Mezzanine Loans to Developers and Owners of Real Estate Projects: 10 Ways to Improve the Quality of the Equity Pledge

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The authors discuss the ways to improve the quality of an equity pledge.

As interest rates rise and real estate sales soften, the quality and enforceability of the equity pledge becomes more important to mezzanine lenders. The use of the equity pledge as collateral is an important feature of mezzanine lending to developers and owners of real estate projects. The collateral for mezzanine financing, being a hybrid of debt and equity financing, generally consists of pledges of the equity interests of the borrower by the member(s) of the borrowing entity and not a deed of trust, mortgage or other security interest in real property. As a result, mezzanine financing is seen as riskier than real estate-secured financing, justifying mezzanine lenders' higher rates of return (in some cases 20 percent or higher). What if, on the other hand, the mezzanine lender could dramatically improve the quality of its equity pledge and still achieve returns of 20 percent or higher? This article focuses on 10 important ways in which a mezzanine lender can (and should) attempt to improve the quality of its equity collateral when providing financing to owners and developers of real estate projects.

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1. Require the Borrower to Opt-In to Article 8

Mezzanine lenders typically rely on filing a financing statement under revised Article 9 of the Uniform Commercial Code (''UCC'') to perfect their interest in the equity collateral. This, however, is not the preferred method of perfecting the lender's security interest in the pledged equity under the UCC. Under the UCC, an equity interest in a limited liability company or limited partnership is initially considered a general intangible and not a ''security.'' A lender can perfect a security interest in a general intangible only by filing a financing statement. The priority among security interests is determined under the ''first to file'' rules of Article 9 of the UCC. In order to enhance the lender's security interest in the pledged equity and turn this ''general intangible'' into a ''security'' under Article 8 and ''investment property'' under Article 9, the lender should require the issuer to ''opt-in'' to Article 8 of the UCC. In order to ''opt-in'' to Article 8, all the issuer must do is amend the operating agreement or partnership agreement to add language to the effect that the equity interests in the issuer are governed by Article 8 of the UCC. The equity interest should also be certificated and the certificate should carry a legend to that effect to permit perfection in the certified securities by ''control.'' Once the entity has opted-in to Article 8, a lender should include provisions in the operating agreement, partnership agreement, the pledge agreement, and consent documentation to ensure that the entity cannot later opt-out of Article 8.

There are several benefits to the mezzanine lender perfecting a security interest in investment property as opposed to a general intangible under Article 9. For example, obtaining exclusive control over the certificate provides protection against all subsequent purchasers. Unlike an Article 9 general intangible, a security interest in investment property can be perfected by either (1) filing, (2) possession or (3) control. Control should, in most cases, have priority over all other security interests previously perfected by filing. If the secured party obtains control or possession of the certificated security, no other party can obtain control. Thus, the mezzanine lender should require the entity in which it will have a pledged equity interest to ''opt-in'' to Article 8, agree not to ''opt-out'' and issue appropriate certificates to the lender which lender should take possession of at the closing.

2. Obtain UCC Insurance and a Land Title Policy Mezzanine Financing Endorsement

UCC insurance is a title insurance product issued by national title insurance companies such as First American Title Company, Fidelity Title and others. The policy effectively shifts the risk of proper attachment, perfection, and priority of lender's security interests to the title company. UCC policies ensure the security interest for enforceability, validity, priority, perfection, and attachment of the equity collateral and include a pre-closing UCC search and filing of a UCC-1 Financing Statement.

UCC insurance also covers fraud, forgery, insures the gap between the loan closing and filing of the UCC-1 and provides cost of defense coverage in the event of a challenge to the lender's security interest. The policy will also cover future advances, or advances made by the insured subsequent to date of the policy. Therefore, advances made in a revolving credit are covered by the policy even though they are made after the date on which the policy is issued. The policy can also cover after-acquired property.

The title company will also serve as a second set of eyes in the transaction and will provide the UCC search functions, thus assuming the responsibility for searching the proper jurisdiction's public records for the correct entity and collateral. The UCC insurance can also replace or supplement a costly legal opinion given by borrower's counsel (discussed below) and pay the cost of defense in the event something goes wrong.

In mezzanine loans where the mezzanine lender is not obtaining a subordinate deed of trust or other interest in real property owned by the borrower but is only receiving a pledge of the equity interest, it is still useful to obtain ''title insurance'' in the form of a ''mezzanine financing endorsement'' to the standard owner's title insurance policy. The title companies have developed this specialized endorsement which insures that (i) all payments for loss under the title policy will go directly to the mezzanine lender until the mezzanine loan has been paid in full, (ii) there will not be a denial of coverage as a result of the transfer of any of the ownership interest to the mezzanine lender, and (iii) the title company waives its right of subrogation and indemnity against any of the policyholder's equity owners until the loan is paid in full. The mezzanine financing endorsement can also include a ''non-imputation'' endorsement whereby the lender is assured that the title company will not deny coverage based on matters known to the borrowing entity or its equity interest owners and such matters will not be imputed to the lender.

Finally, the mezzanine lender should make sure that the borrower or fee-owner of the project has adequate title insurance in the form of an owner's title insurance policy as of the closing of the mezzanine loan. If the lender is required to enforce its rights under the pledge, the lender will succeed to the fee ownership of the borrower's real property (either directly or through the owners of the borrower). As a result, the mezzanine lender will have the benefit of whatever title insurance policy the borrower has obtained at closing.

3. Negotiate Subordination/Intercreditor Agreement With Senior Lender

The relationship between the senior lender and the mezzanine lender is governed by a written (and often recorded) agreement commonly called an intercreditor agreement. The first step to effectively negotiating the intercreditor agreement with the senior lender is identifying what's important. There are several provisions/concessions in the intercreditor agreement that the mezzanine lender should attempt to obtain from the senior lender. They include the following:

(1) Obtain senior lender's consent to the pledge of the equity interests and other mezzanine loan documents.

(2) Ensure that the security interest in the pledged equity is superior to any lien of senior lender.

(3) Obtain the right to purchase or prepay senior debt at par (i.e., principal and interest only without late charges, default interest, prepayment penalties, etc.).

(4) Ensure that senior lender consent is not needed to enforce rights under the equity pledge and that such enforcement will not trigger a default under the senior loan.

(5) Obtain the right to payments of net cash flow (i.e., after payment of closing costs and applicable senior loan release prices and reserves) absent default under the senior loan.

(6) Senior lender should agree to ''stand still'' if borrower is in default under the mezzanine loan

(i.e., no cross-default provision in senior loan documents tied to a default under the mezzanine loan).

(7) Senior lender must provide notice of default under the senior loan and provide junior lender with an opportunity to cure following expiration of senior borrower's cure period.

(8) No amendments to senior loan documents without mezzanine lender's consent.

(9) Mezzanine lender should have right to assign its interest in mezzanine loan without senior lender's consent.

4. Carefully Review Senior Loan Documents

Notwithstanding the importance of the intercreditor agreement, the mezzanine lender (and its legal counsel) should also carefully review the senior loan documents. There are several key provisions that must be considered and often negotiated with the senior lender. First, the senior loan documents must permit the mezzanine loan including the pledge of equity interests that is the security for the mezzanine loan. Additionally, there must be no restrictions on transfer of control to the mezzanine lender in the event the mezzanine lender exercises its rights in the collateral. The senior loan documents should be scrutinized with respect to the maturity date, loan amount, release prices, reserves, default/cross-default or cross-collateralization language and other key provisions to make sure they correlate with the business terms underwritten by the mezzanine lender.

5. Tailor Borrower's Organizational Documents

Make sure the operating agreement and/or other organizational documents of the borrower entity, and any entity that will have its equity interest pledged to the mezzanine lender, contain several important provisions. These include the appropriate UCC Article 8 ''opt-in'' provision, and no ''opt-out'' amendment without consent of mezzanine lender, special purpose entity (''SPE'') provisions and language allowing the lender to remove the manager following a default. The operating agreement for the borrower and the manager of the borrower should also contain standard restrictions on bankruptcy, dissolution and liquidation of the company, merger, consolidation, or reorganization and disposing of all or any substantial part of the company's business or property without lender's consent.

As explained above, the organizational documents should contain language stating that the entity has ''opted-in'' to Article 8 of the UCC and that it cannot ''opt-out.'' Additionally, the entity should be an independent bankruptcy-remote special-purpose entity that is unlikely to be the subject of a bankruptcy or to be consolidated if there is a bankruptcy of a related entity or person. The bankruptcy-remote nature of an SPE should be enhanced by requiring lender approval before commencing a voluntary bankruptcy proceeding. Finally, the organizational documents of the entity should grant the lender the ability to remove the manager in the event the entity violates any of the provisions of its organizational documents or any of the mezzanine loan documents. This will allow the lender to quickly succeed to the ownership and control of the equity interest in the event of such a default. This will allow the lender to prevent bankruptcy filings and gain control over the cash flow without having to resort to a foreclosure. Additionally, the mezzanine lender should obtain written consents from all members authorizing the entire mezzanine loan transaction, including an acknowledgment of lender's pledge and security interest in the equity interests and confirmation that the operating agreement or partnership agreement has not been amended and is in full force and effect.

6. Draft Pledge and Security Agreement to Comply With UCC Requirements

The Pledge and Security Agreement (the ''Pledge'') is the document that grants the mezzanine lender its security interest in the equity collateral. There should be language in the Pledge making it clear that the entity has opted-in to Article 8 of the UCC and which prevents it from opting-out. One way to ensure that there is not an ''opt-out'' of Article 8 is to grant lender an irrevocable proxy in the Pledge, although, as discussed above, this can also be accomplished by a prohibition of amendment to the ''opt in'' language in the operating agreement.

In many states (including California) sureties and guarantors have certain statutory and common law rights. In one respect, pledging the equity interest in the borrower could be seen as a guaranty or suretyship relationship in which case, the mezzanine lender should be careful to include language in the Pledge whereby the pledgor waives any such rights.

7. Make Sure All Mezzanine Loan Documents are Consistent

Each of the mezzanine loan documents should be carefully drafted to ensure internal consistency. There should be restrictions on all transfers of ownership interests. Not only should such transfers be deemed an ''Event of Default'' under the loan document but there should be a ''springing'' or limited indemnity/guaranty if there is any violation of the restrictions on transfer. Standard ''mortgage covenants'' should be required by the mezzanine lender in the mezzanine loan documents with respect to issues such as the establishment of tax, improvements, real estate broker fee and insurance escrows, the approval of the property manager, lease forms (and in some cases the leases themselves) and full access to the borrower's books and records.

8. Require Borrower's Counsel to Provide Opinion Letter

Many mezzanine lenders insist that borrower's counsel provide a legal opinion regarding all legal issues which could affect the rights of the lender, including the legal status (due formation, valid existence and good standing) of the debtor(s), the perfection, attachment and priority of a security interest and the due authorization, delivery and performance of the loan documents and the loan transaction. In some cases, it may be necessary to also obtain a ''non-consolidation'' opinion to make clear the separate nature of the entities involved.

As discussed above, UCC insurance is based upon the same due diligence which must be done to issue a legal opinion and in some cases can (and should) be used to supplement or replace certain portions of the legal opinion. For example, in certain transactions, opinions regarding perfection, attachment and priority of the lender's security interest in the pledged equity can be eliminated since these matters are covered under the UCC insurance policy. The advantage of the UCC insurance is that it does not have the exceptions, qualifications, and assumptions which can weaken the assurances contained in legal opinions. Under a UCC insurance policy, the title company is an indemnitor of the accuracy of the underlying due diligence, whereas a legal opinion assumes such accuracy. In those instances where cost is an issue, the UCC insurance is a cost effective alternative.

9. Establish Comprehensive Checklist for Due Diligence Items

Since mezzanine financing is usually provided to the borrower very quickly, there is often little due diligence conducted on borrower by the mezzanine lender. This is a mistake. You must ''know your borrower'' and the project. Getting to know your borrower and the project can often be done quickly and cost effectively with the help of the title insurance company, lender's counsel and the borrower itself providing the requisite information to get the lender comfortable with the borrower and project. When conducting its due diligence on the borrower entity or entities, the mezzanine lender must scrutinize the organizational documents to make sure the loan and pledge are allowed under the operating documents and that the parties signing the loan documents have the requisite authority to do so. Follow up to make sure that the entity or entities are duly formed, validly existing and in good standing. Conduct lien, UCC and litigation searches in the state of organization as well as the State(s) in which the borrower's principal place of business and real property are located.

Ideally, the lender will also have an adequate opportunity to review a preliminary title report or title commitment, underlying title documents, survey, purchase documents (if the borrower or its affiliate is acquiring the project) and other similar project documents. For example, a purchase agreement may contain provisions regarding seller-carryback financing or retention of a profit participation interest, or requiring the seller to perform certain post-closing obligations such as completion of site improvements or obtaining entitlements. The results of this investigation are very important and will likely be the subject of negotiations between the lender, borrower, seller, and other third-parties.

10. Followup on Items That Need to be Obtained After the Closing

Once the frenzy of activity ends and the mezzanine loan closes, there are still several things the lender should do to ensure the attachment, perfection, and priority of the collateral. First, where the pledge is secured under the UCC, the lender should make sure it obtains physical custody of ownership certificates at closing with endorsement. The lender should also confirm with the title company that the UCC Financing Statements have been filed. While the title company technically is on the hook for any ''gap'' between closing and the title company filing the Financing Statements, it is good practice to follow up to make sure filing takes place as soon after the closing as possible. Similarly, the lender should make sure the title company delivers the final title insurance policy and endorsements based on the pro-forma policy the title company issued prior to closing.

Conclusion

The mezzanine lender can take steps before, during, and after the closing to improve the attachment, priority, and perfection of the collateral and the remedies available it in the event of a default by borrower. The mezzanine lender can (and should) also improve its position relative to the senior lender. The mezzanine lender should utilize the title company and borrower's counsel to further shift risk away from the mezzanine lender. These steps will mitigate the risks associated with mezzanine financing and improve the quality of the equity collateral. If however, notwithstanding lender's efforts to mitigate risk and improve the quality of the collateral, the borrower defaults, there are various steps that the lender should (or must) take to enforce its security interest.