When the Levee Breaks: Understanding Key Variations in CRE Collateral and Foreclosure Processes

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Following the turmoil of the Great Recession, the commercial real estate (CRE) industry generally benefitted from favorable financing conditions for more than a decade. An ocean of available capital and low interest rates created a forgiving environment and allowed borrowers and lenders to mostly avoid rough waters through new equity investments, refinancing opportunities, or sales to better positioned buyers. This long stretch of smooth sailing means that many CRE professionals have worked for an extended period, some for their entire careers, without significant exposure to commercial foreclosure processes.

Recently, however, several factors are impeding the refinancing or work out of distressed or maturing CRE loans, including higher interest rates for borrowers, increases in debt and equity investors' capital costs, and an overall tightening of credit. Consequently, we are seeing a gathering storm of defaults in CRE loans threatening a deluge of foreclosures - the legal processes through which lenders seek to recover on a debt following their borrowers' defaults by selling collateral that secures the borrowers' obligations.

What do business and finance teams facing this potential flood need to know? In this advisory, the G&S CRE Workouts team team provides an overview of CRE collateral types while highlighting variations between judicial and non-judicial foreclosure processes, including UCC Article 9 foreclosures on pledged equity interests.

Real Estate Collateral Basics – Attachment and Perfection of Security Interests

In order for a lender to foreclose on an asset following a borrower's default, the borrower must have previously granted to the lender a lien (also known as a "security interest") on the asset. There are two main asset categories that may serve as collateral for a CRE loan: (1) real property and related assets of a property-owning entity and (2) equity interests in a property-owning entity.

Security interests in real estate and related assets of a property-owning entity are granted by a borrower pursuant to a mortgage or deed of trust. The mortgage or deed of trust typically provides the lender with liens on three different legal types of borrower property: (i) real property (a parcel of land and its improvements), (ii) fixtures (objects which are attached to real property by means of bolts, screws, cement and the like) and (iii) personal property (movable property such as furniture and certain equipment as well as contract rights and accounts receivable).

In addition to, or in lieu of, a mortgage securing the assets of a property-owning entity, some CRE loans are secured by a lien on the equity interests (sometimes referred to as a "pledge of equity") in an entity that owns real property assets. In some debt financing structures, a mortgage lender makes a mortgage loan to a property-owning entity which is secured by the property owner's assets, and a second loan, referred to as a "mezzanine loan" is made to the entity that owns the equity in the property owner with that equity serving as collateral for the mezzanine loan. In other structures, the same lender that has obtained a mortgage over real property assets also obtains a pledge of the equity in the property-owning borrower entity.

Once a security interest in collateral is granted by the borrower, the lender must "perfect" its lien to establish the lender's priority over any unperfected security interests and any security interests that are subsequently perfected. The rules governing perfection vary based on the form of the collateral and applicable state law.

A security interest in real property is typically perfected by filing a mortgage or deed of trust in the public land records of the county where the property is located. In certain states, the filing of the security instrument also perfects the lender's security interest in fixtures, while other states require the filing of a separate financing statement (referred to as a "UCC-1"), in the same records as the security instrument. A security interest in personal property is perfected by filing a UCC-1 financing statement with a state level office for recording security interests over personal property (frequently the office of the secretary of state in the borrower's state of formation).

Equity interests are considered to be personal property, so perfection of an equity pledge may be accomplished by filing a financing statement covering the equity interests at the appropriate state level recording office. However, lenders who take a pledge of equity also typically require that their equity collateral constitutes a "security" and is governed by Article 8 of the Uniform Commercial Code, such that the lender's security interest in the equity may also be perfected by the lender obtaining possession or control of the stock or membership certificates representing the equity interests.

Judicial, Non-Judicial, and UCC Foreclosures

Depending on the law of the state where the subject property is located and the provisions in the underlying security instrument, a real estate foreclosure process may be "judicial" or "non-judicial". Some states permit non-judicial foreclosure (or "power of sale" foreclosure) on real estate assets provided that a power of sale provision is included in the underlying security instrument. Other states require "judicial foreclosures", which are done through the courts. In all states, foreclosure on personal property assets, including pledged equity interests, may be completed on a non-judicial basis pursuant to Article 9 of the Uniform Commercial Code (this is frequently referred to as a "UCC foreclosure" or an "Article 9 foreclosure").

While processes and procedures vary among states, and parties should always retain counsel with specific expertise in the applicable jurisdiction, there are several key differences between these three foreclosure processes.

Key Variations

- **Initial Actions.** Following a borrower's default, a nonjudicial CRE foreclosure process typically starts with a notice of the upcoming foreclosure sale being posted on the property, recorded and/or delivered to the borrower, and/or published in the classified section of one or more newspapers. Similarly, UCC foreclosures on pledged equity begin with a lender determining the proper notice parties by running lien searches in the applicable recording office and sending notice to other secured parties as well as the borrower and guarantors of the underlying debt. Judicial foreclosure, on the other hand, starts with the foreclosing lender filing a lawsuit in an appropriate court with jurisdiction over the matter.

- **Timing Considerations.** Where permitted, nonjudicial real estate foreclosure is typically a significantly faster and cheaper process than judicial foreclosure, often taking no longer than 90 days from start to finish (and it can sometimes be even quicker). Like non-judicial real estate foreclosures, UCC foreclosures on pledged equity can be accomplished relatively quickly, with the UCC indicating that as little as ten days' notice is required (though related notice procedures and safe harbors, as well as requirements for a commercially reasonable marketing process frequently extend a UCC foreclosure timeline to a month or two). Judicial foreclosure typically takes longer (often running 18 months or more), though a lender can attempt to speed the process through a motion for summary judgment, such as that covered in our recent article.
- **Borrower Defenses and Bankruptcy.** If a borrower wants to assert a defense to a nonjudicial foreclosure or a UCC foreclosure on pledged equity, the borrower must file its own lawsuit to raise the defense and/or to seek a restraining order or injunction to stop the sale. On the other hand, in a judicial foreclosure, a borrower's defense is raised in response to the lender's initial lawsuit – a forum has already been established. In any foreclosure process, a bankruptcy filing by the borrower will immediately result in an automatic stay that pauses all foreclosure activity.
- **Auction Process.** In a judicial foreclosure process, the actual sale of the property is conducted as an auction administered by a sheriff or other courtappointed official. This auction is typically held in the courthouse or on the courthouse steps (though online bidding has also become an option in some jurisdictions). Non-judicial CRE foreclosures and UCC foreclosures are not required to be conducted by court-appointed officers, so lenders typically retain a third-party sales agent to conduct the auction, which may be held at the property, in or around the courthouse, or at another locale. Parties should note that the UCC requires that all aspects of a UCC foreclosure sale be "commercially reasonable". We will drill down on commercial reasonableness requirements in an upcoming article.
- **Deficiency claims.** In a nonjudicial foreclosure, a lender is less likely to be able to pursue its borrower for the remaining amount owed on the loan following the sale (referred to as the "deficiency"), while judicial foreclosures may present the ability to maintain a deficiency claim. Please note again, however, that this is a nuanced, state-specific issue requiring expert advice of counsel.

Strategic Considerations

While commercial real estate loan documents and applicable state laws generally allow a lender to foreclose on collateral when a borrower defaults on its obligations, whether or not a lender chooses to pursue foreclosure and the type of proceeding it selects, will depend on a variety of factors, including potential transfer tax liability, the rights and priority of any competing lienholders as well as any intercreditor agreements which may be in place, the remaining value in the property, and whether the lender is well positioned to realize that value. Lenders must also consider the potential rights of third parties, including, for example, tenants who may have certain rights upon an assignment of the property or a change-in-control of the property-owning entity. CRE loans are also often backed by guarantees by well capitalized investors which may provide another avenue for recovery by the lender, and which should always be considered in determining each party's strategy in a distressed real estate scenario.

As noted throughout this article, the details of the various foreclosure processes and the strategies that lenders, borrowers, and potential acquirers may pursue in any given distressed CRE scenario depend on many complex factors and the intricacies of state law, and therefore, the advice of experienced counsel is always a necessity for market participants considering the risks and benefits of a foreclosure on real estate assets or pledged equity.

For more information on these matters, please reach out to a member of The G&S CRE Workouts team and stay tuned for additional related content in forthcoming articles on topics such as Deed-In-Lieu transactions, commercial reasonableness in UCC foreclosure sales, and the enforceability of Non-Recourse Carveout Guarantees.