MEZZANINE FINANCING: LEGAL AND TITLE ISSUES

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Introduction

As a result of the increased securitization of real estate and the packaging of pools of loans for sale into the secondary market, “mezzanine financing” has become very popular in recent years. Mezzanine financing (or, perhaps more appropriately, mezzanine capital) fills the gap between the first mortgage financing, which usually has a loan-to-value ratio between 40% and 75%, and the equity participation of the principals of the borrower, which is usually no more than 10% of the cost of the project. Mezzanine financing commonly supplies financing of 50% to 90% of the project’s capital structure cost. This type of financing can take several forms. Most commonly, it will involve extending credit to the partners or other equity holders of a borrower and taking a pledge of such parties’ equity interests (including the right to distributions of income), or else taking. a preferred equity position that is entitled to distributions (in the form of excess cash flow after debt service) ahead of the borrower’s principals. A “combination” loan structure also may be utilized, which combines a first mortgage loan with mezzanine financing at an aggregate loan-to-value ratio of 90-95% and may contain a shared appreciation or contingent feature or requires an exit fee to be paid by the borrower.

Advantages and Applications of Mezzanine Financing

Mezzanine financing provides a financing or capital vehicle that fills the spread between relatively low-risk senior secured debt and high-risk subordinated equity interests. The borrower is therefore able to obtain a first mortgage loan at a lower loan-to-value ratio, thus decreasing the cost of such primary debt financing and providing the lender with a more favorable debt service coverage ratio (“DSCR”). The same lender can supply both the first mortgage-debt financing and the mezzanine financing, or the funding can come from separate, unrelated entities. If the mezzanine lender is a third party, the mortgage lender may (because of the possibility that the mezzanine lender may acquire an equity interest in, or actually control, the equity owner) have stricter requirements with respect to approval rights of the mezzanine lender with respect to actions of or requests by the borrower and the ability of the mezzanine lender to exercise certain rights and remedies in the event of the borrower's default, may require strict due diligence with respect to the mezzanine lender, and may require the mortgage lender's consent (and rating agency approval) to a transfer or pledge of the mezzanine loan.

Bankruptcy Remoteness

In connection with securitized financings, in which mezzanine financing is commonly utilized, rating agencies (such as Duff & Phelps, Moody's and Standard & Poors) generally disfavor subordinate real-estate financing because they believe it increases the risk of bankruptcy filings. Therefore, many securitized first-mortgage lenders prohibit subordinate mortgage debt, but permit mezzanine financing that allows the subordinate lender to take collateral in the form of an equity or participation interest in the borrowing entity. The borrowing entity for the mezzanine loan will normally be an independent bankruptcy-remote entity or special-purpose entity ("SPE") that is unlikely to become the subject of a bankruptcy or to be substantively consolidated if there is a bankruptcy of any related person or entity. The SPE is often an intermediate holding company, which is separate from the borrowing entity that obtains the first mortgage loan. To demonstrate the separate nature of the entities, a "non-consolidation" opinion is required along with assurance that the general partner (or member, if the mortgagor is a limited liability company) of the mortgagor is not liable for the mezzanine loan. *See* The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 559, 598 (1995); Tribar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717, 724-30 (1991).

Mezzanine lenders and the credit-rating agencies commonly require the following covenants in SPE organizational and loan documents:

(1) Prohibition against any business activity other than operation of the property and against owning any other property.

(2) Prohibition against any merger with another entity or acquisition of any subsidiary.

(3) Prohibition of any other debt other than lease financing, except for ordinary trade debt (fully subordinate financing *may* be permitted if the credit rating is not impaired).

(4) Separate SPE books and records, stationery, bank accounts, tax returns, and office space.

(5) Prohibition against contracts with affiliates, unless arms-length.

(6) Prohibition against commingling of assets with affiliates.

(7) Prohibition against the guarantee (or the pledge of assets to secure) the debt of an affiliate.

(8) "Independent director" approval of major decisions such as a bankruptcy filing, a change in the SPE organizational or governing documents, and transactions with affiliates.

(9) Disclosure, of any transfer of the assets from the borrowing entity to a new SPE, to the transferor's other creditors.

(10) A "lockbox" arrangement to monitor cash disbursements.

The bankruptcy-remote aspects of an SPE may be enhanced by requiring that one or more of the directors, general partners, or members of the SPE be independent, or by requiring a super-majority vote (which would necessarily include at least one of the independent parties) to approve a voluntary bankruptcy filing. An employee, officer, or representative of the lender could obtain a direct ownership or equity interest in the SPE, but this would invite subsequent challenges based on lender liability, equitable subordination, and violations of public policy. Numerous courts have held that as a corporation approaches insolvency, the directors owe a fiduciary duty to the creditors of the corporation. *See, e.g.*, *In re Andreuccetti*, 975 F.2d 413, 421 (7th Cir. 1992); *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); *In re Kingston Square Assoc.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) ("[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors. Nearly all states' law is in accord . . ."); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-89 (Del. Ch. 1992); *Credit Lyonnais Bank, Nederland, N.V. v. Pather Communications Corp.*, No. CIV. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991); *Tampa Waterworks v. Wood*, 121 So. 789 (Fla. 1929); *Franci v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

The use of bankruptcy-remote provisions in the borrowing entity's organizational documents, especially those that require approval of certain entity actions by an independent director who is in actuality under the influence of a major secured lender, may later be determined by a bankruptcy court to run afoul of the Bankruptcy Code's prohibition of provisions preventing an entity from commencing a bankruptcy reorganization. In *In re Kingston Square*, *supra,* the debtor was unable to obtain its board of directors' permission to file a voluntary bankruptcy proceeding because of the refusal of the "independent director" to authorize such a filing. The debtor then orchestrated an involuntary filing by certain unsecured creditors. The bankruptcy court found that the debtor reasonably believed that the best course of action for the entity was to file bankruptcy, and refused to grant the secured creditor's motion to dismiss the involuntary filing. The court also appointed a Chapter 11 trustee, and held that the debtor's board of directors had violated their fiduciary duties owed to the corporation's unsecured creditors and interest holders. The court declined, however, to specifically nullify the debtor corporation's bylaw provision containing the bankruptcy-proof provisions as against public policy. *See also* Michael J. Cohn, *Asset Securitization: How Remote is Bankruptcy Remote?* 26 HOFSTRA L REV. 929 (1998); John C. Murray, *Clogging Revisited*, 33 REAL PROP. PROB. & TR. J. 279, 303-05 (1998).

As a result of negative experiences involving bankruptcy filings by and against borrowers, real estate lenders have learned that creating a borrowing entity with very few creditors, such as a bankruptcy-remote SPE, makes it much more difficult for the borrower to file, or have filed against it, a bankruptcy proceeding or to avoid early dismissal. As the Ninth Circuit Court of Appeals has stated, in *Barakat v. Life Ins. Co. of Va.*, 99 F.3d 1520, 1526 (9th Cir. 1996), when the only bona fide, impaired claim in the bankruptcy case was the claim of the mortgage lender, the debtor "should [not] be able to cramdown a plan that disadvantages the largest creditor." *See also* John C. Murray, *The Lender's Guide to Single-Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 461-71 (1996); Gregory Varallo and Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company,* 48 BUS. LAW. 239 (1992); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Tab 24 at 5 (April 4-5, 1997) (American College of Real Estate Lawyers Annual Meeting on Finance Topics); Portia O. Morrison, *Financial Covenants and Bankruptcy Remote Structures in Real Estate Transactions*, Real Estate Financing Documentation: Coping with the New Realities, ALI-ABA Course of Study, Jan. 16-18, 1997.

Mezzanine Financing Structures

A typical mezzanine financing structure may involve a junior tranche of securitized financing, subordinate to the senior lienholder, payable at a fixed rate out of available cash flow from the project. As previously mentioned, mezzanine financing often consists of a loan to the equity holders of the SPE borrower, and is secured by a pledge of the equity interests in the borrower. The borrower/obligor under such a loan must be an equity holder in the borrower and not the SPE borrower itself.

Because the rating agencies require that a limited partnership have a bankruptcy-remote general partner, which cannot be an obligor under mezzanine financing, loans to the equity holders of the borrower are secured by a pledge of the limited (but not general) partnership interest or by a pledge of shares of the corporate general partner of the borrower, but not by actual equity in the borrowing entity (although the partnership agreement may permit the foreclosing mezzanine lender to remove the general partner and convert it to a limited partner). The collateral for a mezzanine loan may also include a pledge of stock or other equity interest in the borrower's general partner, or a guarantee from the ultimate parent company.

Another variation of a mezzanine financing transaction involves secured subordinated debt with a participating interest, with a slightly higher interest rate than the senior debt and contingent interest (based on net cash flow), or a shared appreciation feature based on an equity event such as sale, prepayment, condemnation, refinancing, or re-valuation. (In order to constitute debt, the financing must have a minimum DSCR of 1:1). A third variation uses combined debt and equity, usually evidenced by a convertible preferred participation in the equity interest of the borrower. The debt portion, which is usually

small, may consist of a convertible mortgage, or may be secured by non-real property collateral.

A mezzanine financing structure might also utilize straight equity with a preferred return, which equity interest may take the form of a preferred equity interest in an intermediate partnership or limited liability company that is a "holding company." This interest would be evidenced by a capital contribution to the SPE borrower in exchange for an equity share in the borrower (such as a limited partnership interest) that is preferred in right of payment over the other common equity in the borrower. The preferred interest holder may further seek a veto over any proposed refinancing of the property if the amount to be realized would be insufficient to repay both the senior debt and the preferred equity interest. Because of the potential conflict with the interest of the holder of the senior mortgage debt, the rating agencies usually will not permit the preferred equity holder to obtain such a right. The rating agencies also generally require that preferred equity, and the mezzanine loan, may not be transferred without written confirmation by the agency that such transfer will not result in a downgrade, withdrawal or qualification of the then-existing rating on the senior mortgage debt. To ensure that existing equity maintains a significant and meaningful continuing equity interest in the property, the rating agencies will generally require that the aggregate amount of preferred equity and senior indebtedness cannot exceed 80% of the value of the property. *See* Standard & Poor's, *Mezzanine Financing and Preferred Equity in Property Specific Transactions* (June 1996); Joseph Philip Forte, Submitted program materials for ALI-ABA *Real Estate Financing Documentation* vol. II, at 697 (Scottsdale, AZ, Jan. 1998).

Clogging Issues

Mezzanine financing must be carefully structured so that it does not violate the legal prohibition against "clogging" the borrower's equity of redemption. The clogging doctrine holds that there can be no provision in a mortgage document that will prevent the mortgagor from redeeming and retaining ownership of the mortgaged property prior to entry of a valid foreclosure decree upon full payment of the indebtedness, or which allows the mortgagee to obtain a "collateral advantage." *See, e.g.*, *West v. Reed*, 55 Ill. 242, 244 (1870) ("It is settled beyond controversy, that contracts between a mortgagor and mortgagee, for the purchase or extinguishment of the equity of redemption, are regarded with jealousy by courts of equity, and will be set aside if the mortgagee has, in any way, availed himself of his position to obtain an advantage over the mortgagor."); *Humble Oil & Refining Co. v. Doerr*, 303 A.2d 898, 906 (N.J. Super. Ct. Ch. Div. 1973) (stating that "the [clogging] doctrine is universally applied, both in the United States and England"); *Lincoln Mortgage Investors v. Cook*, 659 P.2d 925, 927 (Okla. 1982) (stating that "the [clogging] doctrine voids any provision in an original mortgage agreement limiting or modifying the right of redemption by payment of the full mortgage debt after default for any reason"). *See also* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 3.1 cmt. a (1996) [hereinafter RESTATEMENT] ("Under [the clogging] rule, no agreement contained in the

mortgage, or contemporaneous with it, could cut off a delinquent mortgagor's equity of redemption without resort to foreclosure by the mortgagee. Thus the equity courts refused to enforce attempts by a mortgagee, at the inception of the mortgage transaction, to have the mortgagor waive the right to insist on foreclosure in the event of a default"); 1 Grant S. Nelson and Dale A. Whitman, REAL ESTATE AND FIN. L. § 3.1 (3d ed. 1993); John C. Murray, *supra*, *Clogging Revisited*, 33 REAL PROP. PROB. & TR. J. at 280.

Clogging issues may arise as the result of the foregoing variations of mezzanine financing structures, usually resulting from allegations of lender control based on overreaching, pledge and participation rights; conversion options and rights, equity kickers (including contingent interest and shared appreciation), and lack of independent and adequate consideration for the participating features of the transaction. The mezzanine capital provider normally will seek the right to take over, or at least participate in, the management and control (to prevent certain unwanted actions and consequences, such as bankruptcy) of the borrowing entity in the event of a default, and also may seek the alternative or additional right to convert its debt interest to an equity ownership interest in the borrower. The parties could utilize a variety of techniques to accomplish this purpose, including the grant by the borrower of the right to convert the lender's mortgage interest to a limited partnership interest in the borrowing entity upon the occurrence of a future stipulated event, or the grant to the lender of options or warrants to purchase the stock of a corporate borrowing entity. *See* RESTATEMENT § 3.1 at 103 (stating that "[a]n inflexible application of the clogging principle could render questionable the enforceability of such warrants [to purchase stock in the corporate mortgagor] because they enable the mortgagee to acquire indirectly an interest in corporate real estate without resort to foreclosure"). The mezzanine-financing provider also may seek to take a security assignment of any or all other (non-mortgage) collateral of the borrower.

There also may be a significant regarding which state's case and statutory law should apply to a clogging claim, because many mezzanine financings involve multi-site and multi-state transactions and/or provide that a specific state's law (often New York) exclusively governs all enforcement actions under the mortgage and other loan documents.

The mezzanine mortgage lender may require the borrower to execute an Owner's Certificate, or "anti-clogging affidavit," to be signed by the borrowing entity, which seeks to assure the mortgagee (and its counsel) that the feature of the mortgage loan providing the mortgagee with an option to purchase an equity interest in the mortgagor, upon the happening of a future occurrence or contingency, does not constitute a clog on the mortgagor's equity of redemption. The title insurance company that is asked to insure the transaction will need to carefully review the form and substance of this document.

Title insurance coverage issues with respect to clogging claims commonly arise in connection with mortgage transactions providing for the granting of an option to purchase to the mortgagee (whether the purchaser is granted an option to purchase the mortgaged

property or an equity interest in the borrowing entity). In certain instances, after careful underwriting and risk analysis based on the documentation and the facts of a particular transaction, and depending on applicable state statutory or case law (as well as regulatory considerations), title insurance companies issuing mortgagees' polices may be persuaded to issue a limited affirmative endorsement over the clogging issue and acknowledge the mortgagee's continuing right to its foreclosure remedies (although, at least arguably, the standard mortgagee's loan policy already provides this coverage unless a specific exception has been raised or the title insurer is not aware of the additional rights given to the mortgagee that might result in a clogging claim). This is so because, even if an option to purchase (or other collateral right) granted to a mortgagee in connection with a mortgage transaction is subsequently determined by a court to constitute an impermissible and unenforceable clog on the borrower's right of redemption, the court will most likely still permit the mortgagee to exercises its usual foreclosure remedies that arise as the result of the mortgagor's default; it just won't be permitted to exercise the additional rights that constitute a clog.

When a mortgagee wishes to obtain an option to purchase in connection with a mortgage loan, it will commonly ask the title insurer for insurance with respect to the option to purchase. The request may be for an endorsement to the loan policy that affirmatively insures the validity and priority of the option and specifically incorporates the option to purchase into Schedule A of the policy as an interest insured thereby. The availability of such an endorsement may depend on the existence of a state statute establishing the enforceability of such an option or case law in the jurisdiction that supports such a transaction, as well as consideration of other legal and underwriting factors.

There is virtually no case law yet that has applied the clogging doctrine specifically to mezzanine financing transactions, although mortgagees should be aware of the potential clogging issues mentioned elsewhere in this article when drafting documentation to evidence and secure these types of transactions. Hopefully, the courts will not take an overly restrictive view of the clogging doctrine as applied to mezzanine financing transactions. *See* Richard R. Goldberg, *Convertible Mortgage Anti-Clogging Affidavit*, Real Estate Financing Documentation: Coping with the New Realities, ALI-ABA Course of Study, Jan. 16-18, 1997 at 309; Richard R. Goldberg, *Convertible Mortgage Option Agreement*, Real Estate Financing Documentation: Coping with the New Realities, ALI-ABA Course of Study, Jan. 16-18, 1997 at 291; Howard E. Kane, *The Prohibition Against Clogging the Equity of Redemption*: *Recent Developments*, Tab 6 at 19 (April 4-5, 1997) (American College of Real Estate Lawyers Annual Meeting on Finance Topics); John C. Murray, *supra*, *Clogging Revisited*, 33 REAL PROP. PROB. & TR. J. AT 280, 302-07.

See RESTATEMENT § 3.1 at 103 ("An overly dogmatic approach to options granted to mortgagees in loan transactions will unduly discourage the flow of capital to a variety of socially useful projects.").

The various forms of title-insurance endorsements that may be available to protect mezzanine lenders from clogging issues are discussed in the title insurance section of this article, *infra*.

Other Legal Issues

Providers of mezzanine capital must also address potential lender liability issues, usually resulting from allegations of lender control based on conversion, pledge and participation rights, "equity kickers," contingent interest and convertible options. As mentioned earlier in this article, the mezzanine capital provider will normally seek the right to take over, or at least participate in, the management and control (to prevent certain unwanted actions and consequences, such as bankruptcy) of the borrowing entity in the event of a default, and may seek the right to convert its debt interest to a partnership interest in the borrower. The provider of mezzanine financing may also seek take a security assignment of any and all other (non-mortgage) collateral of the borrower. The mezzanine lender must further be concerned about possible environmental liability as a "potentially responsible party," based on control of the borrower or its business, or management and operation of the property.

Other areas of concern include:

(1) The mezzanine lender's ability to exercise its contractual or legal remedies with respect to obtaining, or enforcing, an interest as a partner or participant of the borrower.

(2) Bankruptcy of the borrower entity, including treatment of the mezzanine lender as an "insider" and possible equitable subordination of the lender's interest.

(3) Recharacterization of the mezzanine lender's interest.

(4) Approval rights of prior vs. subordinate lenders, including the scope, limits and timing of such rights (e.g., with respect to lease negotiations). Both the first mortgage lender and the mezzanine lender will want the right to terminate the property manager (and select or approve the new property manager) if DSCR falls below a specified (and realistic) ratio.

(5) Consolidation issues. For securitization purposes and approval by the rating agencies, the mortgage borrower must (as noted earlier in this article) be a bankruptcy-remote entity and separate from the mezzanine borrower (and, perhaps, from any "upper-tier" mortgage borrower entities). The rating agencies will require a non-consolidation opinion from the mezzanine borrower's counsel and evidence that the borrowing entity itself is not liable for the mezzanine loan.

(6) Unlike typical subordinate mortgage financing, a default under the mortgage loan will constitute a default under the mezzanine loan, but not vice versa.

(7) The prepayment penalty provision in the senior lender's loan documents may be triggered if the mezzanine lender is granted the option to buy the mortgage loan.

(8) Respective maturity dates. The rating agencies normally require a slightly longer term for mezzanine loans because of the perceived increase in bankruptcy risk.

(9) Hyperamortization. If the mezzanine loan is not paid off at the end of the initial term, the loan may be extended if there is no default and a satisfactory DSCR, but the interest rate is normally increased substantially and all net cash flow is applied to reduction of principal, in order to incentivize the borrower to obtain refinancing from another source.

(10) Creation of a lock-box arrangement (which may consist of one lock-box for both lenders or separate lock-box arrangements for each lender) to enable the mortgage lender and the mezzanine lender to strictly control and monitor the receipt and disbursement of rents and other income from the property. The mezzanine lender receives net funds from the income "waterfall" only after all operating expenses, reserves and first mortgage debt service have been funded.

(11) Usury (based on contingent or speculative interests granted to the lender).

(12) Negotiation and implementation of complex intercreditor agreements.

Mortgage covenants customarily required by mezzanine lenders with respect to such matters as the establishment of tax and insurance escrows, the approval of leases (and lease forms) and property managers, and access to the borrower's books and records, may be waived or restricted if the borrower has a significant net worth and an established credit and operating history.

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There are also tax consequences (including ERISA issues) that must be addressed in connection with mezzanine lending, especially in those situations where tax-exempt investors provide the mezzanine capital. If debt is recharacterized as equity, any interest deductions taken by the property owner will not be allowed and will be treated as distributions or dividends, and profits and losses will be reallocated in ways not intended or desired by the parties. If the creditor is deemed to in fact be a partner, a proportionate share of the entity's income and losses will be allocated to such "partner." *See Farley Realty Corporation v. Comm'r*, 279 F. 2d 701 (2d Cir. 1960), *aff'g* TCM 422 (1959).

See generally Jack M. Feder, *Either a Partner or a Lender Be: Emerging Issues in Real Estate Finance*, 26 TAX LAW. 191 (1983); William B. Dunn, *Overview of Today's*

World of Financing, REAL ESTATE 2000: A PRACTITIONER'S GUIDE FOR TE RESURGENCE OF TE REAL ESTATE MARKET, Tab A at 4-7 (July 23-26, 1997) (Twenty-Second Annual Summer Conference, State Bar of Michigan Real Property Law Section); Philip M. Horowitz, *Co-Lending Arrangements*, Tab 9 (American College of Real Estate Lawyers Annual Meeting on Finance Topics) (April 4-5, 1997); William G. Murray, *Filling the Gaps*, Finance Topics, American College of Real Estate Lawyers Annual Meeting, Scottsdale, Arizona (April 4-5, 1997), Tab 22; Lawrence G. Preble, *Who's On First? Negotiating Intercreditor Agreements With Senior and Subordinate Debt,* Finance Topics, American College of Real Estate Lawyers Annual Meeting, Scottsdale, Arizona (April 4-5, 1997), Tab 23; Harris Ominsky, *Construction Finance-Mezzanine Debt/Super Equity Issues*, WE'RE THE GOVERNMENT AND WE'RE HERE TO HELP: NEGOTIATE, NEGOTIATE, NEGOTIATE, Tab 12 (October 16-17, 1998) (American College of Real Estate Lawyers Fall Meeting); Laurence G. Preble, *Who's On First? Negotiating Intercreditor Agreements With Senior and Subordinate Debt*, Tab 23 (April 4-5, 1997) (American College of Real Estate Lawyers Annual Meeting on Finance Topics); Andrew L. Herz, *Mezzanine Financing*, 428 PLI/Real 747, 752 (1998); Mark Finerman, *The Return of Mezzanine Capital*, 11 REAL EST. FIN. REV. 17 (1998).

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Title Insurance

Title insurance coverage issues with respect to clogging claims arise most commonly in connection with mortgage transactions providing for the grant of an option to the mortgagee to purchase the secured property. In certain instances, after careful underwriting and risk analysis based on the documentation and the facts of a particular transaction, and depending on applicable state statutory or case law (as well as regulatory considerations), the title insurer may be persuaded to insure the mortgagee's right to exercise the option.

Even if a purchase option (or other collateral right) granted to a mortgagee in connection with a mortgage transaction is subsequently determined by a court to constitute an impermissible and unenforceable clog on the borrower's right of redemption, the court may still permit the mortgagee to exercise its usual foreclosure remedies that arise as the result of the mortgagor's default; the mortgagee just will not be permitted to exercise the additional rights that constitute a clog.

Because the mortgage loan and the option to purchase represent two separate and distinct interests in the property, the mortgage lender may request, and the title insurer may issue, two separate policies—a mortgagee's policy for the loan and an owner's policy for the option to purchase. Although the owner's policy for the option will insure the validity of the option, it will not insure against further sale or alienation of the property by the mortgagor or the failure of the mortgagee to fulfill the conditions of the option. Furthermore, the policy will not insure as to liens or encumbrances that may attach to the property after issuance of the policy or with respect to any liens or encumbrances created or suffered by (or agreed or consented to) by the mortgagor or created by statute (including real estate taxes, special assessments, demolition liens,

drainage liens and water liens). In addition, the policy will not insure as to the right of the mortgagee to any award to be distributed as the result of any condemnation proceeding affecting the mortgaged property. The policy also will exclude coverage for any mechanic's lien claims whether incurred prior to or after the date of the policy or endorsement, as well as any expenses required to obtain conveyances, releases, rights, interests, or liens of record known to the mortgagee at the time of the exercise of the option. For a sample form of title endorsement for an option to purchase granted in connection with the secured property, see **Exhibit "A"** attached hereto. This endorsement is used only with respect to owners' policies in which the optionee is named as insured. It is a mandatory addition to the optionee's policy, and affords coverage to the optionee that the option is valid and that the rights of the optionee under the option are vested in the insured.

The mortgagee must bring any necessary suit, at his or her own expense, to enforce his or her claim to a deed to the secured property from the party vested in title and to obtain the removal or discharge of any subsequent liens against the property. Also, because the option to purchase may be considered an executory contract under section 365 of the Bankruptcy Code, and could be assumed or rejected by a trustee in bankruptcy or a debtor in possession, the title insurer will not want to remove the creditors' rights exclusion from the title policy. *See* 11 U.S.C. § 365(a) (1994). The Bankruptcy Code does not define "executory contract." An executory contract has been described generally as a contract in which obligations remain to be performed by both sides. *See National Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513, 522-23 n.6 (1984) (holding that an executory contract is one "on which performance remains due to some extent on both sides"); *Griffel v. Murphy* (*In re Wegner*), 839 F.2d 533, 536 (9th Cir. 1988) (ruling that a contract is executory if "the obligations of both parties are so unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other"); *In re Anchor Resolution Corp*., 1998 WL 300577 (Bankr. D. Del. 1998) at *6 (citing *Enterprise Energy Corp. v. United States (In re Columbia Gas Sys. Inc.*), 50 F.2d 233, 239 (3d Cir. 1995)); Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L.REV. 439, 460 (1973).

With respect to the issue of whether an option to purchase constitutes an executory contract that can be rejected under section 365(a) of the Bankruptcy Code, *see In re Helms*, 139 F.3d 702, 706 (9th Cir. 1997) (en banc), in which the court held that whether an option is an executory contract depends on whether the option requires further performance from each party at the time the bankruptcy petition is filed, and that performance that is due at the sole discretion of the optionee (*i.e.*, the decision by the optionee whether or not to exercise the option), "doesn't count unless he has chosen to exercise it." The court stated that an option to purchase may on occasion be deemed an executory contract "where the optionee has announced that he is exercising the option, but [has] not yet followed through with the purchase at the option price." The Ninth Circuit in *In re Helms* expressly overruled its previous decision in *Gill v. Easebe Enters.* (*In re Easebe Enters*.), 900 F.2d 1417, 1419 (9th Cir. 1990), which held that all options are executory. Cases holding that an option to purchase is an executory contract under

section 365 of the Bankruptcy Code include *Steffan v. McMillan* (*In re Coordinated Fin. Planning Corp.*), 65 B.R. 711, 713 (9th Cir. B.A.P. 1986); *Horton v. Rehbein* (*In re Rehbein*), 60 B.R. 436, 441 n.6 (9th Cir. B.A.P. 1986); *Rivercity v. Herpel* (*In re Jackson Brewing Co.*), 567 F.2d 618, 623-24 (5th Cir. 1978); *In re* A.*J. Lane & Co.*,107 B.R. 435, 437 (Bankr. D. Mass. 1989); *In re Hardle*, 100 B.R. 284, 287 (Bankr. E.D.N.C. 1989); *In re G-N Partners*, 48 B.R. 462, 465 (Bankr. D. Minn. 1985); *In re Waldron*, 36 B.R. 633, 6360-40 (Bankr. S.D. Fla. 1984), *rev'd on other grounds*, 785 F.2d 936 (11th Cir. 1986).

Other bankruptcy court decisions, however, hold that an option contract is not an executory contract. *See, e.g., Brown v. Snellen* (*In re Geising*), 96 B.R. 229, 232 (Bankr. C.D. Mo. 1989); *In re Lewis*, 94 B.R. 478, 495 (Bankr. D. Mass. 1988); *Travelodge Int'l, Inc. v. Continental Properties, Inc.* (*In re Continental Properties II, Inc.*), 15 B.R. 732, 736 (Bankr. D. Haw. 1981). *See also* 1 WILLISTON ON CONTRACTS § 5:16 (4th ed. 1990) ("The traditional view regards an option as a unilateral contract which binds the optionee to do nothing, but grants him the right to accept or reject the offer in accordance with its terms within the time and in the manner specified in the option."); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 COLO. L.REV. 845, 898-99 (1988) (discussing problems surrounding a bankruptcy trustee's option to reject any executory contract).

The title insurer may also, under certain circumstances, require that the option to purchase granted to the mortgagee contain an "unwind" provision that would permit the mortgagor to repurchase the option for a stipulated fee or charge. This would nullify the mortgagee's option right and preserve the mortgagor's right of redemption in the event of a subsequent default by the mortgagor and foreclosure by the mortgagee.

The document containing the option to purchase normally will be recorded prior to the mortgage, so that the option will survive the mortgage's subsequent foreclosure or extinguishment. The owner's policy could then show the existence of the mortgage lien as an encumbrance subordinate to the option to purchase.

According to one commentator, the measure of damages under the policy would be determined by

> (A) the excess of the fair market value of the property at the time the insured attempts to exercise the option (or when a lawsuit contesting the validity of the option is filed, if filed prior to the attempted exercise of the option) above the price at which the insured could acquire the property by exercise of the option; and (B) the unreimbursed portion of the consideration given by the insured to obtain the option.

See Raymond J. Werner, *Endorsements and Affirmative Coverages for Commercial Title Insurance*, TITLE INSURANCE 1997, 1047, 1098-99 (PLI Handbook 1997).

A sample form of an Owner's Certificate, or "anti-clogging affidavit," is attached hereto as **Exhibit "B."** The borrowing entity executes and delivers such a certificate, in connection with a mezzanine financing transaction, to assure the mortgagee (and its counsel, as well as the title insurer) that the feature of the mortgage loan that provides the mortgagee with an option to purchase an equity interest in the mortgagor when a future occurrence or contingency happens, does not constitute a clog on the mortgagor's equity of redemption. This affidavit applies to a situation where the lender has the right to purchase a limited partnership interest in the borrower. It refers to the option agreement of even date that grants the lender the option to purchase the partnership interest. It further recites that the borrower and its principals are sophisticated and experienced in real estate matters, have been advised by competent and experienced legal counsel, have paid separate and adequate consideration for the option, and acknowledge that the transaction will not trigger application of the clogging doctrine. Hopefully, the provisions of this type of affidavit will be held to be valid and enforceable by the courts. *See* RESTATEMENT § 3.1 at 103 ("An overly dogmatic approach to options granted to mortgagees in loan transactions will unduly discourage the flow of capital to a variety of socially useful projects.").

Sample forms of clogging endorsements are attached hereto as **Exhibits "C"-"E."** These endorsements may be available only in exceptional circumstances, and are always subject to the particular facts of the transaction, careful underwriting analysis and document review, and regulatory and statutory prohibitions and restrictions.

Conclusion

Mezzanine lending is used to describe financing that fills the gap between debt and equity. It has become one of the major sources of financing for lenders who want to stay on the cutting edge of creative commercial lending. First-mortgage lending has become more of a commodity since the revitalization of the capital markets in the mid-1990s. Prior to this time, the mezzanine lender would provide conventional subordinate real-estate financing to the borrower, secured by a second mortgage on the property. When a loan workout, foreclosure or bankruptcy ensued, disputes often resulted regarding the respective rights and obligations of the first and second lienholders. Wearying of such battles, first-mortgage lenders severely restricted the right of borrowers to permit subordinate financing secured by the mortgaged property. The rating agencies, equally concerned about these issues, also severely restricted the ability of a borrowing entity to place subordinate financing on a property that was to be part of a securitization. Mezzanine financing, which arose to address these concerns, effectively transforms a second mortgage into a senior equity security interest, with a fixed or floating interest rate similar to a mortgage, and an amortization schedule. If the borrower defaults, the mezzanine lender has the right to succeed to the ownership and control of the equity interest of the borrower. This enables the mezzanine lender to (at least theoretically) prevent a bankruptcy filing by the borrower and immediately collect and possess the cash flow without having to foreclose on the property. However, as noted in this article, there are many legal concerns that must be addressed, and no established body of law exists to provide guidance in this area. Counsel for mezzanine lenders should closely monitor

developing case and statutory law with respect to mezzanine financing. They should also work closely with the title insurer. Although title insurers may be understandably reluctant to offer special coverages or endorsements for mezzanine-financing transactions, they may be able to alleviate some of the lenders' concerns in connection with these types of transactions.

EXHIBIT "A"

OPTIONEE'S ENDORSEMENT

Attached to Policy No. ______

Issued By
____________________ Title Insurance Company

The Company hereby assures the Insured that the option to purchase referred to in paragraph _____ of Schedule B is at the date hereof valid, and that the rights of the optionee under said option are vested in the Insured. Said option is shown in Schedule B Part II in its order of priority of record.

The Company hereby insures the Insured against loss which said Insured shall sustain in the event the assurances herein shall prove to be incorrect.

Notwithstanding the provisions contained in the conditions and stipulations of the policy of which this endorsement is a part the coverage afforded by said policy and this endorsement shall cease and terminate upon the exercise of said option or on the date the option expires by its own terms, whichever occurs first.

Part I of Schedule B of said policy is hereby amended by the addition of the following paragraph as the last numbered paragraph thereof:

Terms, provisions and conditions, and any failure to comply with same, as contained in the Option Agreement dated _________ by and between
____ as optionor and
____ as optionee as evidenced by that certain instrument which recorded on _________________ in book ________ page _________ Official Records _________________ County.

This endorsement is made a part of the policy and is subject to all of the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

____________________ Title Insurance Company

By: ____

Authorized Signatory

EXHIBIT "B"

OWNER'S CERTIFICATE

THIS CERTIFICATE is made as of the _____ day of _______________, 19___, by ____________________ Limited Partnership, a _______________ limited partnership ("Owner"), to and for the benefit of ____________________, Inc., a _______________ corporation ("__________"), and ____________________ banking corporation, as agent and investment manager for ____________________, a _______________ corporation under the Investment Management Agreement dated __________, 19___ and the Participation Agreement dated __________, 19___ (____________________ and ____________________ being collectively referred to as "Option Holder").

RECITALS

A. Pursuant to that certain Loan Agreement dated as of __________, 19___ (the "Loan Agreement") by and between Owner, as borrower, and Option Holder, as lender, Option Holder has agreed to loan to Owner up to __________ million and __________ thousand dollars ($__________) ("Loan"), such Loan to be secured, inter alia, by a [mortgage] [deed of trust] on certain improved real property owned by Owner located in the City of _______________, _______________ ("Property").

B. Pursuant to that certain Option Agreement dated as of the date hereof ("Option Agreement") by and between Owner and Option Holder, Owner has granted to Option Holder an option ("Option") to purchase from Owner a Class B Limited Partnership Interest in Owner (as defined in the Option Agreement) and to become a Class B limited partner in Owner on the terms and subject to the conditions contained in the Option Agreement.

In order to induce Option Holder to execute and deliver the Loan Agreement and to consummate the transactions contemplated therein and to induce Option Holder to execute and deliver the Option Agreement and pay the Option Fee (as hereinafter defined), Owner hereby certifies to Option Holder and agrees with Option Holder as follows:

1. Owner and its general partner are sophisticated and experienced in the fields of real estate development, operation and financing.

2. In connection with the negotiation of the terms of the Loan Agreement, the Option Agreement and the documents attached as exhibits thereto, Owner has been represented by competent and experienced legal counsel of its choice.

3. As consideration for the Option, Owner has received an option fee of $__________ hundred thousand dollars ($__________) ("Option Fee") from Option Holder.

4. In addition to the Option Fee, Option Holder's making the Loan to Owner constitutes additional consideration to Owner for Owner's granting the Option to Option Holder because the Loan is made upon terms more favorable to Owner than terms currently available from other lenders when no such option is granted. Such favorable terms include a below-market interest rate and a loan-to-value ratio, which is greater than that which is generally available for conventional mortgage loans. Owner is not willing to sell the Property or any percentage thereof at the present time, but is instead willing to grant the Option to permit the purchase of the Class B Limited Partnership Interest in Owner by Option Holder at a future date. Owner is further desirous of borrowing funds against the security of the Property and in partial consideration for the favorable terms of the Loan Owner has agreed to grant the Option to Option Holder.

5. Owner acknowledges that the ability of Option Holder to exercise the Option in accordance with its terms is a material benefit to Option Holder, bargained for and supported by the consideration to Owner described above, including the payment by Option Holder of the Option Fee upon execution of the Option Agreement. Accordingly, Owner understands and agrees that any attempt to prevent Option Holder from enforcing the Option in accordance with its terms would deny Option Holder a material portion of the benefit of its bargain embodied in the transactions contemplated by Owner and Option Holder.

6. Owner has discussed with its legal counsel the doctrine of "clogging of the equity of redemption" and understands that such doctrine has sometimes been applied in certain cases to prevent enforcement of options or deeds given to secured lenders. Owner has been advised by its counsel that such doctrine should not be applied in circumstances such as those that exist in the transaction between Option Holder and Owner contemplated herein to invalidate the Option or prevent its exercise, and Owner understands and agrees that its counsel may rely upon this Certificate in rendering such advice. Owner represents and agrees that the Option is based on independent, bargained-for and significant consideration and is not intended to be a clog or other restraint on Owner's equity of redemption or a contract for the forfeiture of property subject to a lien in satisfaction of the obligation secured thereby.

WITNESS the execution of this Certificate as of the date first above written.

_______________ PARTNERSHIP,
a __________ limited partnership

By ____________________
General Partner

By_____________________
Name:__________________
Title:___________________

EXHIBIT “C”

CLOGGING THE EQUITY ENDORSEMENT (OPTION TO PURCHASE)

Attached to Policy No.

Issued By

_______________ Title Insurance Company

The Company hereby insures the insured against loss or damage the insured shall sustain by reason of a final judgment determining that the Option to Purchase Real Property in accordance with the terms set forth in the Promissory Note secured by the lien of the insured mortgage is invalid or unenforceable because said Option constitutes a “clog” on the mortgagor’s equity of redemption, a fettering of the property, granting of a collateral advantage or other restraint on the mortgagor’s equity of redemption, or an unreasonable restraint on the mortgagor’s rights of alienation.

This endorsement is made a part of the policy and is subject to all of the terms and provisions thereof and any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

_______________ Title Insurance Company

By: ____
Authorized Signatory

EXHIBIT "D"

CLOGGING THE EQUITY ENDORSEMENT (ALTERNATIVE)

Attached to Policy No.

Issued By

_______________ Title Insurance Company

The Company hereby insures the insured against loss or damage the insured shall sustain by reason of the invalidity, unenforceability, or impairment of priority of the lien of the insured mortgage by reason of the collateral rights (alternative: Option to Purchase Real Estate) benefiting the Insured, contained in the Loan Agreement between _______________ and _______________, including, without limitation, any invalidity, unenforceability or impairment of the lien of the insured mortgage resulting from the application of the legal theory known as the clogging of the equity of redemption.

This endorsement is made a part of the policy and is subject to all of the terms and provisions thereof and any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

_______________ Title Insurance Company

By: ____

Authorized Signatory

EXHIBIT "E"

CLOGGING THE EQUITY ENDORSEMENT (MEZZANINE LOAN)

Attached to Policy No.

Issued By

_______________ Title Insurance Company

The Company hereby insures the insured against loss or damage the insured shall sustain by reason of a claim that the lien of the insured mortgage is either invalid or unenforceable or its priority, as insured, is impaired by reason of the fact that the provisions (i) contained in Section _____ entitled "Partnership Warrants" and Article _____ entitled "Buy-Sell Agreement" and (ii) providing for the calculation or payment of monetary sums secured by the insured mortgage, set forth in that certain Loan Agreement dated ____________, ______, by and between _______________ Limited Partnership, as borrower and _______________, as lender, by themselves constitute a clogging of the equity of redemption of the borrower.

This endorsement is made a part of the policy and is subject to all of the terms and provisions thereof and any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

_______________ Title Insurance Company

By: ____
Authorized Signatory