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Subordinate Lenders May Have Better Remedy Option

Pledged interests could be held by the lender until satisfaction of the debt

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Often, a mezzanine or subordinate lender is relegated to taking pledges of collateral in the form of a borrower's membership, ownership and/or financial interests in business entities. The actual value, worth and liquidity of this type of collateral is usually difficult to ascertain with any certainty, which is one of the reasons why mezzanine lenders typically charge interest rates and fees higher than those charged by a more conventional lender.

Unlike a conventional lender, whose collateral consists of tangible and intangible assets or real property, upon a default by a borrower who has pledged these types of interests the mezzanine or subordinate lender is forced to look to these pledged interests to satisfy its debt. This may not be such a simple proposition, as it may necessitate the lender to step into the borrower's shoes and, in effect, becoming one of numerous owners of an entity. Thorny and difficult issues can arise in connection with the actual transfer of ownership of the pledged interests to the secured creditor. One example is if the operating, partnership or shareholder's agreement of the underlying entity precludes or restricts a transfer of ownership.

Does the lender have the right and ability, post-default, to take possession of, and to hold for an extended period of time, these pledged interests, and to receive their financial benefits, without "disposing" of the pledged interests pursuant to the foreclosure provisions of Article 9 of the Uniform Commercial Code (UCC), and without attempting to accept the pledged interests in full or partial satisfaction of the borrower's obligations?

UCC § 9-610, titled "Disposition of Collateral after Default," entitles a secured party to "sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing." UCC § 9-610 (a). By its very title and terms, UCC § 9-610 appears to contemplate a "disposition" of the collateral by a secured party upon a borrower's default.

A second available remedy to a secured party is set forth in UCC § 9-620. It provides the procedure by which a secured party may endeavor to accept the borrower's collateral in full or partial satisfaction of the obligation. Pursuant to UCC § 9-620, however, this remedy cannot be invoked over an objection by the borrower. Because of the probability of an already attenuated relationship between a borrower and its lender at the time of a default, and likely disputes as to the value of the collateral, this remedy is often times non-availing.

Further, there may be reasons why the secured party does not wish to dispose of the collateral, or attempt to obtain and accept the collateral in full or partial satisfaction of the debt. Indeed, the actual value or liquidity of these interests may not be clear to the secured party, and taking over the actual ownership of the entities pledged may be more of a headache than it is worth. By taking actual ownership of the pledged entities, the lender will have placed itself in a position whereby it may have to deal with liabilities, obligations and other burdens of its borrower as the new owner.

So, the question becomes: can the secured party take possession of, and hold, for an extended (but not indefinite) period of time, these pledged membership, ownership and/or finan-

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cial interests, and realize whatever financial benefits they may provide, until the debt is indefeasibly paid in full?

UCC § 9-610 does not expressly provide that holding these types of pledged interests under these circumstances is an option upon a default; it provides only that the secured party may "sell, lease, license or otherwise dispose" of the collateral. UCC § 9-610(a), however, provides that "[a]fter default, a secured party has the rights provided in this part and, except as otherwise provided in Section 9-602, *those provided by agreement of the parties*" (emphasis added).

It seems, then, that if the loan documents between a lender and a borrower provide for and permit the holding of these types of interests by the lender pending satisfaction of the borrower's obligation, taking such action may be an appropriate remedy for the lender. With this in mind, a secured party would be well advised to include such permissive language in its standard form of loan documents.

Also, in situations where the pledged interests represent a controlling interest in an entity, the lender may want to include in its loan documents the right to change or replace the management of such entity during the time that the pledged interests are being held by the lender. If a lender exercises such a right, it must be careful, however, to always conduct itself in a commercially reasonable manner so as to not subject itself to a claim for damages by a defaulting borrower who one can assume would be eager to sue.

What if, however, the relevant loan documents do not contain language permitting the lender to hold the pledged interests upon and after a default? Does Article 9 enable a lender to do so, and to realize upon the monies that they generate, until payment of the debt in full?

The issue does not appear to have been addressed by any New York or New Jersey court, state or federal. The holding of these types of interests in the manner proposed is not inconsistent with any provision within Article 9, and is within the spirit of Article 9 in that it simply provides another (perhaps more effective way) for a secured party to realize upon collateral pledged to secure its loan.

Nor would the holding of the collateral by the lender cause the borrower any undue detriment, as the borrower — who has pledged the interests as security for its debt to the secured party — would be entitled to the return of its pledged interests upon payment of the debt, and would not forfeit its ownership interests outright.

In addition, the initial holding of the interests by the lender may enable it to better understand the value and liquidity of the collateral, and could be useful, from a due diligence standpoint, for purposes of evaluating a prospective ultimate disposition of these interests pursuant to UCC § 9-610 and/or UCC § 9-620. Nothing in Article 9 appears to preclude the initial holding of these types of interests, and the application of their financial benefits and proceeds toward the satisfaction of the debt, prior to the eventual sale or other disposition of the collateral, or the acceptance of the collateral in full or partial satisfaction of the debt.

A lender may be well advised to include in its loan documents provisions entitling it to hold, even for an extended period of time, pledged membership, ownership and/or financial interests, and to receive their financial benefits, until the satisfaction of the debt. This may be a more effective remedy for a lender who is unsure of the actual value or liquidity of these pledged interests, and who may not want to dispose of them or accept them in full or partial satisfaction of the debt. ■