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A Subtle New Pitfall For Mezzanine Loan Borrowers

Joshua Stein Contributor

Real Estate

I write about commercial real estate negotiations, deals and legal issues.

Mezzanine loans contain multitudes of surprises. ULLSTEIN BILD VIA GETTY IMAGES

Commercial real estate financing structures often include not only mortgage loans but also mezzanine loans. These latter loans are secured by pledges of ownership interests in the mortgage borrower. If the mezzanine loan defaults, the mezzanine lender can foreclose on the

ownership interests in the mortgage borrower. Through that foreclosure, the mezzanine lender, or sometimes a third party, will acquire ownership of the mortgage borrower, keeping the mortgage in place. The new owner of the mortgage borrower will need to deal with the mortgage. Mezzanine loans bear interest rates higher than mortgage loans because they entail more risk.

Mezzanine loans are, however, full of surprises. Here's one that many people in the business haven't considered.

After a mezzanine loan foreclosure, the new owner of the mortgage borrower gains legal control of everything the mortgage borrower owns. Although the mortgage borrower's real estate is the main event, the mortgage borrower also owns all its past communications, including any with its attorneys.

Those communications may include juicy discussions about the mortgage loan and mortgage lender that the former (post-mezzanine-loan foreclosure) principals of the mortgage borrower would not want any lender or other third party to see. The former principals' communications with counsel are probably covered by the attorney-client privilege – but the ownership of that privilege stays with the mortgage borrower. Whoever acquires ownership of the mortgage borrower through a mezzanine loan foreclosure will thus gain the legal right of access to all communications of the former principals of the mortgage borrower with their counsel. That can't be good, and it could be very bad, for the former principals. For example, in the worst case the mortgage lender or its affiliate could end up owning the mortgage borrower and could use the former principals' emails to support theories for recourse liability against a guarantor.

The problem the former principals would face looks much like the problem potentially faced by sellers of a corporation's stock. In a corporate stock sale, the buyer of the stock will obtain control of the

corporation's attorney-client privilege and email archives, which could be awkward for the sellers. But parties to corporate deals and their counsel are typically more attuned to these issues than real estate players and their counsel tend to be.

Careful mortgage borrowers can try to keep the potential new owner "enemy" out of their pre-foreclosure communications by making sure the mezzanine loan documents contain appropriate exclusions and waivers. Since a mezzanine lender will probably not think of those communications as valuable collateral, the lender just might accommodate the borrower's request. Then the borrower will need to assure that, at the time of any foreclosure, all communications are safely beyond the reach of any potential "enemy," i.e., any new owner of the mortgage borrower.

Can the principals protect themselves by never having any communications on behalf of the mortgage borrower? The mortgage borrower doesn't need to have an email account. All sensitive communications can go directly to and from the principals without visibly involving the mortgage borrower. If, however, any communications relate specifically to the mortgage borrower and its affairs, the principals will have trouble arguing that the mortgage borrower entity doesn't own those communications. And the principals probably won't always remember, or be able, to dress up communications related to the mortgage loan in ways that separate them from the mortgage borrower.

It's safer to deal with the issue in the mezzanine loan documents, by protecting ownership and control of any communications on behalf of the mortgage borrower and any attorney-client privilege that should travel with them.

Joshua Stein

I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

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