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Expert Analysis

Legal Risks of Debt Financing In Property Development

Todd Soloway and Bryan Mohler explore the common forms of debt financing, and the particular considerations and legal issues involved when a lender seeks to foreclose.

By Todd E. Soloway And Bryan T. Mohler

As tough market conditions persist in New York City, many real estate developers are confronting financing issues and potential loan defaults for the first time in nearly a decade. Due to a series of factors, including a surplus of new supply, new tax laws that make buying more costly, and declining demand from foreign buyers, some significant projects are struggling and at risk of foreclosure. In light of the increasing number of disputes arising between lenders and borrowers, understanding the foreclosure process—which materially differs depending on the type of financing—is ever more critical. This article explores the common forms of debt financing, and the particular considerations and legal issues involved when a lender seeks to foreclose.

Mortgage Loan Foreclosures

Traditional debt financing, in the form of a mortgage loan, involves using the real property as collateral, with the attendant risk of losing the property in the event of a default and eventual foreclosure. Under a traditional mortgage loan, a creditor that wishes to foreclose on the mortgage loan must first initiate a foreclosure proceeding. The foreclosure process is often lengthy, bogged down by court proceedings, and at all times is subject to the equitable right of redemption (i.e., the right of a borrower to pay off the balance due and satisfy its loan at any time before a foreclosure proceeding is complete). *See, e.g., Northwest Mortgage, Inc. v. Brown*, 35 A.D.3d 682, 683 (2d Dept. 2006); *Carnavalla v. Ferraro*, 281 A.D.2d 443, 443 (2d Dept. 2001).

In light of the increasing number of disputes arising between lenders and borrowers, understanding the foreclosure process—which materially differs depending on the type of financing—is ever more critical.

In addition, the nature of the collateral for a mortgage loan—real property—creates an additional important recourse for the debtor to stop the foreclosure.

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Under New York law, ownership of real property is considered a unique interest, the loss of which cannot be compensated by monetary damages. *See Concourse Rehabilitation & Nursing Ctr., Inc. v. Gracon Assoc.*, 64 A.D.3d 405 (1st Dept. 2009). Since the improper loss of an ownership interest in property will, therefore, cause "irreparable harm" to the property owner, courts may be inclined to grant injunctive relief to stay a foreclosure sale until the proceedings are completed and it is determined that a loan default did exist. *See, e.g., Five Star Development Resort Communities, LLC v. iStar RC Paradise Valley LLC*, 09-cv-2085 (LTS) (S.D.N.Y. March 18, 2010). A mortgage foreclosure proceeding therefore offers several opportunities for developers to save their ownership interest in a property, along with saving the development project, even if they have defaulted on their obligations under the mortgage loan.

Mezzanine Loan Foreclosures

Mezzanine financing, in turn, is a hybrid of debt and equity financing that gives the lender the right, following a process laid out in the Uniform Commercial Code, to convert to an equity interest in the company in case of default. While a mezzanine loan can supplement financing for property owners seeking to raise additional capital, it offers far less protections to the borrower and fewer, albeit more efficient, recourses for the lender.

A mezzanine loan is made by pledging the equity interest in the entity that is the owner of the property-owning entity ("Prop LLC") as collateral. So, for example, if the entirety of the membership interest in Prop LLC is held by a parent entity ("Equity LLC"), Equity LLC will pledge its membership interests in Prop LLC as collateral for the mezzanine loan. In another example, Prop LLC might have two or more members, each holding an interest in Prop LLC. If Prop LLC were to take out a mezzanine loan, each member could pledge its interest in Prop LLC as collateral. In either example, if the borrower defaults on the mezzanine loan, the creditor is then able to foreclose on the membership interest in Prop LLC, assuming ownership of Prop LLC. Since lenders often lack the expertise or desire to step into the shoes of the property owner, they often seek to auction off the membership interests of Prop LLC to the highest bidder.

> Since not all debt financing provides for the same foreclosure and redemption processes, it is critical that property developers understand the varying risks inherent in their loan portfolio.

Mezzanine loans differ from mortgage loans in two critical respects. First, mezzanine loans are governed by the Uniform Commercial Code, which provides an entirely different process for foreclosure by the creditor, as well as a different process for potential redemption of the collateral by the debtor. Typically, when a debtor is in default of its obligations under a mezzanine loan, UCC § 9-623(b) provides that such a debtor may "redeem" its collateral—and stave off foreclosure—by "(1) fulfillment of all obligations secured by the collateral"; and (2) paying the creditor's reasonable expenses and attorney fees.

However, the debtor's ability to "redeem" its collateral is closed off as soon as the creditor either disposes of the collateral (in many cases, through a UCC foreclosure auction), or if the creditor enters into a contract to dispose of the collateral. (*See* UCC §9-623(c)(2)). The creditor must conduct the foreclosure in a "commercially reasonable" manner and must give notice to the borrower of the upcoming sale. (*See* UCC § 9-610). Under UCC § 9-612(b), ten days or more notice before a disposition of the collateral is considered reasonable notice. Unlike a mortgage

foreclosure proceeding which necessarily happens in front of a court, an Article 9 UCC sale will generally not be subject to court oversight or review unless "it is established that a secured party is not proceeding in accordance with" Article 9. (*See* UCC § 9-625(a)).

Second, an equity interest in a limited liability company or limited partnership is considered personal property under New York law, and any such member or partner does not have any interest in the specific property of the company or partnership. (*See* N.Y. LLC Law § 601; N.Y. PTR § 121-701); *see also 5303 Realty Corp. v. O&Y Equity Corp.*, 64 N.Y.2d 313, 323 (1984) (affirming cancellation of notice of pendency where contract was for the sale of stock in entity that owned real property, not the actual underlying real property); *Savasta v. Duffy*, 257 A.D.2d 435, 436 (1st Dept. 1999) (cancelling notice of pendency proper "since shares in a cooperative apartment are personal and not real property").

As such, under New York law, Equity LLC does not have a property interest in the underlying property, despite its 100% ownership interest of all of the equity of Prop LLC, the property owner. As personal property, any loss of the membership interests is compensable with money damages, and is not considered "irreparable harm," and courts are unlikely to grant an injunction to stall the foreclosure process. Critically, if a developer has both a mortgage loan and a mezzanine loan with the same lender, the lender may choose to foreclose on the mezzanine loan alone. In doing so, the lender only initiates the UCC foreclosure process, and completely bypasses the lengthy mortgage foreclosure proceedings. If the debtor cannot timely redeem the collateral, the developer would lose its entire interest in the entity that owns the property, and, despite not having the benefit of a mortgage foreclosure proceeding, would lose the property as well.

In a recent analogous case, *HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC*, No. 652871/2018, 2018 WL 3056919 (Sup. Ct. N.Y. Co. June 20, 2018), the court rejected a limited partnership's request for a preliminary injunction to restrain the sale of their equity interest in another limited partnership which was the owner of certain real property. It held that the plaintiff was not entitled to injunctive relief because the interest at stake was in the limited partnership, not an interest in a "home or a unique piece of property in which [they have] an unquantifiable interest," and the plaintiff therefore would not suffer irreparable harm. *Id.* at *2 (internal citation and quotation mark omitted). Importantly, the court also held that the UCC foreclosure of the mezzanine loan did not "clog" the plaintiff's equitable right of redemption under its mortgage loan. *Id.*

Conclusion

As the New York City development climate softens, property developers should pay close attention to their rights, remedies and obligations under their loans. Since not all debt financing provides for the same foreclosure and redemption processes, it is critical that property developers understand the varying risks inherent in their loan portfolio, and to prioritize their debt satisfaction accordingly.

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