, dealing with these hazards often leads to inefficient and wasteful practices that end up compounding the problem, leading to further market imperfections. The result is over-confident lenders who overlend at interest rates that do not adequately reflect all of the hazards inherent in these complicated financings. In effect, this causes a classic market imperfection since there is a mismatch between (or mispricing of) risks and rewards. This is clearly a concern for mezzanine lenders since they bear the risk of default. Overlending is also a concern for the real estate marketplace in general since it will inevitably bear many of these risks (sometimes referred to as negative externalities) if and when the borrowers in these complicated financial arrangements begin to default.

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could be worth between \$65 billion and \$135 billion); Donald Braun, *Entrepreneurial Mezzanine Financing Sources Offer Flexible Equity*, COM. INVESTMENT REAL EST., available at [http://www.ciremagazine.com/article.php?article\\_id=268](http://www.ciremagazine.com/article.php?article_id=268) ("[o]n a marketwide basis, the real estate mezzanine financing sector represents 10 percent of the \$4.5 trillion dollar total property market"). See Derrick E. McGavick, *Subordinate Debt Investments in Commercial Real Estate: An Introduction for Equity Investors*, <http://www.ifecorp.com/Papers2006/RREEF.pdf> ("there is no industry group or government entity that tracks the size of the mezzanine market").

22. See Berman, *supra* note 12.

23. There are many hazards of mezzanine loans, including bankruptcy risks, the potential for lender liability, concerns regarding breach of fiduciary duty and basic principles of corporate governance, and recharacterization risks such as clogging the equity of redemption and blurring the distinction between debt and equity. These other hazards are outside the scope of this article and will be addressed in a future article.

This article is a first step in evaluating and discussing some of the hazards, legal risks and uncertainties inherent in mezzanine financings and the way in which the market fails to adequately take these factors into account. In Part II, I describe the legal background and structure of mezzanine loans. Part III focuses on the risks and realities of mezzanine loans. In particular, I describe some of the difficulties in perfecting a security interest in, and foreclosing upon, mezzanine loan collateral. In Part IV, I argue that the recent subprime mortgage crisis offers a cautionary tale for many of the hazards that may be looming in the near future for the mezzanine loan market, that mezzanine lenders must better understand and evaluate these hazards, and that the legal system needs to produce clearer rules on these non-traditional financings.

## II. BACKGROUND – LEGAL STRUCTURE OF MEZZANINE LOANS<sup>24</sup>

In the financial markets, the term ‘mezzanine financing’ describes many different types of financings such as junk bonds, unrated debt, unsecured notes, zero-coupon bonds, deferred interest debentures, and convertible loans.<sup>25</sup> These financings are all related but have different legal structures, responding in part to the needs of specific industries and their regulatory regimes and/or market participants.<sup>26</sup> The common thread, however, in all mezzanine financing is a capital structure with debt that is senior to equity but junior to other more senior debt. Like a theater, mezzanine debt sits in the mezzanine section between senior debt in the more expensive orchestra, and equity sitting in the cheaper section of the balcony.

In real estate, “mezzanine financing” refers to a particular type of debt that is junior to the senior mortgage loan but senior to the equity investors.<sup>27</sup> The senior mortgage loan is typically secured by income-producing real estate owned by the underlying mortgage borrower.<sup>28</sup> A mezzanine loan, however, is secured solely by equity interests in other entities that either directly or indirectly own income producing property. These “Equity Interests” are usually membership interests in a limited liability company, sometimes stock

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24. This Part relating to the legal structure of mezzanine loans is based on Berman, *supra* note 12, at 105-10.

25. *Id.* at 105; Christian C. Day, Michael P. Walls & Lisa A. Dolak, *Riding the Rapids: Financing the Leveraged Transaction Without Getting Wet*, 41 SYRACUSE L. REV. 661, 739 (1990); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Finance Topics, American College of Real Estate Lawyers Midyear Meeting, Scottsdale, Arizona (Apr. 4-5, 1997) (on file with author), abstract at: <http://www.acrel.org/Public/Publications/default.asp?Action=DrawOneArticle&ArticleID=2319&ArticleType=Seminar>.

26. Berman, *supra* note 12, at 105; Mario L. Baeza, *Recent Developments in Leveraged Buyouts*, 700 PLI/CORP. 9, 47-50 (1990).

27. Forte, *supra* note 12, at 442.

28. Berman, *supra* note 12, at 79 n.13.

in a corporation, and rarely limited or general partnership interests in a limited or general partnership.<sup>29</sup> The collateral for a mezzanine loan consists solely of the mezzanine borrower's (direct or indirect) Equity Interests of the mortgage borrower – the underlying entity that actually owns the income-producing real property.

Mezzanine loans are typically secured by the Equity Interests in the mortgage borrower, but mezzanine borrowers do not directly pledge the equity of the underlying mortgage borrower. Instead, the mezzanine loan is structured as a “second tier” (or even “third tier”) financing. Consequently, the mezzanine borrower pledges the Equity Interests in its subsidiary – an intermediary entity that directly or indirectly owns the underlying mortgage borrower.<sup>30</sup>

Whereas a mortgage borrower directly owns real estate, a mezzanine borrower only owns equity. In fact, the national rating agencies often require that the mezzanine borrower be structured as an entity that is both special-purpose (SPE) and bankruptcy remote (BRE), and that owns no assets other than its equity ownership in other entities.<sup>31</sup> Since only the bottom-tiered entity (the mortgage borrower) actually owns real property, the mezzanine borrower's entire net worth, cash flow, and value of its collateral is derived solely from its (direct or indirect) equity in the entity that owns the underlying income-producing property.<sup>32</sup> The mezzanine borrower typically has no source of revenue to repay the mezzanine loan other than cash distributions it might receive as an indirect equity owner of the underlying mortgage borrower.<sup>33</sup>

The mezzanine lender's collateral is further complicated since that same underlying parcel of land simultaneously serves as collateral for a mortgage loan between a conventional mortgage lender and the mortgage borrower. The mortgage borrower is technically a wholly-owned subsidiary of the mezzanine borrower, and the mezzanine loan is, therefore, always structurally subordinate to the senior mortgage.<sup>34</sup> At the same time, however, the mezzanine loan remains senior to the equity investments in the underlying mortgage

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29. Elliot Surkin, *Modern Real Estate Transactions: How Do I Get Out of Here? A Discussion of Exit Strategies in Closely-Held Real Estate LLCs*, SM002 A.L.I.-A.B.A. 809, 813 (2006) (the choice of entity for real estate projects should almost always be an LLC).

30. STANDARD & POOR'S, US CMBS LEGAL AND STRUCTURED FINANCE CRITERIA 20 (2003), available at [http://www2.standardandpoors.com/spf/pdf/fixedincome/040103\\_cmbslegalcriteria14.pdf](http://www2.standardandpoors.com/spf/pdf/fixedincome/040103_cmbslegalcriteria14.pdf).

31. See, e.g., RUBOCK, *supra* note 20, at 3; STANDARD & POOR'S, *supra* note 30, at 20-21; FITCH RATINGS, SPECIAL PURPOSE ENTITIES IN US CMBS (2006), available at [http://www.fitchratings.com/corporate/reports/report\\_frame.cfm?rpt\\_id=278942&sector\\_flag=2&marketsector=2&detail=](http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=278942&sector_flag=2&marketsector=2&detail=).

32. Berman, *supra* note 12, at 79.

33. STANDARD & POOR'S, *supra* note 30, at 20.

34. See *infra* Part III.D.1.



and mezzanine borrower.<sup>35</sup> As a result of this unique capital structure, mezzanine loans have characteristics of both secured debt and equity.<sup>36</sup>

### III. RISKS AND REALITIES

This Part discusses in detail some of the risks relating to the special nature of the mezzanine lender's collateral. These risks arise primarily at two different points of time – at the very beginning of the lender-borrower relationship and later on in that relationship if the borrower defaults. At the time a mezzanine lender originates a mezzanine loan, lenders face many risks associated with the proper creation, attachment, and perfection of a security interest in mezzanine loan collateral. Since the lenders underwrite these loans and determine the interest rate based on the assumption that the loan is secured, it is essential that the lender takes the proper steps under the Uniform Commercial Code to ensure the validity of its lien in the mezzanine loan collateral. Later on in the lender-borrower relationship if the mezzanine borrower defaults, the lender must also ensure that it has effective remedies at its disposal, including the right and ability to foreclose upon the mezzanine loan collateral.

#### *A. Creation, Attachment and Perfection of a Security Interest*

There are special risks for the mezzanine lender under the Uniform Commercial Code (“UCC”) because of the legal structure of mezzanine loans and the unusual nature of the collateral. The UCC governs the proper creation, attachment and perfection of the mezzanine lender's security interest in its collateral prior to the origination of the loan. As discussed above, the mezzanine lender's principal collateral consists of the mezzanine borrower's Equity Interests in other entities: membership interests in a limited liability company; stock in a corporation; limited partnership interests in a limited partnership; or general partnership interests in a general partnership. Since this collateral is technically personal property under state law, local mortgage law does not apply.<sup>37</sup> Rather, the mezzanine lender must create, attach, and

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35. Forte, *supra* note 12, at 442.

36. Poindexter, *supra* note 12, at 240; Berman, *supra* note 12, at 79.

37. Mezzanine loans differ significantly from traditional mortgage loans where the mortgage borrower grants a lien on its real property pursuant to a written instrument (typically a mortgage or in some states, a deed of trust), and thereafter the lender holds an effective mortgage lien on the collateral. By recording the mortgage in the land records where the property is located, mortgage lenders can also generally ensure that its lien is effective and superior to the liens and claims of most other third-parties. Once a mortgage is properly recorded, most states generally protect the mortgagee by ensuring that its lien is superior to most other subsequent liens and encumbrances and subsequent bona fide purchasers. See Berman, *supra* note 12, at 107-08.

perfect a security interest in its collateral under Article 9 (or if applicable, Article 8) of the UCC.<sup>38</sup>

Under section 9-203(a) of the UCC, a security interest generally attaches to collateral “when it becomes enforceable against the debtor with respect to the collateral.” The security interest generally becomes enforceable when it satisfies the requirements of UCC section 9-203(b): (i) the secured party gives “value” (this typically occurs at the closing when the mezzanine lender disburses the loan proceeds);<sup>39</sup> (ii) the debtor has “rights in the collateral;”<sup>40</sup> and (iii) one of the following conditions is met:

- (A) the mezzanine borrower “authenticates” a security agreement which describes the collateral;
- (B) the collateral is not a certificated security and the secured party has possession of the collateral under UCC Section 9-313 pursuant to the debtor’s security agreement;
- (C) the collateral is a certificated security and the certificate has been delivered to the secured party; or
- (D) the secured party has control and the collateral is deposit accounts, electronic chattel paper, investment property, or letter-of-credit rights.<sup>41</sup>

38. Article 9 of the UCC governs the attachment, perfection and priority of liens on most types of personal property serving as collateral, including goods, instruments, general intangibles, and equipment. However, if the equity interests are securities, then Article 8 of the UCC would apply. See Leanne R. Dunn & Peter Dopsch, *Mezzanine Loan Foreclosure: UCC Sales of Equity Interests Under Revised Article 9*, 2002 REAL EST. FIN. J. 1422 (“[T]he creation and enforcement of security interests in equity pledges, as opposed to second mortgages, are governed by the Uniform Commercial Code rather than by real property law.”).

39. The term “value” is defined in section 1-201(44) of the U.C.C.

[A] person gives ‘value’ for rights if he acquires them (a) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection; or (b) as security for or in total or partial satisfaction of a pre-existing claim; or (c) by accepting delivery pursuant to a pre-existing contract for purchase; or (d) generally, in return for any consideration sufficient to support a simple contract.

U.C.C. § 1-201(44) (2007).

40. U.C.C. § 9-203(b)(2) (“the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party”).

41. U.C.C. § 9-203(b)(3).

The UCC provides that Equity Interests are typically general intangibles rather than a “security” under Article 8 or “investment property” under Article 9.<sup>42</sup> Equity Interests are securities under Article 8 only if the equity is traded on a security exchange, issued by a registered investment company or if the organizational documents of the entity expressly provide that its equity is a security governed by Article 8 – i.e., the issuer “opts in” to Article 8.<sup>43</sup> Since Equity Interests are not commonly traded on a public exchange or issued by a registered investment company, Article 8 typically only applies if the issuer has opted-in.<sup>44</sup> Conversely, if the mezzanine borrower has not “opted in” to Article 8, the mezzanine borrower’s collateral remains a general intangible under Article 9 and the secured lender perfects its security interest

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42. U.C.C. Section 9-102(a)(42) defines a “general intangible” as any “personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.” The term “general intangible” includes “payment intangibles” which are defined in section 9-102(a)(61) as “a general intangible under which the account debtor’s principal obligation is a monetary obligation.” U.C.C. Section 8-102(a)(15) defines a “security” as

an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer: (i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer; (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and (iii) which: (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or (B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.

U.C.C. Section 9-102(a)(49) defines a “investment property” as “a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account.” See also John Murray, *Title Insurance for Mezzanine Financing Transactions*, SM002 A.L.I.-A.B.A. 1305, 1309-10 (2006) [hereinafter Murray, *Title Insurance*].

43. U.C.C. § 8-103. According to U.C.C. Section 8-103(c), “[a]n interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security.” See also James D. Prendergast & Keith Pearson, *How to Perfect Equity Collateral Under Article 8*, PRAC. REAL EST. LAW., Nov. 2004, at 35, [hereinafter Prendergast & Pearson, *How to Perfect Equity Collateral*]; Lynn Soukup, ‘Opting in’ to Article 8 – LLC and Partnership Interests as Collateral, Oct. 2004, <http://www.eagle9.com/downloads/A8OptInLynnS.pdf> [hereinafter Soukup, *Opting in to UCC*]; Lynn Soukup, *Using the UCC: Protection and Flexibility for Buyers and Pledges of LLC and Partnership Interests*, <http://www.eagle9.com/downloads/blt-opt.pdf> [hereinafter Soukup, *Using the UCC*].

44. Soukup, *Using the UCC*, *supra* note 43, at 2.

by filing a UCC-1 financing statement in the appropriate recording office.<sup>45</sup> Once perfected, the mezzanine lender's lien and security interest is generally superior to that of most third parties, including subsequent lien holders, judgment lien creditors and bona fide purchasers.<sup>46</sup> However, with general intangibles, the priority of security interests is typically determined by the "first to file" rules of UCC section 9-322.<sup>47</sup>

Article 8 of the UCC, therefore, only applies to the Equity Interests if the Mezzanine Borrower expressly "opts in" to these provisions. In order to opt-in to Article 8, the organizational documents of the Mezzanine Borrower must unambiguously state that the Equity Interests are securities to be governed by Article 8 of the UCC.<sup>48</sup> In addition, if the Equity Interests are represented by a certificate, the certificate must also contain a "legend" with express language stating that Article 8 of the UCC governs.<sup>49</sup> Once the mezzanine borrower takes these steps ("opt-in" and legend) then the Equity Interests are "securities" under Article 8 and "investment property" under Article 9.

Unlike a security interest in a general intangible which may only be perfected by filing a financing statement, the mezzanine lender may perfect a security interest in investment property by any of the following actions: (i) filing a UCC-1 financing statement,<sup>50</sup> (ii) delivery (lender takes possession of the certificate evidencing the Equity Interests, and Mezzanine Borrower endorses the certificate (or delivers a separate assignment) to the mezzanine lender or its designee or sometimes endorses it in blank to be filled in later by

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45. U.C.C. § 9-310(a) (2007) (secured lender must file a financing statement to perfect a security interest in a general intangible). Pursuant to Revised Article 9 of the U.C.C., a mezzanine lender would file a financing statement with the Secretary of State of the state where the debtor is "located" to perfect its security interest in collateral consisting of equity interests. U.C.C. §§ 9-501, 9-301. And, a debtor is deemed located in the state where its organizational papers are filed if such debtor is required to file organizational documents (e.g., a corporation or limited liability company). U.C.C. § 9-307(b). If the equity interests are certificated, however, a mezzanine lender would typically also take possession of the certificates evidencing the equity interests to ensure its first lien priority. U.C.C. § 9-313(a).

46. Soukup, *Opting in to UCC*, *supra* note 43, at 3.

47. U.C.C. § 9-322 provides that, in general, priority among conflicting security interests in the same collateral is determined from the earlier of the time a filing covering the collateral is first made or the security interest is first perfected.

48. U.C.C. § 8-102 (a)(15) (definition of security includes an interest in an issuer which by its terms provides that it is a security governed by Article 8); Prendergast & Pearson, *How to Perfect Equity Collateral*, *supra* note 43, at 35.

49. Prendergast & Pearson, *How to Perfect Equity Collateral*, *supra* note 43, at 35 (noting that the legend puts potential purchasers on notice).

50. U.C.C. §§ 9-310, 9-312. See also Soukup, *Opting in to UCC*, *supra* note 43, at 3; Soukup, *Using the UCC*, *supra* note 43, at 2.

the Mezzanine Lender upon foreclosure),<sup>51</sup> or (iii) control (either through taking possession if the Equity Interests are certificated or by entering into a control agreement if the Equity Interests are uncertificated).<sup>52</sup> However, perfection by possession or control typically ensures a first priority lien over another lien holder who previously perfected by filing a financing statement even if the later secured party knew of the filing by the previous secured lender.<sup>53</sup> As a result of the operation of Articles 8 and 9 on mezzanine loan transactions, it is common for lenders to take all of the following steps to ensure the validity of its lien on its collateral:

Insist that the issue of the equity opt-in to Article 8; certificate the equity; take possession of the certificate; try to obtain an endorsement to perfect by control; obtain a covenant that the borrower will not opt-out; require independent member consent for opt-out; and file back-up financing statement in case opt-in is defective or, if effective, in case borrower manages to opt-out later.<sup>54</sup>

In fact, rating agencies and title companies have begun to require that parties to a mezzanine loan take all of these steps.<sup>55</sup>

In an attempt to mitigate some of the risks associated with ensuring the proper creation, attachment and perfection of a security interest in mezzanine loan collateral, mezzanine lenders now routinely require that the mezzanine borrower obtain mezzanine loan title insurance.<sup>56</sup> In addition, the rating

51. U.C.C. § 9-313(a) (permitting delivery); U.C.C. § 8-301(a) (method to effect delivery). *See also* Soukup, *Opting in to UCC*, *supra* note 43, at 2; Soukup, *Using the UCC*, *supra* note 43, at 2; Murray, *Title Insurance*, *supra* note 42, at 1311.

52. U.C.C. § 9-314(a) (permitting control); U.C.C. § 8-106 (method to obtain control). *See also* Soukup, *Opting in to UCC*, *supra* note 43, at 2; Soukup, *Using the UCC*, *supra* note 43, at 1-2.

53. U.C.C. § 9-328(5). *See also* Prendergast & Pearson, *How to Perfect Equity Collateral*, *supra* note 43, at 35-36; Soukup, *Using the UCC*, *supra* note 43, at 3; Murray, *Title Insurance*, *supra* note 42, at 1310.

54. Prendergast & Pearson, *How to Perfect Equity Collateral*, *supra* note 43, at 49.

55. RUBOCK, *supra* note 20, at 5 (borrower to opt-in, certificate its Equity Interests and file a UCC-1 Financing Statement as a “fail-safe” protection); James Prendergast, *Secured Real Estate Mezzanine Lending (with Form)*, *PRAC. REAL EST. LAW.*, March 2007, at 35.

56. RUBOCK, *supra* note 20, at 5 (noting that the mezzanine lending financial community has “coalesced” around the requirement of mezzanine title insurance). Although there are many articles discussing title insurance for mezzanine loans, almost all are written by individuals employed by the title companies. As a result, many of these articles are often marketing pieces thinly disguised as helpful advice to the bar. In a recent LEXIS search, for example, John Murray of First American Title Insurance Company had written over 40 articles published in various publications discussing “title” insurance for mezzanine loans, including First American’s Eagle 9

agencies also believe that special mezzanine loan title policies and endorsements “add value” and now routinely require such policies.<sup>57</sup> This so-called insurance typically takes one of two forms: either (i) the ALTA 16/CLTA 128 Endorsement<sup>58</sup> or (ii) “Article 9” Mezzanine Loan Policy<sup>59</sup> (which is sometimes referred to as the UCC “Eagle 9” Policy).<sup>60</sup>

### B. ALTA 16 Endorsement

Since the mezzanine loan collateral is indirectly derived from the value of the underlying mortgage borrower’s interest in the underlying real property, the mezzanine borrower has a financial interest in ensuring the quality of the title to the underlying property (i.e., that the mortgage borrower owns the property “free of undisclosed liens and other defects”)<sup>61</sup> and “that the mezzanine lender has rights . . . to any payments otherwise payable” to the underlying mortgage borrower under the mortgage borrower’s title insurance pol-

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UCC insurance policy. See, e.g., Murray, *Title Insurance*, *supra* note 42; John C. Murray, *Benefits of the UCC Insurance Policy*, SM002 A.L.I.-A.B.A. 1533 (2006) [hereinafter Murray, *Benefits*]; John C. Murray and Randall L. Scott, *Title Insurance for Mezzanine Financing Transactions*, 532 PLI/REAL 31 (2006) [hereinafter Murray & Scott, *Mezzanine Financing Transactions*]; John C. Murray, *Limitation of Liability for UCC Searches: Can UCC Insurance Provide an Alternative?*, 500 PLI/REAL 561 (2003).

Many other articles on this topic have been written by other employees of national title insurance companies. See, e.g., Edward S. Rusky, *Title Insurance and Due Diligence*, 531 PLI/REAL 479 (2006); Janice E. Carpi, *Endorsements: A Summary of the Various Endorsement Forms Available Throughout the United States*, 532 PLI/REAL 327 (2006); Clifford L. Morgan, *Inside the Industry: New Endorsement Forms Advance Industry*, SL004 A.L.I.-A.B.A. 1321 (2005); Marvin Bagwell, *What are Those? Mezzanine Financing and Synthetic Leases – Explained*, N.Y. L.J., Aug. 21, 2006, at S8.

57. RUBOCK, *supra* note 20, at 5.

58. Am. Land Title Ass’n, ALTA Form 16/CLTA 128, available at <http://www.alta.org/forms/> (follow “ALTA Endorsement Form 16-06 Mezzanine Financing” hyperlink) [hereinafter ALTA Form 16 Endorsement].

59. First Am. Title Ins. Co., Eagle 9 UCC Insurance Policy, available at <http://www.eagle9.com/downloads/MEFK.pdf>. See also Christine McGuinness, *Title Insurance for the Mezzanine Lender*, N.Y. REAL EST. L. REP., December 2004.

60. First American Title Insurance Company was one of the first issuers of a mezzanine loan insurance policy and called it “Eagle 9.” Currently, the following title insurance companies offer the UCC-9 title insurance policy in New York: First American Title Insurance Company of New York, Chicago Title Insurance Company, Fidelity National Title Insurance Company of New York, and LandAmerica Commonwealth Land Title Insurance Company. See Bagwell, *supra* note 56.

61. John C. Murray, *New ALTA Commercial Endorsement Coverages (2003-2004)*, SL004 A.L.I.-A.B.A. 1499, 1513 (2005) [hereinafter Murray, *New ALTA Commercial*].

icy.<sup>62</sup> As a result, the mezzanine lender desires to ensure that the underlying mortgage borrower has title insurance for its property and that somehow the mezzanine lender can receive any payments made under that policy. A problem arises since the mezzanine lender lacks an “insurable interest” in the underlying mortgaged property; accordingly, most title companies wouldn’t issue an owner’s title insurance policy to the mezzanine lender.<sup>63</sup> Similarly, the mezzanine lender doesn’t have a mortgage on the underlying property so a typical lender’s mortgage policy is not available either.<sup>64</sup>

The ALTA Form 16 Endorsement is an attempt by the title industry to deal with this apparent gap in coverage. It is an endorsement to the underlying mortgage borrower’s owner’s title insurance policy, which among other things, assigns to the mezzanine lender the right to receive payments otherwise payable to the underlying mortgage borrower from the owner’s title insurance policy relating to the mortgaged property.<sup>65</sup> In addition, this endorsement ensures that no amendment of, or endorsement to, the owner’s title policy can be made without the written consent of the mezzanine lender.<sup>66</sup>

The ALTA Form 16 Endorsement also includes a “non-imputation” provision whereby the title insurance company agrees that it will not refuse to pay a claim to the mezzanine lender because of any fact previously known to any of the pledgors of the Equity Interests. Section 4 of the endorsement states:

In the event of a loss under the policy, the [Title Insurance] Company agrees that it will not assert the provisions of Exclusions from Coverage 3(a), (b) or (e) to refuse payment to the Mezzanine Lender solely by reason of the action or inaction or knowledge, as of [the] Date of the Policy, of the Insured . . . .<sup>67</sup>

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62. *Id.*

63. Morgan, *supra* note 56, at 1327. See also Murray, *Title Insurance, supra* note 42, at 1307.

64. Morgan, *supra* note 56, at 1327.

65. ALTA Form 16 Endorsement, *supra* note 58, § 2(a). Section 2(a) of the ALTA Form 16 states: “[The underlying mortgage borrower] assigns to the Mezzanine Lender the right to receive amounts otherwise payable to the insured under [the underlying mortgage borrower’s title insurance policy].” *Id.*

66. *Id.* § 2(b). Section 2(b) of the ALTA Form 16 states: “[The underlying mortgage borrower] agrees that no amendment of or endorsement to the [underlying mortgage borrower’s title insurance policy] can be made without the written consent of the Mezzanine Lender . . .” *Id.* See also Murray, *Title Insurance, supra* note 42, at 1309.

67. ALTA Form 16 Endorsement, *supra* note 58, § 4. See also Dennis B. Arnold, *Enforcing Security Interests in Membership Interests and Partnership Interests under Revised Article 9 of the Uniform Commercial Code*, 535 PLI/REAL 717, 753-54 (2007).

Without this endorsement, any knowledge of the pledgors of the Equity Interests would have been imputed to the mezzanine lender, thereby depriving the mezzanine lender from making a claim for liability arising from title defects relating to the previously known matter.<sup>68</sup>

In addition, section 5 of the ALTA Form 16 protects the mezzanine lender from the exclusion in the owner's policy relating to events that occur after the effective date of the title policy. Section 5 states:

In the event of a loss under the [Owner's Title Insurance] Policy, the [Title Insurance] Company also agrees that it will not deny liability to the Mezzanine Lender on the ground that any or all of the ownership interests (direct or indirect) in the [underlying mortgage borrower] have been transferred to or acquired by the Mezzanine Lender, either on or after the Date of the [Owner's Title Insurance] Policy.<sup>69</sup>

Without this additional insuring language, the mezzanine lender would be denied coverage under the underlying mortgage borrower's owner's title policy since the mezzanine lender invariably would acquire its indirect equity interests in the underlying mortgage borrower after the effective date of the owner's policy.

As nice as it must be for the mezzanine lender to believe it has the comfort of "insurance," the reality is quite different since ALTA Form 16 raises many serious issues.<sup>70</sup> First, the underlying mortgage borrower's assignment of the proceeds of its owner's title insurance policy to the mezzanine lender may make the underlying mortgage borrower a surety.<sup>71</sup> Since the underlying mortgage borrower is not indebted to the mezzanine lender, it is technically paying the debt of a third-party obligor, thereby making it a surety under common law. If the mortgage borrower becomes a surety of the mezzanine borrower, it incurs a type of surety debt. Some have argued that the incur-

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68. This provision in the ALTA Form 16 is similar to the non-imputation endorsement commonly given in loans to partnerships and other constituent entities. Exclusion 3(b) of the ALTA Owner's title insurance policy generally excludes claims for matters known to the insured but not found in the public records. Since the insured is an entity, any knowledge known to the insured prior to the mezzanine loan would technically still be known by the insured entity even after a mezzanine lender forecloses on the equity of the indirect owners of the insured – the underlying mortgage borrower. Am. Land Title Ass'n, ALTA Owner's Policy, available at <http://www.alta.org/forms> (follow "ALTA Owner's Policy" hyperlink).

69. ALTA Form 16 Endorsement, *supra* note 58, § 5.

70. Arnold, *supra* note 67, at 754. Dennis Arnold has cataloged four significant risks to the mezzanine lender under the ALTA 16 Form – suretyship, legal capacity, potential impact on non-consolidation opinions, and article 9 security interests. *Id.* at 754-55. Portions of this section are based on his writing in this area.

71. *Id.* at 754.



rence of such debt by the mortgage borrower might violate the special purpose, bankruptcy remote provisions contained in its organizational documents which prohibit or severely restrict additional debt.<sup>72</sup>

Furthermore, a title company will not typically issue the ALTA Form 16 unless the underlying mortgage borrower consents to assigning the proceeds of its title insurance policy to the mezzanine lender.<sup>73</sup> The problem, of course, is that the underlying mortgage typically prohibits the mortgage borrower from executing such a consent (and assigning the loss proceeds). Furthermore, the mortgage lender will not waive this provision since it wants to receive all proceeds from the owner's title insurance policy to apply to the mortgage loan. The proceeds under the title insurance policy would be treated like any other cash proceeds received by the mortgage borrower. Typically the intercreditor agreement between the mortgage and mezzanine lender dictates that any such proceeds be used first to pay down the senior mortgage loan.

In addition, the mortgage borrower's policy may not fully protect the mezzanine lender against actual liens on the underlying mortgaged property. Oftentimes, there might be a lien against the property that was omitted from the mortgage borrower's policy because of an indemnity given to the title company. In this case, the mezzanine borrower would take subject to the pre-existing lien but would not have the benefit of the indemnity.<sup>74</sup> Furthermore, the ALTA Form 16 fails to protect the mezzanine lender from any liens filed against the mortgaged property after the effective date of the policy. Therefore, even with an ALTA 16 endorsement, if a mezzanine lender forecloses on its equity collateral, it still indirectly owns the mortgaged property subject to whatever liens and title defects might then exist.<sup>75</sup> There is also a concern that a mezzanine lender might be liable for these liens upon foreclosure.<sup>76</sup>

### C. Article 9 Mezzanine Loan Title Insurance

Several title insurance companies are now also issuing UCC Article 9 Mezzanine Loan title insurance policies (sometimes referred to as the Eagle

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72. RUBOCK, *supra* note 20, at 5 n.13 (citing Arnold, *supra* note 67, at 754).

73. Murray, *New ALTA Commercial*, *supra* note 61, at 1513 (“[T]he endorsement requires the signature of an authorized representative of the insured entity consenting to the assignment to the mezzanine lender of any loss payable under the Policy”).

74. William McInerney & Melissa Hough Hinkle, *Use of Mezzanine Debt in Commercial Mortgage Loans*, N.Y. L.J., Sept. 20, 2004 (“real estate borrower may have indemnified over existing liens that do not appear on the mortgagee's title policy”).

75. *Id.* (noting that there are “no protections against future real property liens.”).

76. *Id.*

9).<sup>77</sup> This policy attempts to mimic a traditional mortgage lender's title insurance policy by insuring the attachment, perfection and priority of the mezzanine lender's lien in the mezzanine loan collateral.<sup>78</sup> In addition, the policy covers the risks of mis-indexed filings and incorrect filings. The UCC policy also claims to insure the mezzanine borrower's ownership of the collateral (i.e., the Equity Interests in the underlying mortgage borrower) and that the security interest has attached to the collateral.<sup>79</sup> Perhaps most significantly, the UCC title insurance policy also pays all costs, legal fees and expenses incurred in the defense of the mezzanine lender's security interest in the collateral.<sup>80</sup>

The title insurance industry has spent much time and energy in its attempt to convince the market (i.e., mezzanine lenders and their attorneys) that these new "title" products are essential.<sup>81</sup> Representatives of the title industry have authored many articles and spoken at many conferences with dire warnings. According to the title industry, the new Article 9 is so complicated that there is "'hidden' legal malpractice risk to real estate attorneys who only occasionally deal with UCC issues in their practice (especially with respect to mezzanine financing)"<sup>82</sup> and that mezzanine lenders face "devastating 'all or nothing' consequences" if its lien is found to be defective.<sup>83</sup> Title insurance

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77. See *supra* note 60. See also James D. Prendergast, *UCC Insurance vs. Credit Insurance – A Look at Two Risk-Shifting Alternatives for Lenders*, ABF J., Jan./Feb. 2006, available at <http://www.eagle9.com/downloads/credit-insurance.pdf> (noting that most of the policies "do the same thing") [hereinafter Prendergast, *UCC Insurance vs. Credit Insurance*].

78. Coverage clauses 1-4 of the mezzanine loan policy explains that it insures against any loss or damage sustained or incurred by the mezzanine lender by reason of (1) the failure of the security interest to attach to the mezzanine loan collateral, (2) the failure of the security interest to be perfected with respect to any portion of the mezzanine loan collateral, (3) the priority of the mezzanine lender's security interest over any other security interest in any portion of its collateral, and (4) the priority of the mezzanine lender's security interest over the lien of any judgment lien creditor. Eagle 9 UCC Insurance Policy, *supra* note 59.

79. James D. Prendergast, *UCC Insurance: Cost-effective Alternative to Borrower's Counsel Legal Opinion*, ACC DOCKET, Jan. 2004, at 82, available at <http://www.eagle9.com/downloads/altopinion.pdf> [hereinafter Prendergast, *UCC Insurance*].

80. See *id.*

81. See *supra* note 56.

82. Murray & Scott, *Mezzanine Financing Transactions*, *supra* note 56, at 40. See also James D. Prendergast, *It Can Happen and It Does! The Cases for UCC Insurance* (pt. 1), COM. L. NEWSL., Mar. 2003, at 2, available at <http://www.eagle9.com/downloads/itcanhappen.pdf> [hereinafter Prendergast, *It Can Happen*].

83. John C. Murray, *Is UCC Insurance the Answer to Limitation of Liability in UCC Searches?*, PRAC. REAL EST. LAW., Sept. 2003, at 13, available at

companies claim that it might be malpractice for lawyers not to advise their lender clients to obtain these products,<sup>84</sup> that legal opinions delivered by attorneys are “generally worthless,”<sup>85</sup> and that very little case law exists dealing with many of the legal issues faced by mezzanine lenders when enforcing their rights.<sup>86</sup> They claim that lawyers “ought to love UCC insurance because it off-loads to the insurance company the high risk/low profit work.”<sup>87</sup> Fortunately, according to the title industry, it can provide “peace of mind to lenders and their counsel”<sup>88</sup> and a “second set of eyes” to review loan documents.<sup>89</sup> The title companies claim that these UCC mezzanine loan policies can provide extra due diligence and assurance that the proper steps for perfection have been taken.<sup>90</sup> Furthermore, they claim that the policies cover the legal costs of a mezzanine lender to defend against claims challenging the attachment, perfection and priority of the mezzanine lender’s lien, even if such claim is eventually unsuccessful.<sup>91</sup>

The title industry has been quite persuasive and successful in its marketing efforts. Many practitioners and rating agencies now state that it is the customary industry standard for the mezzanine borrower to obtain a Form 16 endorsement to the title policy insuring the underlying mortgaged property

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<http://www.eagle9.com/downloads/PREL0309-MURRAY.pdf> [hereinafter Murray, *Is UCC Insurance the Answer*].

84. Murray, *Benefits*, *supra* note 56, at 1538 (“[I]t is possible that the failure of lender’s counsel to mention the availability and utility of UCC insurance may constitute malpractice.”); Prendergast, *UCC Insurance*, *supra* note 79, at 10 (noting that “common sense suggests . . . the utility of UCC insurance is so great that it amounts to malpractice for lender’s counsel not to use UCC insurance”).

85. Murray, *Benefits*, *supra* note 56, at 1537 (“The opinions . . . do not address priority, and with the numerous carve-outs, qualifications, exclusions, assumptions and exceptions contained therein, are generally worthless.”); James D. Prendergast, *The Utility of UCC Insurance*, SECURED LENDER, Nov./Dec. 2003, at 104, available at <http://www.eagle9.com/downloads/utility.pdf> (noting that legal opinions regarding perfection are generally worthless and are “totally circular”).

86. Murray, *Title Insurance*, *supra* note 42, at 1312.

87. Prendergast, *It Can Happen*, *supra* note 82, at 14. See also Murray, *Title Insurance*, *supra* note 42, at 1312.

88. Murray, *Benefits*, *supra* note 56, at 1535.

89. Murray, *Is UCC Insurance the Answer*, *supra* note 83, at 15; California Offers “UCC Policy” for Secured Loans, CLARKS’ SECURED TRANSACTIONS MONTHLY (2003), available at <http://www.eagle9.com/downloads/calucc.pdf> [hereinafter *UCC Policy for Secured Loans*].

90. Murray, *Benefits*, *supra* note 56, at 1535; Grant Puleo & Michael Lyon, *Mezzanine Loans to Developers and Owners of Real Estate Projects: 10 Ways to Improve the Quality of the Equity Pledge*, REAL EST. FIN. J., Spring 2007, at 47.

91. Murray, *Benefits*, *supra* note 56, at 1535-36; Murray, *Is UCC Insurance the Answer*, *supra* note 83, at 15.

and/or purchase a UCC title insurance policy.<sup>92</sup> However, the question of whether these mezzanine loan endorsements and UCC policies are actually worthwhile has not really been analyzed (at least by any person unrelated to a title company). Instead, almost every article relating to mezzanine loan endorsements and UCC title insurance policies has been written by employees of title companies who extol the benefits of these new products. Of course, title companies also earn significant premiums, so it is not surprising that they discuss only the positive aspects of these products or that they seek out this allegedly “high risk/low profit work.”<sup>93</sup> It is important to know the reality – are these products really as good as they seem or are title insurance companies simply using scare tactics to sell their products and boost their bottom lines?

I believe that the title companies are publicizing worst case scenarios in order to sell a new product. In reality it simply is not that hard for a mezzanine lender to ensure that its lien is a perfected first priority lien. As discussed above, the mezzanine lender requires that the equity interests in the mezzanine borrower are certificated, the entity opts in to Article 8 and covenants not to opt out of Article 8, the certificates are marked conspicuously with a legend or other notation, the borrower enters into a control agreement, the mezzanine lender files a precautionary UCC-1 financing statement, and the lender takes physical possession of the certificate. After completing these steps, the mezzanine lender is guaranteed a first perfected priority lien in the collateral subject to the standard risks such as fraud, forgery, undue influence, duress, incapacity, incompetency or impersonation. So in effect, the title policy insures the lender against these possible but unlikely events, but at great cost.<sup>94</sup>

There are other significant limitations of the mezzanine loan policy since it may not be available in cases where the lender suffers a loss due to claims of lender liability, breach of fiduciary duty, equitable subordination, or avoidance of its lien. Because these losses arise from the lender’s own actions, a court could easily find that the exclusion of the title policy relating to matters “‘created, suffered, assumed or agreed to’ by the insured” releases a title insurance company’s obligation to pay any claim under a mezzanine loan

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92. RUBOCK, *supra* note 20, at 5 (Moody’s embraces UCC title insurance for mezzanine loans as a “baseline” and generally expects mezzanine loans will have the benefit of the ALTA Form 16 or the UCC title insurance policy); McInerney & Hinkle, *supra* note 74, at 2 (“mezzanine loan policies are becoming commonplace when a mezzanine loan is originated”).

93. Murray, *Benefits*, *supra* note 56, at 1543 (the cost of a UCC policy generally ranges between “30 cents and \$1.75 per thousand dollars of coverage”).

94. Spencer Compton, *Commercial Applications of the New UCC Insurance Policy*, PRAC. REAL EST. LAW., March 2003, at 12.

policy.<sup>95</sup> Also, the mezzanine policy will not protect the mezzanine lender if its foreclosure on the equity collateral actually causes the legal existence of the mezzanine borrower to terminate. Because of the operation of state laws governing partnerships and limited liability companies, the mezzanine lender's foreclosure upon the partnership or membership interests may "inadvertently operate to terminate the legal existence of the borrower and, consequently, the borrower's insurance coverage."<sup>96</sup>

Furthermore, the title insurance companies would like mezzanine lenders to believe that the UCC title insurance policy eliminates the need to obtain a legal opinion. From the perspective of the title industry, legal opinions are expensive, mostly unnecessary, and do not cover the most important topic (i.e., perfection and priority) anyway. However, many of the same shortcomings apply to mezzanine loan policies. For example, both a standard legal opinion and mezzanine title insurance would carve out and exclude any opinions (in the case of a legal opinion) and any losses (in the case of a title policy) arising as a result of the application of bankruptcy, insolvency or similar provisions.<sup>97</sup> Similarly, both legal opinions and title policies would also make special exceptions, assumptions, and exclusions.<sup>98</sup>

In addition, there are certain distinct disadvantages of a mezzanine loan policy while there are other clear advantages of a legal opinion. For example, many UCC title insurance policies fail to insure that the mezzanine borrower actually owns the collateral since these policies assume that the insured has "rights in the collateral."<sup>99</sup> As a result, the policy often will not cover any losses if the mezzanine borrower does not actually own the pledged equity collateral.<sup>100</sup> On the other hand, a legal opinion often provides certain protections lacking from a UCC title insurance policy. For example, a typical legal opinion would opine that there are no conflicts between the credit agreement and other material agreements of the mezzanine borrower and that there is no material pending litigation. A mezzanine loan policy does not cover these matters.<sup>101</sup>

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95. John C. Murray, *Limited Liability Companies – Bankruptcy Issues*, SM002 A.L.I.-A.B.A. 2879 (quoting *Lawyers Title Ins. Corp v JDC (Am.) Corp.*, 52 F.3d 1575, 1580 n.9 (11th Cir. 1995)).

96. Suarez & Xethalis, *supra* note 16.

97. See Eagle 9 UCC Insurance Policy, *supra* note 59. See also Model Form of Legal Opinion (on file with author).

98. See Eagle 9 UCC Insurance Policy, *supra* note 59. See also Model Form of Legal Opinion (on file with author).

99. See Eagle 9 UCC Insurance Policy, *supra* note 59.

100. Bagwell, *supra* note 56 ("[B]ecause there is no public record of who 'owns' the secured property, the policy does not cover damage or loss resulting from the failure of the debtor to have rights in the collateral.").

101. Gary Samson, *When The Borrower Says "No" to a Lender's Request for a Legal Opinion*, THE SECURED LENDER, Nov./Dec. 2005, available at <http://www.eagle9.com/downloads/borrower-says-no.pdf>.

Unlike property and casualty insurance which is risk-shifting insurance, UCC title insurance is based on risk elimination.<sup>102</sup> There is nothing an insurance company can do to reduce the occurrence of fires or other casualties. There is an actuarial likelihood of such events occurring, and insurance companies assume that risk for a premium based on the severity and probability of loss. With UCC title insurance (as with property title insurance), a title insurance company can exercise due care and skill, thereby virtually eliminating any risk that the lender's lien will not be a senior perfected lien. Of course, the due care and skill that the title company exercises is exactly the same type of due care and skill that a lawyer regularly exercises in advising his or her clients and closing a mezzanine loan. Another way of stating this is that both a lawyer and a title company are generally equally capable of exercising the due care and performing the work necessary to create a senior perfected lien in the mezzanine loan collateral. The significant difference, therefore, is cost – a lawyer's hourly rate for its work versus the title insurance company's premium for the mezzanine loan policy. When looked at this way, it is clear that the mezzanine loan policy's cost is exorbitant as compared to the equivalent cost of a lawyer's service to ensure the perfection and priority of the mezzanine lender's lien.<sup>103</sup>

In effect, in exchange for the large premium, the title company is “selling” three things to its clients: (i) an indemnity to pay all costs to defend, (ii) the financial stability and credit worthiness of the insurer, and (iii) an indemnity standard for recovery (instead of a negligence standard). First, under a mezzanine loan title policy, a title company will pay any costs to defend the insured's lien if the perfection or priority of its lien is challenged in court, irrespective of whether such suit is successful or not. Without the mezzanine loan title policy, the mezzanine lender would bear its own cost of defense (i.e., lawyers fees and court filing charges) as is typical in the American system of jurisprudence.<sup>104</sup>

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102. Prendergast, *UCC Insurance vs. Credit Insurance*, supra note 77, at 1.

103. For a \$300 million dollar mezzanine loan, an Eagle 9 mezzanine loan policy would cost \$108,000, using a rate of \$0.36/\$1,000. See supra note 93. See also First Am. Title Ins. Co., UCC Basic Insurance Rates, <http://www.eagle9.com/rates.html> (last visited Oct. 18, 2007). Whereas, the cost for a lawyer to do the necessary work to perfect a security interest in typical mezzanine loan collateral would not generally exceed \$6,000. This estimate is based on the assumption that the work necessary to perfect a security interest might amount to 10 hours at most, and the current average hourly rate for an associate at a large NY law firm is approximately \$300 per hour. Even if the cost of a lawyer's legal opinion was added, the lawyer's fees would still be significantly lower than the premium paid for the mezzanine loan policy.

104. In the Anglo-system, it is customary for the losing party to pay the legal costs of the winning party. However, with some notable exceptions in the American system, each party typically pays its own costs irrespective of whether it wins or loses.

Secondly, the title companies are in effect selling their creditworthiness as a possible source of recovery to the mezzanine lender if its lien is set aside or found to be subordinate to other liens. The title companies are basically saying that they are “experienced, stable, and well capitalized” national companies with deep pockets, and that the lender’s law firm is, well, just a law firm that may or may not have the financial wherewithal to pay any potential malpractice claim.<sup>105</sup>

Thirdly, the title companies are offering the insured an indemnity standard of recovery instead of a negligence standard. In order for the insured to recover against a law firm, it must prove that the loss arose as a result of the lawyer’s negligence. With the mezzanine loan policy, however, an insured can collect under its policy for a defective lien irrespective of whether the insurer was negligent. As is typical with such insurance policies, the mezzanine loan policy is a contract of indemnity, and the title company will have strict liability for any loss arising from the loss of priority or perfection of the mezzanine lender’s lien. The insured doesn’t have to prove negligence against the title company.<sup>106</sup>

Title companies typically use horror stories of filings gone bad to justify the purchase of mezzanine loan policies. They cite to UCC-1 financing statements that have been mis-indexed, improperly completed and/or filed,<sup>107</sup> and poorly reviewed by paralegals and junior associates.<sup>108</sup> They warn of incomplete searches and other scenarios lurking in the UCC-world. Sure enough, there are serious dangers and pitfalls for lenders and their counsel to be aware of, but these arguments seem to be missing the point since they mostly apply to lenders taking security interests solely in general intangibles or other typical Article 9 personalty. With mezzanine loan collateral, most lenders now require the mezzanine borrower to opt in to Article 8, thereby converting the Equity Interests into “investment property” under Article 9 and securities under Article 8. As discussed above, the lender perfects its first priority security interest by having “control” of the equity pursuant to a control agreement and taking possession of the certificated security that contains a restrictive legend. The lender, of course, also files a UCC-1 financing statement, but this tends to be merely belts and suspenders to put others on notice of their security interest in the collateral. So what really is the cost-benefit analysis of a mezzanine loan title insurance policy? As discussed above, this new policy surely offers some benefits, but the premium price is

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105. Murray, *Is UCC Insurance the Answer*, *supra* note 83, at 13.

106. *UCC Policy for Secured Loans*, *supra* note 89 (“there is no need to prove negligence, as would be the case for a malpractice claim”).

107. Murray, *Title Insurance*, *supra* note 42, at 1310; Prendergast, *It Can Happen*, *supra* note 82, at 2 (discussing the pitfalls of preparing and filing financing statements).

108. Prendergast, *It Can Happen*, *supra* note 82, at 2 (“The initial ordering and review of the financing statements is usually performed by paralegals, who are often not as well trained as lawyers but equally overworked”).

also high. In addition, the title industry might be simply hyping this product, promising benefits that are elusive while at the same time collecting hefty premiums that contribute richly to bottom line. The difficult question, therefore, is whether the premium price is justified by these benefits. Each mezzanine lender will have to make its own decision on the cost-benefit of the mezzanine loan policy.

#### *D. Limitations of the Rights and Remedies Available to Mezzanine Lenders*

Mezzanine lenders face risks both at the very beginning of the lender-borrower relationship and later on if the borrower defaults. This Part examines the risks faced by lenders if the mezzanine borrower defaults. At that time, a mezzanine lender must ensure that it has effective remedies at its disposal, including the right and ability to foreclose upon the mezzanine loan collateral. However, the mezzanine lender often has difficulty in the realization and foreclosure on its collateral after an event of default. This difficulty arises in part because of the difficulty in realizing upon the special nature of the collateral in conformity with the UCC, limitations imposed upon the mezzanine lender under intercreditor agreements with the senior mortgage lender, and other issues such as requirements of the rating agencies and the legal relationship between the mezzanine lender's lien and other liens.

##### 1. The Realization and Foreclosure on Mezzanine Loan Collateral under the UCC

The mezzanine lender has no direct rights against the underlying real property or the mortgage borrower and often does not even have the ability to seek direct recourse against the mezzanine borrower or the equity owners.<sup>109</sup> As a result, the mezzanine lender's remedies typically derive solely from foreclosing on the pledged Equity Interests under Article 8 or Article 9 of the UCC.<sup>110</sup> At first glance it appears that the mezzanine lender has many remedies under the UCC after the mezzanine borrower defaults, including foreclosure by public sale, foreclosure by private sale, retention of collateral in satisfaction of the debt, judicial foreclosure, execution as a judgment creditor upon the collateral, and collection rights.<sup>111</sup> As a practical matter, however, mezzanine loan collateral is very specialized since it consists solely of Equity Interests in special purpose entities with no assets other than equity ownership in yet another entity that may directly or indirectly own the underlying

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109. See *supra* Part II.

110. Dunn & Dopsch, *supra* note 38, at 1422.

111. See U.C.C. § 9-601(2007) (Rights after Default); U.C.C. § 9-607 (Collection and Enforcement); U.C.C. § 9-609 (Right to Take Possession); U.C.C. § 9-610 (Disposition of Collateral).



real property which is itself subject to a securitized first mortgage. Consequently, the utility of many of these remedies is quite limited.<sup>112</sup>

In addition, with a typical secured loan under the UCC (especially where there is a recognized market or standard price quotations), lenders would prefer to dispose of collateral at a private sale since it frequently results in higher proceeds than a public sale.<sup>113</sup> With a mezzanine loan, however, the secured lender typically cannot effectively dispose of the collateral at a private sale. Since there is no established market, no standardized price quotations, and mezzanine loan collateral is extremely complicated, there is rarely any third party to bid at a private sale.<sup>114</sup> Furthermore, the mezzanine lender cannot bid in and "buy" the collateral itself since the UCC only permits the secured lender to purchase the collateral at a private sale "if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations."<sup>115</sup> This presents the mezzanine lender with a Catch-22: since there is no recognized market or standard price quotations for mezzanine loan collateral, the mezzanine lender may not purchase the collateral at a private sale, but no third party is likely to purchase the collateral either because of its specialized nature.

As a result, the mezzanine lender must typically sell the mezzanine collateral at a public sale. However, the mezzanine lender faces a set of similar problems. Since there is no established market for Equity Interests and no other bidders, the mezzanine lender often has no choice other than to bid in and "buy" the equity at the foreclosure sale.<sup>116</sup> In such a case, the mezzanine lender still has not received any cash proceeds, although after the foreclosure sale, the mezzanine lender owns the Equity Interests and at least in theory also has indirect control of the mortgage borrower and the underlying real property. Only then may the mezzanine lender (in its new capacity as the indirect owner of the mortgage borrower) attempt to force a sale of the mortgaged property. This right is of limited value, however, since the underlying real property remains subject to the senior mortgage, which generally prohib-

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112. Arnold, *supra* note 67, at 721 (noting that UCC remedies will differ in terms of practical utility).

113. U.C.C. § 9-610 cmt. 2 (the U.C.C. "encourages private dispositions on the assumption that they frequently will result in higher realization on collateral for the benefit of all concerned").

114. Dunn & Dopsch, *supra* note 38, at 1428 ("Even if a mezzanine lender makes every effort to actively market the collateral and conduct a foreclosure sale complying with every requirement of the UCC, chances are still high that no third party buyers will make a bid for the interests."); Arnold, *supra* note 67, at 736. (noting that the private sale exceptions will not generally apply to dispositions of Equity Interests in Mezzanine Borrowers because of the lack of an active sales market for such collateral).

115. U.C.C. § 9-610(c)(2).

116. Dunn & Dopsch, *supra* note 38, at 1428 (noting how mezzanine lenders are often the sole bidder at a UCC foreclosure sale).

its the sale of the real property and contains an extensive set of restrictive covenants and other prohibitions.<sup>117</sup> The fact remains that even after a successful foreclosure on its collateral – the Equity Interests formerly owned by the mezzanine borrower – the mezzanine lender is still just an owner in the underlying mortgage borrower. As equity, the mezzanine lender's claims are structurally subordinated and junior to every other secured or unsecured creditor of the mortgage borrower.

The mezzanine lender must also ensure under the UCC that “[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.”<sup>118</sup> The question of what constitutes a “commercially reasonable” sale, however, is far from clear and is often vexing for even the most conscientious mezzanine lender. The only guidance from the UCC itself states that dispositions of collateral are deemed “commercially reasonable” if the disposition is made: “(1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition,”<sup>119</sup> or if the sale has been approved: “(1) in a judicial proceeding; (2) by a bona fide creditors’ committee; (3) by a representative of creditors; or (4) by an assignee for the benefit of creditors.”<sup>120</sup> Since there is neither a recognized market nor recognized standards for this type of collateral, the mezzanine lender is left with the circular definition that a commercially reasonable sale is one that is “otherwise in conformity with reasonable commercial practices.”<sup>121</sup>

Many jurisdictions also require the mezzanine lender to prove that the public disposition of the mezzanine loan collateral was commercially reasonable in order to claim a deficiency judgment against the mezzanine borrower or other guarantors.<sup>122</sup> Furthermore, the mezzanine borrower may sue the mezzanine lender for damages if the sale is not commercially reasonable.<sup>123</sup>

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117. See Berman, *supra* note 12.

118. U.C.C. § 9-610(b).

119. U.C.C. § 9-627(b).

120. U.C.C. § 9-627(c).

121. U.C.C. § 9-627(b)(3). See also Jeffrey J. Temple, *Mezzanine Loan Foreclosure: If It's Necessary Do It Right*, N.Y. L.J., Mar. 12, 2007.

122. *Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P.*, 821 A.2d 296, 314-15 (Del. Ch. 2002) (a Delaware court applying New York law to the transaction documents). See also Arnold, *supra* note 67, at 737.

123. U.C.C. § 9-625(b) (“Subject to subsections (c), (d), and (f), a person is liable for damages in the amount of any loss caused by a failure to comply with this article. Loss caused by a failure to comply may include loss resulting from the debtor’s inability to obtain, or increased costs of, alternative financing.”); U.C.C. § 9-626(a) (“In an action arising from a transaction, other than a consumer transaction, in which the amount of a deficiency or surplus is in issue, . . . [i]f the secured party’s compliance is placed in issue, the secured party has the burden of

The mezzanine lender, therefore, is typically left with the burden of proving the commercial reasonableness of its disposition procedures where there is no established market, recognized procedures, safe harbors under the UCC or many reported decisions.<sup>124</sup>

Some have argued that a mezzanine loan is preferable to a second mortgage since the mezzanine lender can theoretically foreclose upon its equity pledge quickly. A mortgage foreclosure is typically slower, since a mortgage lender must strictly adhere to local judicial foreclosure laws and often results in time-consuming and expensive litigation. However, because there is insufficient data relating to mezzanine loan defaults, these arguments are not factually supported.<sup>125</sup> Furthermore, as Moody's Special Report indicates, there are unresolved legal issues concerning what constitutes "commercial reasonableness" in order to make a UCC sale of mezzanine loan collateral unassailable, and how courts will resolve transfer restrictions contained in many intercreditor agreements (such as transfers may only be made to Qualified Transferees).<sup>126</sup>

## 2. Limitations on Rights and Remedies Under Intercreditor Agreements

Mezzanine loans are structurally subordinated to the senior mortgage loan because of the legal superiority of the mortgage lender vis-à-vis the mezzanine lender. Notwithstanding this structural subordination, mezzanine loans are also typically contractually subordinated to the related senior mortgage loans pursuant to the terms of an intercreditor agreement entered into between the senior mortgage lender and mezzanine lender.<sup>127</sup> These intercreditor agreements severely limit and restrict the ability of mezzanine lenders to enforce their rights and remedies under the mezzanine loan documents.

The existence of an intercreditor relationship between the senior mortgage lender and the mezzanine lender has become almost uniform now since the rating agencies explicitly state that "failure to provide an acceptable Intercreditor agreement may result in . . . issuing a lower rating of the senior mortgage debt, or the inability to issue a rating of the senior mortgage debt."<sup>128</sup> As a result, over the past five years the market has developed a general consensus on the broad structure of this intercreditor relationship. National trade groups, most notably the Commercial Mortgage Securities Association (CMSA), have even developed model forms that have become

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establishing that the collection, enforcement, disposition, or acceptance was conducted in accordance with this part.").

124. Dunn & Dopsch, *supra* note 38, at 1423.

125. RUBOCK, *supra* note 20, at 7.

126. *Id.*

127. STANDARD & POOR'S, *supra* note 30, at 22.

128. *Id.*

the industry norm on the content and coverage of these intercreditor agreements.<sup>129</sup>

These intercreditor agreements always subordinate the mezzanine lender's rights and remedies to the senior mortgage lender, and contain myriad restrictions on the mezzanine lender's ability to exercise control of the Equity Interests and indirect control of the underlying real estate and to make certain decisions and take certain actions (including the ability to exercise many of its remedies upon an event of default) without the senior mortgage lender's consent.<sup>130</sup> If the senior mortgage loan is securitized, the intercreditor agreement typically requires that the mezzanine borrower obtain a "No Downgrade Letter" from the rating agencies prior to enforcement of any of its remedies.<sup>131</sup> The "No Downgrade Letter" provides the senior mortgage lender "written confirmation from the rating agencies that the mezzanine lender's enforcement actions will not cause a downgrade of the rating of[, or otherwise adversely affect,] the related CMBS issuance which is secured or contains the related senior mortgage on the underlying real property."<sup>132</sup>

The model form of intercreditor agreement makes limited exceptions to the "no downgrade" requirement if the new holder of the mezzanine debt

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129. There is currently a form of intercreditor agreement (referred to as the CMSA form) which is posted on the website of the Commercial Mortgage Securities Association. Model Form of Intercreditor Agreement, [http://www.cmbs.org/standards/Intercreditor\\_Agreement.pdf](http://www.cmbs.org/standards/Intercreditor_Agreement.pdf) [hereinafter Model Form]. The national rating agencies confirm that this form has become the standard form used in almost every mezzanine loan transaction. RUBOCK, *supra* note 20, at 6 (although never formally approved, it has become the "standard" used in the capital markets). *See also*, Suarez & Xethalis, *supra* note 16, at 2.

130. Model Form, *supra* note 129, §§ 4-5, 7-9 (Section 4 restricts the transfer of 49% or more of the mezzanine loan; Section 5 limits the mezzanine lender's ability to foreclose and take other remedial actions against the mezzanine loan collateral; Section 7 restricts the mezzanine lender's ability to make material modifications to the mezzanine loan; Section 8 subordinates the lien of the mezzanine lender to the senior mortgage; and Section 9 subordinates the right of the mezzanine lender to receive any payments under its mezzanine loan under certain specified conditions).

131. STANDARD & POOR'S, *supra* note 30, at 22; Suarez & Xethalis, *supra* note 16, at 2; Model Form, *supra* note 129, § 4. Section 4(a) of the Model Form states "Mezzanine Lender shall not Transfer more than 49% of its beneficial interest in the Mezzanine Loan unless . . . a Rating Agency Confirmation has been given with respect to such Transfer." Model Form, *supra* note 129, § 4(a). In addition, Section 5(a) of the Model Form states "Mezzanine Lender shall not exercise any rights it may have under the . . . [collateral] or applicable law with respect to a foreclosure or other realization upon the Equity Collateral (including, without limitation, obtaining title to the Equity Collateral or selling or otherwise transferring the Equity Collateral) without a Rating Agency Confirmation." *Id.* § 5(a).

132. *See, e.g.*, Berman, *supra* note 12, at 109. These agencies typically waive the requirement of obtaining a No Downgrade Letter if the mezzanine lender is a qualified, accredited or otherwise approved investor such as an institutional investor, bank or life insurance company. *See Forte, supra* note 12, at 443.

(either as a result of voluntary transfer or foreclosure) is a “qualified transferee;”<sup>133</sup> the property will be managed by a “qualified manager;” and a “hard lockbox” is put in place for cash management and reserves for typical expenses like taxes, insurance, debt service, underlying ground rents, tenant improvement expenses, and other operating expenses.<sup>134</sup> Typically, a “qualified transferee” is defined to include the following:

a real estate investment trust, bank, savings and loan association, investment bank, insurance company, trust company, commercial credit corporation, pension plan, pension fund or pension advisory firm, mutual fund, government entity or plan . . . [or] an investment company, money management firm or “qualified institutional buyer” within the meaning of Rule 144A . . . or an institutional “accredited investor” within the meaning of Regulation D.<sup>135</sup>

In addition, the qualified transferee must have total assets over \$600,000,000 and capital/statutory surplus or shareholder’s equity of \$250,000,000 and be “regularly engaged in the business of making or owning commercial real estate loans or operating commercial mortgage properties.”<sup>136</sup>

The rating agencies and intercreditor agreements also place strict limitations on the identity of the mezzanine lender since it may succeed to the indirect ownership of the underlying mortgage borrower and therefore end up being the owner and operator of the land serving as collateral for the mort-

133. Model Form, *supra* note 129, § 4(a). Section 4(a) of the Model Form states that the transfer restrictions will not apply a “Qualified Transferee”. *Id.*

134. *Id.* § 5(a). Section 5(a) of the Model Form allows exceptions to obtaining a Rating Agency Confirmation if the following conditions are satisfied:

- (i) the transferee of title to the Equity Collateral is a Qualified Transferee,
- (ii) the Premises will be managed by a Qualified Manager promptly after the transfer of title to the Equity Collateral, and (iii) if not in place prior to the transfer of title to the Equity Collateral, hard cash management and adequate reserves for taxes, insurance, debt service, ground rents, capital repair and improvement expenses, tenant improvement expenses and leasing commissions and operating expenses will be implemented under the Senior Loan promptly after the transfer of title to the Equity Collateral . . . . Additionally, if a non-consolidation opinion was delivered in connection with the closing of the Senior Loan, the transferee of the Equity Collateral shall deliver a new non-consolidation opinion relating to the transferee acceptable to the Rating Agencies within ten (10) business days of the transfer of title to the Equity Collateral.

*Id.*

135. *Id.* § 1(a), at 6.

136. *Id.* § 1(a), at 3. This language is included in the definition of “Eligibility Requirements.” In addition, the model form notes that in large loans, the minimum amount of \$600 million of total assets and \$250 million of capital/statutory surplus or shareholder’s equity may need to be higher. *Id.*

gage included in the CMBS pool. Typically, a strong real estate operator owns and manages the mortgage borrower, and the rating agencies and senior mortgage lender all want to ensure that any subsequent owner has similar financial wherewithal and experience to manage and operate the underlying property after a mezzanine loan default and possible foreclosure. Therefore, the rating agencies typically require that the initial mezzanine lender and any successor lender be adequately capitalized with substantial real estate experience.<sup>137</sup> This requirement is typically reflected in the provision of the inter-creditor agreement that requires a “qualified property manager” to manage the property. A property manager is “qualified” if it:

(i) is a reputable management company having at least five (5) years’ experience in the management of commercial properties with similar uses . . . ,

(ii) has, for at least five (5) years prior to its engagement as property manager, managed at least (5) properties of the same property type as the [p]remises . . . ,

(iii) at the time of its engagement as property manager has leasable square footage of the same property type as the Premises equal to the lesser of (A) 1,000,000 leasable square feet and (B) five (5) times the leasable square feet of the [p]remises, and

(iv) is not the subject of a bankruptcy or similar insolvency proceeding.<sup>138</sup>

The standard intercreditor agreement also requires that “if a non-consolidation opinion was delivered in connection with the closing of the [senior mortgage loan], the [mezzanine lender] shall deliver a new non-consolidation opinion relating to the transferee acceptable to the Rating Agencies within ten (10) business days of the transfer of title to the [e]quity [c]ollateral.”<sup>139</sup> Typically, a nationally recognized law firm opines in the non-consolidation opinion that the assets of the mortgage borrower will

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137. Berman, *supra* note 12, at 107.

138. Model Form, *supra* note 129, § 1(a), at 5. This language is included in the definition of “Qualified Manager.” In addition, the model form notes that in large loans, the tests in clauses (ii) and (iii) may need to be higher and that additional criteria may need to be added depending on the type of asset (such as luxury hotel, convention center, regional mall, etc. *Id.*

139. *Id.* § 5(a)

unlikely to be substantively consolidated with the mezzanine borrower in case of a bankruptcy.<sup>140</sup>

The only ability of the mezzanine lender to escape the confines of the senior mortgage is to buy out the senior lender. If there is a default under the senior mortgage loan, most intercreditor agreements grant the mezzanine lender the right to purchase the senior mortgage loan or to cure any monetary and certain other non-payment defaults within a commercially reasonable period of time (approximately 5-10 business days).<sup>141</sup> Section 13(a) of the Model Form provides that if the senior mortgage loan has been accelerated, any enforcement action has been commenced under the senior mortgage loan, or if the senior mortgage loan is a "specially serviced mortgage loan" under the related servicing agreement, then the mezzanine lender shall have the right to purchase the senior mortgage loan in its entirety upon payment of the outstanding principal and interest and any "late charges, default interest, exit fees, advances and post-petition interest."<sup>142</sup> Therefore, if the senior mortgage loan is in default, the mezzanine lender has to spend an enormous amount of money to protect its interest.<sup>143</sup> In addition, this right may be severely limited by prepayment premiums and exit fees and bankruptcy protections of the mortgage borrower.<sup>144</sup>

If the mezzanine lender cannot (or chooses not to) buy out the senior mortgage lender, however, it has very limited ability to work out a loan default. For example, most intercreditor agreements typically prevent a mezzanine lender from making any significant changes to the mezzanine loan documents.<sup>145</sup> In addition, mezzanine lenders are typically not permitted to accept any payments from the mezzanine borrower if such payments are derived from proceeds of the underlying property and both the mortgage loan is in default and the related cure period has expired.<sup>146</sup>

### *E. Other Limitations on Remedies Available to Mezzanine Lenders*

Even if the mezzanine lender is able to obtain control of the mortgage borrower, its rights remain very limited not only because of the restrictions in the intercreditor agreement, but also because the mezzanine lender (in its new capacity as mortgage borrower) is still subject to the senior mortgage cove-

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140. Berman, *supra* note 12, at 109. See also Forte, *supra* note 12, at 443; Horowitz & Morrow, *supra* note 12, at 552-53, 570; STANDARD & POOR'S, *supra* note 30, at 20.

141. Suarez & Xethalis, *supra* note 16, at 4.

142. Model Form, *supra* note 129, § 13(a).

143. STANDARD & POOR'S, *supra* note 30, at 22; Temple, *supra* note 121 (mezzanine lender has option to purchase the mortgage loan and "dramatically increase its investment in a troubled property").

144. Suarez & Xethalis, *supra* note 16, at 4.

145. STANDARD & POOR'S, *supra* note 30, at 22.

146. *Id.*

nants and restrictions.<sup>147</sup> The senior mortgage typically contains many limitations on the ability to sell the property (due on sale), make major improvements to the property, change control of the property, or undertake other major decisions without the senior mortgage lender's consent.<sup>148</sup> Oftentimes, the mezzanine lender's only true option is to refinance the property (subject to any prepayment penalties that are due) or to buy out the senior lender at par. Mezzanine lenders are further restricted since they rarely succeed to the benefits from certain third-party agreements such as ground leases, subordination and non-disturbance agreements, estoppel certificates, building contracts, or easement agreements.<sup>149</sup>

In addition, the mezzanine lender has extreme time pressure and must realize upon its collateral and exercise its remedies prior to the senior mortgage lender completing a foreclosure on the underlying mortgage. Once the senior mortgage lender completes its foreclosure, the underlying mortgage borrower will no longer own the income producing property, and the mezzanine borrower will own equity in an entity with no assets (other than any surplus that is unlikely to exist after the foreclosure of the senior mortgage).<sup>150</sup> The ability of the mezzanine lender to exercise its remedies prior to the senior mortgage lender is very difficult, however, because of the restrictions in the intercreditor agreement entered into with the senior lender and also because the maturity date of most mezzanine loans are either coterminous or after the related mortgage loan.<sup>151</sup>

Further complicating matters, the mezzanine lender often lacks many of the common law and mortgage protections afforded to a mortgagee such as the right to an appointment of a receiver, protections against waste, statutory limitations on the borrower's equity of redemption, and most important the protection that a mortgage lien runs with the land and will bind subsequent purchasers of the property. The mezzanine lender's only protection if the underlying borrower sells the property is an action against the mezzanine borrower for a breach of the contractual promise not to sell. With a mortgage, even if the mortgagor breached the negative covenant against selling the property, the lien would follow the land. Unlike a mortgage lender, however, the mezzanine lender does not have a direct legal relationship to the

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147. RUBOCK, *supra* note 20, at 5-6 (“[m]ezzanine loan collateral is fragile” and the only rights the mezzanine lender has is “to step into the shoes of its borrower, as the mortgage borrower”).

148. Dunn & Dopsch, *supra* note 38, at 1427 (noting that “it is virtually boilerplate for a senior mortgage loan to contain a ‘change in control’ default”).

149. RUBOCK, *supra* note 20, at 8.

150. Dunn & Dopsch, *supra* note 38, at 1425 (“[T]he foreclosure sale of the mezzanine equity interests would need to be expedited so that it is complete well before the real property foreclosure process concludes; otherwise any value in the mezzanine collateral would be effectively wiped out.”).

151. STANDARD & POOR'S, *supra* note 30, at 21.



land, and the law has not developed any set of rules to protect the mezzanine lender.

Because of the interplay between federal bankruptcy law and mortgage law, a mortgagee may also typically assert a powerful arsenal of rights and remedies against both the mortgage borrower and any third party claiming any of the bankrupt debtor's assets, including any junior secured lender, unsecured creditor, or equity investor.<sup>152</sup>

The mortgage law of most states, for example, permits a mortgagee to appoint a receiver for the property, foreclose the mortgage and sell the real property, and eliminate many subordinate junior liens and encumbrances adversely affecting the value of the collateral. By granting the mortgagee the power to eliminate certain junior liens and encumbrances, the mortgage foreclosure process typically enables a mortgagee to sell the property at the foreclosure sale for a higher price, thereby increasing the cash available to repay the outstanding debt.<sup>153</sup>

Compared to the senior mortgage lender's right to foreclose its senior mortgage, the mezzanine lender's right to foreclose on the Equity Interests of the mezzanine borrower is both riskier and of somewhat limited value. Whereas a mortgagee's foreclosure rights derive from its mortgage on the borrower's real property, a mezzanine lender's remedies derive solely from its lien on personal property (i.e., the equity in the mezzanine borrower). And unlike a mortgagee's right to foreclose all junior liens and encumbrances on the underlying real property, a mezzanine lender has no rights to foreclose any other liens on the underlying real property – its rights are limited solely to foreclosing junior liens on the equity in the mezzanine borrower and not the real property.

Even after a successful foreclosure of a mezzanine loan, therefore, the underlying mortgage property remains subject to the lien of the senior mortgage as well as any other liabilities, liens, leases and other encumbrances of the underlying mortgage borrower and the underlying real property.<sup>154</sup> As Moody's explains, the mezzanine lender will only indirectly own the underlying mortgaged property subject to "[s]ubordinate debt, contract claims of service providers, claims of tenants, judgment creditors, mechanics' liens, [and] federal and state tax liens."<sup>155</sup> Furthermore, the existence of a default under the mezzanine loan suggests that there is probably inadequate cash flow or some other problem with the fundamentals of the real estate venture; therefore, it is likely that there will also be new tax liens, mechanics' liens,

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152. Berman, *supra* note 12, at 108 & nn.161-62.

153. *Id.*

154. Dunn & Dopsch, *supra* note 38, at 1423.

155. RUBOCK, *supra* note 20, at 7.

and perhaps even judgment liens recorded against the underlying mortgaged property. These other liens only further deteriorate the value of the mezzanine lender's collateral.

Unfortunately for many mezzanine lenders, even their right to foreclose junior liens on their own collateral – the equity in the mezzanine borrower – is often of little value. Since the mezzanine loan documents typically prohibit any other liens on the lender's collateral and because of its limited marketability, it is unlikely (except in the case of fraud or willful violation of the mezzanine loan documents) that there are any other junior liens on the equity anyway. "Oftentimes, the mezzanine lender's sole remedy is to foreclose its lien on the equity and then attempt to sell the equity at a UCC foreclosure sale."<sup>156</sup>

#### IV. THE CURRENT REALITY

As discussed in Part III above, mezzanine lenders attempt to deal with some of the inherent risks with mezzanine loans by obtaining title insurance, entering into intercreditor agreements, requiring non-consolidation opinions, setting up special purpose bankruptcy remote entities, and the like. Unfortunately, these actions often lead to expensive, inefficient and wasteful practices that end up compounding the problem, leading to further market imperfections and risks to the economy. The net result is that we now have overconfident lenders who over-lend at interest rates that do not adequately reflect all of the hazards inherent in these complicated financings.<sup>157</sup>

The recent crisis in the sub-prime mortgage market bears witness to the risks to the economy when a real estate financing technique is overused and perhaps even misused. I believe that the recent problems in the sub-prime mortgage market will soon migrate over to some of the non-traditional financing techniques used in the commercial mortgage market, including mezzanine loans. As with sub-prime residential loans, commercial mezzanine financings will increasingly become a concern for the real estate marketplace since it will inevitably bear many of the negative externalities if and when these complicated financial arrangements begin to default.

In a recent review of the first quarter of 2007, Moody's raised the specter of the sub-prime mortgage crisis and argued for more prudent risk taking with many other non-traditional financings, including mortgage securitizations and mezzanine financings.<sup>158</sup> Moody's questioned whether there might

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156. Berman, *supra* note 12, at 109.

157. Alan Christenfeld & Shephard Melzer, *Navigating the Second Lien Financing Market*, N.Y. L.J., Oct. 6, 2005, at 5 (mezzanine lenders "saw decreased returns . . . owing to competition from new investors chasing the same deals")

158. MOODY'S INVESTORS SERVICE, STRUCTURED FINANCE, SPECIAL REPORT, US CMBS & CRE CDO 1Q 2007 REVIEW: CONDUIT CREDIT AT THE TURNING POINT? 7 (2007), available at <http://www.mortgagebankers.org/files/Conferences/2007/CREFAAssetAdmin2007/ConduitLoanUnderwriting.pdf>.

be another “market meltdown” in the CMBS market since many of the same factors are present. These factors include (i) increased liquidity and availability of capital, (ii) high loan-to-value ratios and increased use of subordinate debt, (iii) riskier underwriting, weaker loan documentation and greater volatility, and (iv) a maniac devotion to short-term results over the long-term. All of these factors apply equally to the mezzanine loan market and signal that there will be an increased risk of defaults when the market goes down.<sup>159</sup>

### A. Increased Liquidity

Moody’s has reported that there is now ever increasing liquidity and availability of capital. Similarly, Standard & Poors has reported similar changes – “increased liquidity, fierce competition among loan originators, and an influx of new buyers.”<sup>160</sup> This increased liquidity and capital is due in part to the very success of new real estate financing techniques since there is now “abundant and efficiently priced debt from the real estate capital markets.”<sup>161</sup> In addition, the average size of real estate transactions has decreased. Whereas, “[t]he minimum deal size has historically been in the range of \$10 million to \$25 million,” the “minimum amount has . . . dropped dramatically in recent years, as this type of financing gains in popularity and the cost of such transactions has decreased.”<sup>162</sup> As a result, mezzanine loans are more available to a broader group of real estate owners, including relatively small owner-operators.

The abundant flow of capital and liquidity is also due in part to the tremendous growth of collateralized debt obligations (CDOs) which has provided more capital to make mezzanine loans.<sup>163</sup> In addition, as lenders need to create more “product” – loans to be included in subsequent securitizations and CDO offerings – I believe there are increasing pressures to originate even more loans. And, the historically low interest rate environment has given the real estate finance sector a “free ride,” making capital easily available and

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159. *Id.*

160. C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COM. L.J. 189, 190 (2006) (observing that the substantial increase in the availability of what he refers to as “second lien” loans is due to the “ready availability of capital that can be employed at higher returns in highly leveraged transactions”).

161. DUCA & PHILIPP, *supra* note 16, at 2.

162. Murray & Scott, *Mezzanine Financing Transactions*, *supra* note 56, at 33.

163. FITCH RATINGS, STRUCTURED FINANCE, US CMBS 2007 OUTLOOK 2 (2007), available at [http://www.fitchratings.com/corporate/reports/report\\_frame?rpt\\_id=307824&sector\\_flag=2&marketsector=2&detail=](http://www.fitchratings.com/corporate/reports/report_frame?rpt_id=307824&sector_flag=2&marketsector=2&detail=).

cheap. There is no doubt that this "free ride" is surely over now for both residential and commercial real estate.<sup>164</sup>

Although many may argue that increased liquidity and capital in a market is beneficial, it is also true that too much of a good thing often brings unexpected and oftentimes calamitous events. In the past, the perception that borrowers had equity in their projects and that there were many sources of easy capital often hid cash flow and management difficulties in the real estate marketplace.<sup>165</sup> As Fitch Ratings recently reported, there is a potentially troubling cascade of events: the spectacular availability of capital secured directly or indirectly by real estate contributes to the increases in property values, which improves the economics of transactions (e.g., loan-to-value ratios decrease as property values increase), which then leads to more sales and even more demand for capital.<sup>166</sup> As with most unsustainable cycles, at some point the financing sources tighten up the supply of capital and property values begin to languish.

### *B. High Loan-To-Value Ratios and Increased Use of Subordinate Debt*

As discussed above, mezzanine lenders are making loans with very high loan-to-value ratios. A mezzanine loan often brings the total loan-to-value ratio of a transaction as high as 105% of the total value of the underlying real estate.<sup>167</sup> Like similar high loan-to-value sub-prime loans, these high loan-to-value mezzanine loans are also risky. These risks will surface if, and when, mezzanine loans begin to default. Because of the high loan-to-value ratios and their unique structure, mezzanine loans may be much more vulnerable to default if property values and cash flows begin to decline.<sup>168</sup> In addition, "[i]t will now take less of a downturn to cause a spike in delinquencies than it would have in the past."<sup>169</sup>

Furthermore, property owners increasingly rely upon subordinate debt in order to borrow the maximum from each property. Unlike traditional junior mortgages or even silent second mortgages, mezzanine loans are very subordinated compared to other traditional real estate loans. Moody's reports that

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164. MOODY'S INVESTORS SERVICE, STRUCTURED FINANCE, SPECIAL REPORT, US CMBS & CRE CDO 3Q 2006 REVIEW: THE DOUBLE-A ENVIRONMENT: AMBIVALENCE AND ANXIETY (2006), available at <http://www.moody.com>.

165. Theodore H. Sprink, *The Story of UCC Insurance: An Insider's View*, SECURED LENDER, Jan. 1, 2006, at 68.

166. FITCH RATINGS, *supra* note 163, at 2.

167. See *supra* notes 15-16 and accompanying text.

168. Dunn & Dopsch, *supra* note 38, at 1430 ("Mezzanine loans are likely to be among the hardest hit as declining rent streams yield insufficient cash flow to pay the mezzanine debt after payment of the senior mortgage loan.")

169. DUCA & PHILIPP, *supra* note 16, at 4.

“[m]ost mezzanine loans are targeted to be at the bottom of the debt stack and are expected to receive below-investment-grade shadow ratings.”<sup>170</sup>

*C. Riskier Underwriting, Weaker Loan Documentation, and Greater Volatility*

The ready supply of capital has resulted in riskier underwriting standards, weaker loan documentation, greater volatility, and questionable loans. Moody's warns that there is a relationship between increased liquidity and declining underwriting standards.<sup>171</sup> As a result, “[d]uring the past few years the commercial mortgage market has witnessed a slow but steady erosion of underwriting quality.”<sup>172</sup> Some have called it an almost “anything goes” environment.<sup>173</sup>

Along with the declining underwriting standards there has been a sharp increase in volatility. Fitch Ratings, a national rating agency, recently reported that it expects more volatility in the commercial real estate marketplace, in part, because issuances are now including more volatile property types (e.g., hotels, health care facilities, timber, billboards). Since these “volatile loans are often priced at higher spread than their less volatile counterparts,” there is also increased lender competition “for product and profitability.”<sup>174</sup> This has the perverse effect of encouraging lenders to make even more loans secured by volatile properties. As a result, commercial real estate loans will be very “sensitive to future economic downturns due to higher concentrations of more volatile property types[,] . . . interest-only loans, and a more competitive lending environment . . . .”<sup>175</sup>

In addition, the ready availability of capital and competition among the many mezzanine lenders has caused a sharp increase in competitive pressures in the marketplace. In the past, mezzanine lenders typically earned a rate of return between 15% to 23%. However, in the past few years, these rates have fallen sharply.<sup>176</sup> As a result, mezzanine lenders are making riskier loans, although they are also being compensated less for the additional risk. Furthermore, many of these loans are interest only, which only adds to the greater volatility in the marketplace.<sup>177</sup>

170. RUBOCK, *supra* note 20, at 3.

171. DUCA & PHILIPP, *supra* note 16, at 4.

172. *Id.* at 1.

173. MOODY'S INVESTORS SERVICE, *supra* note 158, at 1.

174. FITCH RATINGS, *supra* note 163, at 1, 3, 5 (noting however that its general outlook for CMBS is positive).

175. *Id.* at 3.

176. Murray & Scott, *Mezzanine Financing Transactions*, *supra* note 56, at 33.

177. FITCH RATINGS, *supra* note 163, at 3. *See also* MOODY'S INVESTORS SERVICE, *supra* note 158, at 9 (“The share of loans [included in securitizations] with an interest only period reached a new high during [the first quarter of] 2007 of 84.6%.”).

Many believe that the “negative credit implications of the ongoing erosion of conduit loan underwriting, particularly the increase in leverage, now exceed the benefits of [the] generally positive property market fundamentals.”<sup>178</sup> In many of its recent credit reports, Moody’s has signaled “its growing discomfort” with weakening underwriting standards for at least the previous year.<sup>179</sup> In fact, all three national rating agencies have issued warnings concerning weakening underwriting standards in the commercial real estate mortgage market.<sup>180</sup> According to Moody’s, there is no evidence that the quality of underwriting will improve or even stabilize.<sup>181</sup> The complacency in the real estate marketplace could easily prove to be the cause of its eventual failure in the near future.<sup>182</sup>

#### *D. Focus on Short-Term Results over the Long Term*

The riskier underwriting is due in part to the competitive pressures to book quarterly profits.<sup>183</sup> Mezzanine lenders are also using the increasingly popular CDO as an “exit strategy instead of buying and holding for the long term.”<sup>184</sup> This short-term mindset makes the lenders less likely to care about the quality of many of its loans since after origination, they quickly sell the mezzanine loans into a CDO or otherwise into the secondary market.<sup>185</sup> Not surprisingly, the rating agencies and many others are beginning to believe that the entire system along with the current low default rates are “inherently unsustainable.”<sup>186</sup>

Unfortunately, as the recent crisis in the sub-prime mortgage market has shown, the health of the nation’s economy depends in large part on the continuing success of the real estate market. This is also true with the commercial mortgage market because it makes up such a large amount of our GDP. Currently, “commercial mortgages as a share of GDP now stand at 16.8%”

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178. DUCA & PHILIPP, *supra* note 16, at 1.

179. *Id.* at 4

180. Poonkulali Thangavelu, *Underwriting Seen Slipping in Securitized Mortgages*, ORIGINATION NEWS, May 1, 2007, at 34.

181. MOODY’S INVESTORS SERVICE, *supra* note 158, at 7.

182. *Id.* at 1.

183. Berman, *supra* note 12, at 122-23; Dobbs, *supra* note 160, at 190 (observing that the “substantial increase in the availability” of what he refers to as “second lien loans” is due to the “ready availability of capital that can be employed at higher returns in highly leveraged transactions”).

184. Thangavelu, *supra* note 180.

185. *Id.*

186. DUCA & PHILIPP, *supra* note 16, at 3; MOODY’S INVESTORS SERVICE, *supra* note 158, at 2 (it is unlikely that the “recent strong performance will continue unabated”).

which is much higher than the previous record of “15.0[%] reached at the peak of the last cycle.”<sup>187</sup>

## V. CONCLUSION

This article has shown that mezzanine lenders face significant risks both at the origination of their loans and later on if there is an event of default. At loan origination, lenders are faced with complex rules for the creation, attachment and perfection of liens on their collateral. Oftentimes, lenders feel forced to purchase expensive mezzanine loan insurance to address the inherent risks associated with taking Equity Interests as collateral. However, it is questionable whether a mezzanine lender receives much from the purchase of a mezzanine loan policy. Later on, a mezzanine lender is faced with other risks if the mezzanine borrower defaults and the lender must actually foreclose upon its collateral. The rules are far from clear and there just is not enough market experience with mezzanine loan foreclosures to offer much additional comfort.

I believe that mezzanine lenders often misunderstand and underestimate these hazards. This article attempts to clarify some of these risks so that mezzanine lenders will either adequately price their loans to reflect the increased risk or return to traditional junior mortgage financing. In any event, the recent experience with the sub-prime mortgage crisis clearly signals a red flag to all mezzanine lenders to proceed with caution – to tighten up their underwriting standards, strengthen their loan documentation, and review the ready availability of capital to questionable projects. In addition, mezzanine lenders need to be cautious in making overly leveraged loans and should try to keep within the traditional parameters of loan-to-value ratios associated with junior mortgage financing. Hopefully, the problems with the sub-prime mortgage market will not migrate to mezzanine loans and other non-traditional real estate financing techniques.

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187. MOODY'S INVESTORS SERVICE, *supra* note 158, at 3.