

Governmental Considerations Attendant to a Mezzanine Loan Foreclosure

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The foreclosure of a mezzanine loan (or the acceptance of a transfer of the pledged equity interests in lieu of foreclosure) and its timing are decisions that require careful consideration and planning.

Unlike a mortgage foreclosure, title to the property will not be conveyed to a new owner free and clear of subordinate liens and encumbrances and other obligations or liabilities of the existing property owner. Instead, a foreclosing mezzanine lender (which, for purposes of this article, will also include any purchaser of the pledged equity interests at foreclosure or a designee of the mezzanine lender that acquires the pledged equity interests by transfer in lieu of foreclosure) will “step into the shoes” of that property owner and, in so doing, acquire only an indirect interest in the property, subject to all claims, liabilities, agreements or other obligations to which the property owner or the property is subject or otherwise bound.

A foreclosing mezzanine lender must properly obtain the benefits expected from acquiring the pledged equity interests in the property owner within the parameters prescribed by the intercreditor agreement, which governs the relative rights, priorities and obligations of the mezzanine lender and any other lenders (whether senior or subordinate to the mezzanine lender) that have provided financing for the property, and applicable law. While this article is limited to a discussion of governmental franchises, licenses, permits, approvals, authorizations and the like, there are a myriad of other issues attendant to a mezzanine loan foreclosure, such as compliance with loan documents, intercreditor provisions and UCC requirements.

Upon a change in ownership of the property owner, the foreclosing mezzanine lender will need to update the registered agent, registered office and/or mailing address of the reconstituted property owner with the secretary of state (or other applicable government official) of the state in which the property owner is organized, as well as any other state in which the property owner is qualified to do business, to ensure that annual or biennial statements and/or invoices for franchise taxes are mailed to its correct address and service of process upon the property owner in any action, suit or other proceeding in such state is made upon the appropriate agent. If these updates are not timely made, the property owner may be at risk of losing its good standing or having its status as a legal entity revoked or cancelled in the state of its organization and, if applicable, any other state in which it is qualified to do business. The property owner may also be at risk of an adverse outcome, including a determination of liability and/or damages, in any action, suit or proceeding involving the property owner for failure to serve an answer to, or appear in, such action, suit or proceeding.

While virtually all licenses and permits will require the foreclosing mezzanine lender to update the issuing entity of the new mailing address of the reconstituted property owner, a subset may also entail compliance with additional requirements in order to continue the validity of those licenses and permits, or to prevent their revocation or suspension, as a result of the change in ownership of the property owner. For example, liquor and gaming licenses for hospitality properties and operational licenses for health care, assisted living and skilled nursing facilities are generally subject to additional requirements, ranging from filings describing the change in ownership of the property owner to background checks for its new officers, directors and/or principals or even a requirement for making application for a new license or permit following the change in ownership. By contrast, if a license or permit was issued to a third-party operator or manager which will survive, or constitutes an entitlement of the property that will remain in effect, then no further action may be required. When an existing license or permit is rendered invalid or is revoked or suspended, or a new license is not issued, the reconstituted property owner may be required to suspend or cease the affected business or operations at the property until the license or permit is reinstated or a new license or permit is issued.

Special consideration should be given to condominium development projects, which are especially challenging to a foreclosing mezzanine lender for a number of reasons. These projects may involve completion of project construction and the marketing and sale of units (unless the mezzanine lender opts to abandon the condominium plan and convert the project to a rental property). The same defaults that would lead a mezzanine lender to decide to foreclose, and the

foreclosure itself, often result in delays in construction and additional costs, which must be disclosed (along with the change in ownership of the property owner) to existing and prospective unit purchasers and which may necessitate additional filings with the relevant state office or officials and amendments to the condominium documents and/or plan. The preparation, filing and approval of these required disclosures and amendments can be costly and time-intensive, and the disclosures may trigger rescission rights of unit purchasers under the terms of existing contracts and/or applicable law. In addition, these factors may have a chilling effect on future marketing efforts and unit sales (as well as the sales prices for such units), which, in turn, may impact the timing of the effectiveness of the condominium plan or the financeability of unit purchases, or both.

Because so much of the value of the collateral for a mezzanine loan depends upon the continued existence of the property owner and the maintenance of governmental franchises, licenses, permits, approvals and other authorizations to develop, use, operate and sell the property, the importance of giving due consideration to these matters when contemplating whether and, if so, when, to conduct a mezzanine loan foreclosure cannot be overstated. The mezzanine lender must carefully consider the scope of these franchises, licenses, permits, approvals and authorizations and understand the applicable laws, rules and regulations pertaining to their maintenance and continued validity following a change in ownership of the property owner.