THE MORTGAGE OBSERVER

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Steln's Law

Not So Fast! (The Mezzanine Loan Surprise)

veryone familiar with mezzanine loans knows a mezzanine lender can realize on the collateral for its loan much more quickly than a mortgage lender can. But not too many people understand just how quickly and easily a mezzanine lender can do that—at least if the mezzanine

borrower isn't paying attention or if things otherwise go wrong for the mezzanine borrower.

Probably the most common security package for mezzanine loans consists of the equity interests in the mortgage borrower, or in some other entity that indirectly owns the mortgage borrower. Those equity interests are not real property. As a result, the Uniform Commercial Code, rather than real property law, will govern that security package. And the UCC gives every

mezzanine lender that receives an equity pledge a potentially very powerful and quick way to get rid of the mezzanine borrower.

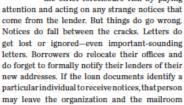
Specifically, if the borrower is in default, the lender can send the borrower a notice proposing that the lender retain the collateral, the equity interests. The borrower can reject that retention proposal, provided that the lender actually receives the rejection within 20 days after the lender mailed

the retention proposal. If that doesn't happen, then the lender owns the equity interests. The borrower doesn't. That's it. And the mezzanine loan will be deemed paid in full. Legally, the process is called "strict foreclosure."

At aminimum, the possibility of a strict foreclosure

means that a borrower in default needs to keep its eyes open for a retention proposal coming from its lender. If such a proposal arrives, the borrower must realize what it is, then move quickly to send avalid notice to the lender rejecting it. If the borrower does that, then the lender's gambit will fail and the lender will need to exercise its other rights under the UCC and the loan documents.

As a practical matter, any borrower ought to be able to protect itself from the strict foreclosure risk by paying



might mishandle their mail.

That is exactly what happened in one recent death penalty case, in which the lawyers who represented the defendant, as a pro bono client, left their firm but remained the addressees-of-record for important notices. When a notice arrived that began the period to file an appeal, the mailroom didn't handle it properly. The defendant missed his deadline to appeal. The federal appellate court refused to overlook the mix-up, and would have upheld the death penalty conviction as final. It took an appeal to the Supreme Court to reopen the matter and allow the appeal to proceed even though the defendant had missed his deadline only because of a screw-up in his former lawyers' mailroom.

Aborrower that doesn't respond in timely fashion to a retention proposal might similarly persuade a court to protect the borrower after the fact, but also might not.

Because of concerns like these, a borrower could reasonably say that the whole strict foreclosure mechanism creates an unacceptable and unreasonable risk that the borrower will lose its entire investment because of some failure or hiccup in a process that moves blindingly fast when compared with the usual pace of real estate foreclosures. In other words, the mere possibility of a strict foreclosure, even if the borrower can probably stop it, creates a risk that the borrower might reasonably regard as inappropriate.

In real estate transactions, an investor isn't supposed to be able to lose its investment as easily or quickly as strict foreclosure might permit—even if the borrower should be able to prevent the problem by paying attention.

A borrower concerned about protection from a strict foreclosure might reasonably ask the lender to agree not to exercise its strict foreclosure rights under the UCC. Nothing prevents a lender from making such an agreement. And a practical lender will probably accommodate the borrower's request, recognizing that a retention proposal will ordinarily be futile and useless, because the borrower will probably pay attention and reject it. The only time a retention proposal helps the lender is when the borrower screws up. And that possibility hardly gives a lender a defensible basis to insist on retaining the right to send a retention proposal.

More generally, a borrower might want to have its counsel think about and try to trim back other lender rights under the UCC that may seem extreme and overly harsh if they ever become relevant. Strict foreclosure represents the beginning but not the end of that discussion.

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