

## **Asset-Based Financing and Mezzanine Lending Playing Larger Role in Real Estate Transactions**

*By Lawrence P. Schnapf*

Until the financial markets seized up in August, securitized loans were the dominant form of financing for office towers, apartment buildings and shopping centers. Conduit lenders who originated the securitized loans did not hold loans on their books like traditional lenders but sold them to investors. As a result, the conduit lenders reportedly did not require rigorous due diligence and allowed their underwriting standards to erode as they chased the lucrative fees associated with securitized loans. Indeed, the emergence of so-called commodity due diligence shops was a result in large part from the incredible growth in securitized loans.

Since the era of the “Henny Youngman economy” (take my money please) ended, some studies estimate that the volume of securitized loans has fallen off by as much as 90%. While lenders have tightened the lending reins, borrowers with highly-leveraged bridge loans that were based on projected rent increases or property appreciation are having to sell properties to refinance their loans, contribute additional equity or seek mezzanine debt to fill the financing gap.

In real estate deals, mezzanine debt occupies the middle ground between the secured creditors who have first priority liens and a property owner’s equity. Mezzanine investors are willing to invest in properties because they are able to demand yields in the teens and are positioned to take over the property if the owner defaults on its mezzanine debt. Indeed, much mezzanine debt is called “hard mortgages” because the investors follow a “loan to own” investment model where the investors actually anticipate there is a good likelihood that they will take control of the property and eventually sell it for a profit. Many of the remediation funds that provide up-capital for

the cleanup of property that is to be developed follow the loan-to-own strategy.

The mezzanine investor typically takes an interest in the entity that owns the building or property as opposed to the actual real estate. As a result, mezzanine lenders will usually not commission their own Phase I ESA reports but usually “piggy-back” or review the reports generated by the senior lender.

Another form of lending that is returning to prominence is asset-based lending or commercial finance. These loans are typically extended to businesses and are collateralized by liens on equipment, inventory, accounts receivables and mortgages. These lenders will hold the loans and foreclose on their collateral if the borrower defaults. Indeed, most of the early lender liability caselaw such as Fleet Factors involved a variety of asset-based lenders. These lenders will usually perform Phase I ESA reports prior to closing on a loan and should also perform additional environmental diligence prior to foreclosing on the facility or personal property of a defaulted borrower. The HSBC settlement that was discussed in SEJ earlier this year was an example of a defaulted asset-based loan where the lender did not follow prudent foreclosure procedures.

*Commentary: SEJ has been periodically discussing trends in real estate and corporate financing so subscribers can better understand client’s needs and also help subscribers position themselves to take advantage of market opportunities. When designing environmental due diligence for a client, a consultant should take time to understand the nature of the transaction to better understand the potential risks facing the client as well as determine the particular risk threshold of the client.*