

New York Lawmakers Re-introduce Legislation to Impose Recording Tax on Mezzanine Loans and Preferred Equity Investments

By: Tim Davis, Eric Sauter, Meredith Bieber and Brian Kim

Real Estate Alert

2.1.23

New York State lawmakers have reintroduced proposals to impose a tax on the creation of mezzanine debt and preferred equity. Both the New York Senate and Assembly have put forward similar bills that would require both mezzanine lenders and preferred equity investors to file a UCC-1 financing statement and pay a mortgage recording tax in order to perfect a security interest with respect to mezzanine loans and preferred equity investments. The bills were introduced on January 4, 2023 by the New York State Senate as Bill S-318, which parallels the previous S-7231A bill, and its counterpart by the New York State Assembly as Bill A407, which mirrors the previous A9041 bill. (Please see our previous *Real Estate Alert* commenting on the previous iterations of this bill here.)

The proposed legislation would impose the New York State mortgage recording tax (and permit counties and authorized cities to impose a mortgage recording tax) on both mezzanine loans and preferred equity investments, effectively treating mezzanine loans and preferred equity investment akin to mortgage loans on real estate. The proposals would (1) amend the Uniform Commercial Code (UCC) as adopted in New York to require filing a UCC-financing-statement evidencing any "mezzanine debt" or "preferred equity investment" be filed at the county level in order to perfect a security interest with respect to the same, and (2) levy a tax at the applicable New York State and county (or authorized city, as applicable) mortgage recording tax rate on such debt and/or investment at the time the financing statement is filed. The proposed legislation would not extend recording requirements or recording taxes to debt on cooperative or common shares of a residential dwelling.

If enacted, the legislation would amend New York's Real Property Law by, *inter alia*, adding a new Section 291-k, defining "mezzanine debt" and "preferred equity investments" as follows:

"...debt carried by a borrower that may be subordinate to the primary lien [sic: of a mortgage] and is senior to the common shares of an entity [sic: or person having an interest in such borrower] or the borrower's equity and reported as assets for the purposes of financing such primary lien. This shall include non-traditional financing techniques such as a direct or indirect investment by a financing source in an entity that owns the equality [sic: equity] interests of the underlying mortgage [sic: mortgage borrower] where the financing source has special rights or preferred rights such as: (i) the right to receive a special or preferred rate of return on its capital investment; and (ii) the right to an accelerated repayment of the investors capital contribution."

Some apparent clarifications and corrections are assumed and bracketed above. But without careful editing and additional precision, such legislative draftsmanship equating equity and debt, and investors with borrowers, could significantly disrupt the stability and integrity of the capital stack available for commercial real estate transactions in the State of New York. Critics of the proposed legislation have also been quick to point out that it does not offer guidance concerning mezzanine debt financings and preferred equity investments that do not occur simultaneously with a mortgage financing and recording. The proposed legislation requires financing statement(s) and the payment of such tax(es) only when the origination of a mezzanine financing and/or preferred equity investment occurs simultaneously with the recording of a mortgage securing a "related" mortgage loan.

Moreover, the proposed legislation subjugates the widely accepted practice of perfection-by-control under Article 8 of the UCC to the filing standards of Article 9 as the necessary means of perfecting a party's security interest covering mezzanine debt (and in some instances, preferred equity) in New York. Security interests covering mezzanine debt (and in some instances, preferred equity) are commonly perfected by delivering the pledgor's certificated stock or limited liability company interests in the subject entity to the control of the beneficiary of the pledge. Such standard practice usually involves such subject entity "opting-in" to Article 8 under such entity's organizational documents.

As currently proposed, the consequence or penalty for the failure to (i) file a financing statement and (ii) pay the recording tax would be that the holder of the mezzanine loan or preferred equity investment would be barred from enforcing remedies under Article 9 of the UCC. If there was ever an expectation the UCC would promote and encourage the adoption of uniform principles and application, the proposed legislation would render New York an outlier while offering no guidance concerning the enforcement of such principles pertaining to Article 8 of the UCC, particularly in respect to multi-jurisdictional and/or multi-asset secured transactions.

If ratified, the proposed legislation could likely have significant impact on real estate financing and the structuring of real estate transactions in New York. Mezzanine loan and preferred equity investments would be treated more like mortgage loans, increasing the cost of financings and investments. Currently, mortgage recording tax in New York range from 1.0% to 2.8% depending on the county, property use, and loan amount.

We expect that many industry stakeholders will follow with great interest this latest attempt to tax mezzanine debt and preferred equity transactions in New York. We will continue to monitor the progress of this proposed legislation and any changes to it and will provide further updates.

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.

