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NY Lenders May Face Barriers In Real Estate Dispositions

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As the country entered into an extended period of lockdowns this spring, there was widespread concern that the anticipated severe economic impact of the pandemic would lead to a wave of defaults and foreclosures in the commercial real estate market.

In response to these concerns, New York Gov. Andrew Cuomo enacted a series of executive orders suspending all commercial eviction and foreclosure proceedings in the state.[1] There remained some ambiguity, however, as to whether these orders applied to the disposition of collateral securing a loan under Article 9 of the Uniform Commercial Code, or UCC.

Three recent decisions in New York County Supreme Court demonstrate that although the governor's executive orders do not expressly bar UCC dispositions from moving forward, courts have imposed some barriers on the lenders' ability to dispose of the collateral during the ongoing pandemic.

These court decisions relate to nonjudicial dispositions of collateral securing mezzanine loans in the commercial real estate industry.

A typical mezzanine loan structure involves a loan made by a lender to an entity — the mezzanine borrower — that owns 100% of the interests in a special purpose entity — typically a limited liability company — that owns a commercial real estate property with the mezzanine loan secured by a mezzanine borrower's pledge of its ownership interest in the property owner entity.

Such a loan is called mezzanine because it is made to an entity above the property owner entity in the ownership structure.

If a mezzanine borrower defaults under a mezzanine loan beyond any applicable notice and cure period, the mezzanine lender may, among other things, "sell, lease, license or otherwise dispose of any or all of the collateral" subject to the terms of the applicable mezzanine loan documents.[2]

The UCC mandates that "[e]very aspect of a disposition of collateral, including the method, manner, time, place and other terms, must be commercially reasonable."[3]

Typically, the property owner entity obtains a separate mortgage loan secured by the property owner entity's interest in the real property.

Relative to the lender under a mezzanine loan, the lender under a mortgage loan is often referred to as a senior lender as, following default under a mortgage loan beyond any applicable notice and cure period, the senior lender may foreclose on the real property secured by the mortgage through the judicial process, which, in turn, can potentially wipe out the underlying value of the collateral securing the mezzanine loan — i.e., the mezzanine borrower's equity interest in the property owner entity.

In part because of that potential, the mezzanine and senior lenders typically enter into an intercreditor agreement that sets forth their respective rights vis-a-vis each other upon defaults under the mortgage or mezzanine loan.

While some practitioners refer to all dispositions of collateral under Article 9 of the UCC as UCC foreclosures, the use of that phrase is a misnomer because the UCC uses the word "foreclose" to denote only a judicial proceeding.[4] Whereas judicial and nonjudicial sales of collateral share the broader term "disposition of collateral after default" or "disposition" for short, only the judicial variety can also accurately be called a foreclosure sale.[5]

The distinction is important because, on their face, Cuomo's executive orders bar foreclosures of residential and commercial properties, not dispositions under the UCC generally. Nonetheless, New York courts are split on the executive orders' effects on nonjudicial dispositions of collateral under the UCC.

In the first case, 1248 Associates Mezz II LLC v. 12E48 Mezz II LLC,[6] the mezzanine borrower brought suit seeking to enjoin the sale of its ownership interest in an LLC that owned a hotel and timeshare project at 12 East 48th Street in Manhattan after allegedly defaulting on its loan in January.[7]

The mezzanine borrower argued that the mezzanine lender sought to take advantage of the pandemic to conduct a commercially unreasonable fire sale of its sole asset, in contravention of the governor's executive order barring all foreclosures.[8] Specifically, the borrower relied on the order's direction that "[t]here shall be no enforcement of either an eviction of any tenant residential or commercial, or a foreclosure of any residential or commercial property for a period of ninety days."[9]

The mezzanine lender opposed the motion for a preliminary injunction, arguing that the executive order "is inapplicable inasmuch as the proposed sale is of property posted to secure a loan as governed by the UCC, not a mortgage upon real property."[10] The lender noted that the executive order was silent as to the sale of collateralized assets, and enumerated only judicial proceedings, which were distinguishable from a nonjudicial Article 9 UCC disposition of collateral.[11]

The court agreed with the mezzanine lender, concluding that a nonjudicial sale of a pledged interest was distinguishable from the type of judicial foreclosure action described in the executive order:

> While the terms of Executive Order No. 202.8 prohibit foreclosure of any commercial property for a period of ninety days without limitation to mortgages, that provision addresses enforcement of a judicially ordered foreclosure. The sale of the pledged interests in this matter results from the parties' agreement, as guided by the UCC.[12]

Ultimately, the court denied the motion for a preliminary injunction, ruling that the borrower's injury could be remedied with monetary damages, and that it therefore failed to establish irreparable injury.[13]

In contrast with the ruling in 1248 Associates, at least two New York courts have enjoined UCC dispositions on the basis that the proposed sales at issue were commercially unreasonable in light of the conditions created by the ongoing public health emergency.

In the first such case, D2 Mark LLC v. OREI VI Investments LLC, the mezzanine borrower obtained from the mezzanine lender a $35 million loan secured by the mezzanine borrower's equity interest in an entity that indirectly owned, through a wholly owned subsidiary, the leasehold estate in the Mark Hotel.

The hotel owner and certain of its affiliates owning other assets relating to the Mark Hotel obtained a separate $230 million senior loan secured by, among other things, a mortgage on the hotel owner's leasehold estate. The senior loan was subsequently securitized in a commercial mortgage-backed securitization transaction, while a private institution held the mezzanine loan. The same loan servicing firm serviced both loans.[14]

Due to the COVID-19 pandemic, the Mark Hotel was forced to temporarily close on March 27, and it purportedly suffered significant financial hardship as a result.[15] The mortgage borrower failed to make payments on the senior loan to the mortgage lender in April and May, thereby triggering a cross-default under the mezzanine loan.[16]

As a result, the mezzanine lender began to advance payments to cure the delinquent payment under the senior loan, in order to protect the mezzanine loan from being wiped out by acceleration and foreclosure by the mortgage lender.[17] At the same time, Cuomo's executive orders prohibited the mortgage lender from foreclosing on the mortgage loan.[18]

While the mezzanine lender and mezzanine borrower were negotiating a forbearance agreement in recognition of the effects of the pandemic, the mezzanine lender gave notice under the New York UCC of the sale of the mezzanine borrower's equity interest in the LLC that indirectly owned the commercial real estate property.[19]

The sale was scheduled for June 24 — 36 days from when the notice was given.[20]

The mezzanine borrower filed for a preliminary injunction to prevent the auction from going forward, arguing that the proposed UCC sale was not commercially reasonable under Article 9 of the UCC because, inter alia, the mezzanine borrower was initially excluded from the bidding process, the 36-day notice period was too short a sale period in light of the ongoing pandemic, and the proposed sale process was not designed to comply with New York's stay-at-home orders.[21]

Justice Andrea Masley of the New York Supreme Court's Commercial Division, found these arguments persuasive, holding that the mezzanine borrower had demonstrated a likelihood of success on the merits of its claim.[22]

Although the court declined to address whether the governor's executive orders staying all commercial evictions and foreclosures applied to all UCC dispositions of collateral, it noted that the orders "are persuasive authority that support plaintiff's contention that what is reasonable during normal business

times may not be reasonable during a pandemic."[23]

Specifically, the court concluded that the notice of 36 days "may be unreasonable during a global pandemic as the Mark Hotel was closed until June 15 making inspection impossible for 27 of the 36 days of notice, which deprives interested bidders of the chance to do due diligence."[24]

The court also held that the mezzanine borrower had established irreparable injury because the mezzanine loan agreement did not provide for money damages, instead limiting the mezzanine borrower's remedies to injunctive relief.[25] Finally, the court held that the balance of the equities weighed in favor of the mezzanine borrower because it would lose control of its sole asset if the relief were denied.[26]

Ultimately, the court stayed the sale for 30 days from June 24 during which time the mezzanine lender was ordered to re-notice the sale with an additional 30 days' notice and develop a plan for sale that complied with current U.S. Centers for Disease Control and Prevention, state and local safety guidance and allowed bidders to participate virtually given the current fears surrounding the use of public transportation in New York City.[27]

The second case is Shelbourne BRF v. SR 677 Bway LLC, in which the commercial division issued a similar preliminary injunction enjoining a UCC disposition.[28]

The case involved a $3.35 million mezzanine loan secured by the mezzanine borrowers' interest in two special purpose entities that owned a 12-story commercial building in Albany.[29] In May, the property-owning borrowers failed to make their monthly payment under the senior loan, which caused the mezzanine lender — after curing the loan default — to give notice that it would proceed with a UCC disposition of the mezzanine borrowers' equity interests in the property-owning LLCs.[30]

The mezzanine lender provided 32 days' notice that the sale would take place on July 20.[31] The mezzanine borrowers sought a preliminary injunction to enjoin the sale, arguing that it was commercially unreasonable to proceed with the sale on such short notice in light of the pandemic, and that they would face irreparable harm based on a provision in the mezzanine loan agreement — similar to the one on which the court relied in D2 Mark — that foreclosed monetary damages.[32]

Justice Jennifer Schecter of the New York Commercial Division granted the injunction for largely the same reasons as set forth by Justice Masley in D2 Mark. The court first cited the chief judge's administrative order barring any auction, sale or foreclosure of commercial property before Oct. 15, noting that the order was not merely for safety reasons as it did not make any exception for virtual auctions.[33]

Although the court found that the administrative order did not apply directly to the instant case, its logic was equally applicable: "Severe turmoil in the real estate market due to the pandemic makes the notion of a sale resulting in payment of fair market value highly uncertain."[34]

The court held that because bids would likely be discounted due to the uncertainty surrounding the continued pandemic, it would be commercially unreasonable to continue with the auction as initially planned by the mezzanine lender.[35] The court therefore enjoined the mezzanine lender from noticing or proceeding with a UCC auction prior to Oct. 15.[36]

In sum, taken together, these three decisions illustrate that although lenders are not barred from

moving forward with UCC disposition sales during the pandemic, they should proceed carefully if they choose to do so.

In light of the widespread impacts caused by the ongoing public health emergency, courts in New York are taking the pandemic's effects into account in evaluating commercial reasonableness associated with UCC dispositions of collateral after default.

For example, lenders should ensure that the procedures for a UCC disposition sale comply with any public health orders and regulations regarding the size of indoor gatherings, social distancing and the use of personal protective equipment. Similarly, lenders should be cognizant of the limitations on travel and public transportation in the current environment. Finally, lenders should be cognizant of the length of the notice period that they provide in light of the current circumstances.

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[1] Executive Order 202.8 (Mar. 20, 2020), available at https://www.governor.ny.gov/sites/governor.ny.gov/files/atoms/files/EO_202.8.pdf. This moratorium has been extended several times by subsequent executive orders and currently runs through September 20, 2020. See Executive Order 202.57 (Aug. 20, 2020) available at https://www.governor.ny.gov/news/no-20257-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency.

[2] UCC § 9-610(a).

[3] Id. § 9-610(b).

[4] See UCC § 9-601(a)(1).

[5] See id. § 9-610.

[6] 1248 Assoc. Mezz II LLC v. 12E48 II LLC, Index No. 651812/2020, 2020 WL 2569405 (N.Y. Sup. Ct. May 18, 2020).

[7] Id., Compl. ¶¶ 1-5, 2020 WL 2115462 (Apr. 30, 2020).

[8] Id.

[9] Id., May 18, 2020 Decision & Order, 2020 WL 2569405 at *1 (quoting Executive Order 202.8).

[10] Id.

[11] Id.

[12] Id.

[13] Id.

[14] D2 Mark LLC v. OREI VI Invests., LLC, Index No. 652259/2020, 2020 WL 3432950, at *1-*3 (N.Y. Sup. Ct. June 23, 2020) (Masley, J.).

[15] Id. at *2-3.

[16] Id.

[17] Id. at *3.

[18] Id. at *4.

[19] Id.

[20] Id.

[21] Id. at *4-5.

[22] Id. at *5.

[23] Id.

[24] Id.

[25] Id. at *6.

[26] Id.

[27] Id. at *6-7.

[28] Shelbourne BRF v. SR 677 BWAY LLC, Decision & Order [Dkt. #38], Index No. 652971/2020 (N.Y. Sup. Ct. Aug. 3, 2020) (Schechter, J.).

[29] Id., Compl. [Dkt. # 1] ¶¶ 6-12.

[30] Id. ¶¶ 12-26.

[31] Id.

[32] Id. ¶¶ 27-31.

[33] Id., Decision & Order at 1.

[34] Id.

[35] Id. at 1-2.

[36] Id. at 2.