Client Alert

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Mezzanine Loan Workouts: Issues To Be Considered By Distressed Real Estate Investors

Distressed real estate investing comes in many forms. With the recent uptick in distressed commercial real estate, sponsors and investors often seek restructuring advice in the context of mezzanine loan defaults. In this Client Alert, we discuss the unique aspects of distressed mezzanine loans and issues to consider in mezzanine loan restructurings.

Understand the Capital Structure: Investors looking to invest in a mezzanine foreclosure sale situation must first recognize that mezzanine financing is typically secured by the borrower's pledged equity interests in the property owner and NOT the real property itself. In the event of default, the mezz lender can foreclose on these pledged equity interests and it, or the successful bidder at the UCC sale, will own the property "subject to" any fee mortgages and other claims that the borrower has. In many situations, the mezz lender is completely "underwater" or "out of the money," which will require a much more comprehensive workout with the fee mortgage holder and other creditors such as taxing authorities, mechanics lienors and trade vendors.

Review the Senior Loan Documents: As mentioned above, buying the equity either as part of a distressed investment or at a UCC sale is, in essence, "stepping into the shoes" of the fee owner and its balance sheet. You may need to cure defaults under the senior loan or negotiate the purchase of the senior loan to prevent the senior lender from exercising default remedies. As a result, understanding the borrower's debt instruments is critically important.

Understand the Intercreditor Agreement: As between mezz lenders and senior fee mortgage lenders, there are often intercreditor agreements ("ICAs") that define the rights between lenders. ICAs will often grant the mezz lender rights to cure senior loan defaults to preserve its position as well as the right to purchase the senior mortgage upon a borrower default.

UCC Foreclosure Procedures are FAST: Mezzanine loan UCC foreclosures are non-judicial sales and as a result are much faster than real

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property foreclosure sales. In practice, UCC sales are typically done in 45-60 days (sometimes faster) with the lender often hiring a broker to “market” the sale to ensure it is a “commercially reasonable” sale, as is required by the UCC.

Communicate with All Stakeholders: While UCC sales are fast, mezz loan workouts can be complicated and require significant due diligence. It is important to understand the key players (borrower, lenders, special servicers, brokers and receivers) and obtaining the documents and financial information quickly is often essential.

Valuation is Key. **Be Creative**: Given the deeply subordinated nature of mezz loans, distressed investors need to quickly assess both valuation expectations as well as the temperature of the players. Will the parties be realistic and agree to a fair valuation? If so, a deal can be done. Will the lenders refuse to take a loss and instead look to “extend and pretend” or “kick the can”? If so, a deal may be difficult to achieve or may require a more creative workout strategy.

Please contact the Olshan attorney with whom you regularly work or the attorney below if you would like to discuss further or have questions.

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