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REAL ESTATE AND CREDITORS' AND DEBTORS' RIGHTS

Adapting to the New Mezzanine Loan Foreclosure Dynamics

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Everything old is new again. As the pandemic's impact on the real estate industry matures, lenders are becoming more reluctant to keep kicking the can down the proverbial road and are taking action to enforce their rights. The raft of litigation arising out of pandemic-induced foreclosure actions and diligence-intensive distressed deals are causing lenders and borrowers alike to carefully scrutinize their loan documentation. Methods of enforcement and potential defenses are critical.

Both mezzanine lenders contemplating foreclosure, and mezzanine borrowers considering their options, would be wise to be cognizant of and adapt their practices in response to recent New York Court decisions concerning the "commercial reasonableness" of Article 9 foreclosure sales of limited liability membership interests.

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"Commercially Reasonable"

It is well known that Article 9 of the Uniform Commercial Code requires "every aspect of a disposition of collateral, including the method, manner, time, place, and other terms" to be "commercially reasonable." U.C.C. §9-610(b). However, what is considered "commercially reasonable" has always been a litigated issue; it is, therefore, no surprise that it continues to be litigated during a worldwide pandemic. While no bright-line rule yet exists regarding what is or what is not commercially reasonable during a pandemic, New York courts have found shorter notice-to-sale time periods and in-person sales requirements to be unreasonable.

The raft of litigation arising out of pandemic-induced foreclosure actions and diligence-intensive distressed deals are causing lenders and borrowers alike to carefully scrutinize their loan documentation. Methods of enforcement and potential defenses are critical.

In *D2 Mark LLC v. OREI VI Investments LLC*, No. 652259/2020, 2020 WL 3432950 (Sup. Ct., N.Y. Cty. June 23, 2020) (Masley, J.), plaintiff-borrower D2 Mark LLC sought to enjoin the defendant-lender from selling the plaintiff's membership interests in the historic Mark Hotel, located on Madison Avenue and East 77th Street. The argument was that a 36-day notice-to-sale period was insufficient during a pandemic.

In granting D2 Mark's motion for an injunction, the Commercial Division found the 36-day sale period to be commercially unreasonable given that the Mark Hotel

was closed from the beginning of the pandemic until June 15, 2020, pursuant to Governor Andrew Cuomo's executive order, making it impossible for potential bidders to conduct a physical inspection of the hotel for 27 of the 36 days of the notice period. *Id.* at *5.

The court stayed the sale for 30 days, holding that this decision was "consistent with the spirit of the governor's [executive orders] and the timing of Phase 2 and possibly Phase 3 re-opening in New York City." *Id.* at *6. A month later, the court vacated the preliminary injunction as part of a so-ordered stipulation discontinuing the case.

Likewise, in *GVS Portfolio 1 B, LLC v. Teachers Insurance Annuity Association of America*, Index No. 654095/2020 (Sup. Ct., N.Y. Cty. Oct. 23, 2020) (Masley, J.). After argument on plaintiff's motion for a preliminary injunction of the sale of its interests in 64 self-storage sites, the Commercial Division Court ordered the sale to occur on March 10, 2021 to balance various considerations, including consistency with "appraisals which recommended a six-month marketing period" rather than the 33-day notice-to-sale period offered by the defendant-lender. When the March 10 date approached, the plaintiff-borrower unsuccessfully sought another injunction to delay the sale, and then filed for Chapter 11 bankruptcy protection.

In both *D2 Mark LLC* and *GVS Portfolio*, the court also encouraged both lenders and borrowers to proceed with sales virtually as opposed to in-person and to comply with relevant CDC regulations and executive orders regarding COVID-19. In *D2 Mark LLC*, for example, where the defendant-lender originally scheduled the sale to take place in counsel's conference room, the court ordered that "[g]iven the limitations on transportation and the population's fear of modes of transportation, defendants must clearly state that bidders may participate virtually" and "defendant's notice must, at a minimum, comport with current CDC, state and local regulations." 2020 WL 3432950, at *6. The court even cited a CDC warning against taking subways and trains to support its order in this regard. 2020 WL 3432950, at *6 n.5.

In *GVS Portfolio*, where the plaintiff-borrower suggested the sale be held in person on the courthouse steps and virtually, the court noted that the chief clerk "would prefer not to have any group of people, you know, six, ten, whatever it is, he just would prefer not to [have them on the courthouse steps] and he believes that's consistent with the Governor's executive orders." *See* Transcript of Oral Argument, Sept. 18, 2020, at 21:2-5.

Though not expressly for pandemic-related reasons, other restrictive bidding practices that seemingly favor defendant-lenders have also been found commercially unreasonable in recent decisions. In *D2 Mark LLC*, the court noted the defendant-lender's requirement that "the potentially winning bidder must submit a 10% non-refundable deposit at the sale and the remaining 90% within 24 hours" was unreasonable because it was a term, coupled with others, which "rigged" the process so that "as a practical matter, only defendant can obtain the [c]ollateral." 2020 WL 3432950, at *5.

Similarly, in *301 West 53rd Street Junior Mezzanine LLC, et al. v. CCO Condo Portfolio (AZ) Junior Mezzanine, LLC*, Index No. 656178/2020 (Sup. Ct., N.Y. Cty. Dec. 9, 2020) (Ostrager, J.), the court found the defendant-lender's noticed UCC sales commercially unreasonable for, among other things, "requir[ing] bidders to post an unreasonably high deposit [of $1 million] to qualify to bid." There the court also found the defendants' requirement that potential bidders must acquire the collateral (four separate properties) in one package, instead of allowing bidders to bid on individual portions of the property, to be unreasonable. The court noted "it was not surprising that the prior scheduled UCC sales

attracted no bidders for the property interests in the on [sic] the four trophy [p]roperties, thereby allowing the defendant to take control of the collateral…." *Id.*

Borrowers Still May Be Unable To Stop Sales

Not all recent decisions favored arguments advanced by the borrowers. In *1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC*, 651812/2020 (Sup. Ct., N.Y. Cty. May 18, 2020) (Nervo, J.), the court denied plaintiff-borrower's motion for a preliminary injunction, noting that "Plaintiff's anticipation of economic damage resulting from the noticing, the manner, or timing of the sale, particularly in light of the current economic shutdown and restrictions on travel as a result of the COVID-19 pandemic, is merely speculative" and "any such damages may be properly remedied subsequent to the sale" because "[w]here harm to a plaintiff's commercial property interest is the loss of investment as opposed to a loss of an unquantifiable interest, damages suffice and irreparable harm does not befall plaintiff." *Id.*

In early March 2021, the First Department endorsed Justice Frank Nervo's reasoning when it held it to be improper to enjoin a scheduled Article 9 foreclosure sale where the plaintiff-borrower was free to seek monetary damages from the lender if it is was ultimately determined that the lender failed to act in a commercially reasonable manner. *Shelbourne BRF LLC v. SR 677 Bway LLC*, 2021 NY Slip Op. 01346 (1st Dept. 2021). The Appellate Division made clear that the "plaintiffs failed to demonstrate the requisite irreparable harm" prong of an application for a preliminary injunction because, "[n]otwithstanding the existence of the COVID-19 pandemic, the feared loss of an investment can be compensated in money damages." *Id.* (citations omitted).

Adapting to the Changing Dynamic

Foreclosing lenders will be well advised to consider these decisions when determining when and how to notice a foreclosure sale and how best to market the subject collateral. Lenders should consider stipulating with the defaulting borrowers concerning commercially reasonable foreclosure terms that take into account these recent decisions, perhaps as part of a post-default forbearance agreement. Borrowers, in turn, should not get overly ambitious since they may no longer be able to obtain a pre-sale preliminary injunction. As a result, borrowers will need to consider how and when to leverage their objections to the proposed sale terms so that they are best positioned to protect their rights.

Foreclosing lenders also must tailor their enforcement strategy to standards arising from these decisions in order to minimize the risk that defaulting borrowers will be able to claim post-foreclosure sale monetary damages arising from a sale of collateral by arguing that a foreclosing lender failed to act in a commercially reasonable manner in selling the pledged collateral.

Borrowers seeking to preserve equity in their investment or seeking to gain leverage and additional time to refinance the defaulted debt must also ensure that they are aware of the holdings arising from these recent decisions when developing their litigation strategy.

These issues are sure to evolve as the distress in the real estate industry deepens.