

What's the Standard for “Commercially Reasonable” in a Commercially Unreasonable World (Health Crisis)?

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By: Steven Coury, Timothy E. Davis and Kristen E. Andreoli

On April 30, 2020, Judge Frank P. Nervo of the New York State Supreme Court, New York County, granted a temporary restraining order preventing a public sale of collateral securing a junior mezzanine loan, issuing an order that the borrower's request for relief in having its case considered by the court was “essential” in the current environment.

The junior mezzanine loan at issue was secured by limited liability company interests in the entity which owns and controls the owner of a 161-key hotel/timeshare and retail property currently under construction at 12 East 48th Street in Manhattan. The junior mezzanine lender, 12E48 Mezz II LLC, argued that the failure of the borrower to cause the mortgage borrower to achieve substantial completion of the project pursuant to the terms of the junior mezzanine loan documents no later than December 31, 2019 was an event of default thereunder, and sought to sell the limited liability company interests securing its loan at a public auction (the default alleged was not related to payment under the junior mezzanine loan, but performance related to the completion dates). It is noteworthy that the default notice to the borrower was dated January 16, 2020, weeks before New York Governor Andrew Cuomo declared a state of emergency in the State of New York on March 7, 2020, which halted all non-essential construction work.

The borrower, 1248 Associates Mezz II LLC (the plaintiff in the matter before Judge Nervo), argued, in part, that substantial completion of the property was not possible in the current environment, citing various executive orders issued by Governor Cuomo, and the declared state of emergency in New York, which is currently in effect until September of this year. The borrower also argued that not only had the property achieved 80% of the substantial completion threshold cited in the loan documents, but that it had attempted to find replacement financing beginning as early as late last year in order to pay off its current lenders. The junior mezzanine lender had participated in such negotiations with one prospective lender until negotiations ultimately fell apart in March.

The sale of the collateral was advertised in the Commercial Mortgage Alert, a subscription-only industry publication on April 17, 2020, inviting potential bidders to the auction to be held at the offices of the junior mezzanine lender's counsel on May 1, 2020 (more recent filings in this case indicate that there is currently a dispute of fact between the borrower and the junior mezzanine lender as to whether there were additional publications of the notice). One factor cited by the borrower in disputing whether such a sale would be commercially reasonable was the lack of mention in the published notice of the possibility of participating in the sale without being physically present in an office at a time when all non-essential gatherings are banned (and the offices of all non-essential businesses are closed in New York). It bears mention that a more recently published Uniform Commercial Code (UCC) sale notice in an industry publication advertising an unrelated UCC foreclosure sale in New York, explicitly stated appropriate measures to protect public health and safety would be taken, including the implementation of electronic and telephonic bidding.

The borrower further alleged that the nature of the sale was constructed so that the junior mezzanine lender could ensure that it would be the only qualified bidder present, in order to gain control of the collateral (and as such, control of the underlying property). The borrower argued that in the current environment, the planned manner of the sale was intended to prevent potential qualified bidders from having the meaningful opportunity to conduct customary due diligence, and to bid on the collateral at a public auction for the highest possible price.

While a mezzanine debt position (or in this case, secondary mezzanine debt) may enjoy less security than traditional mortgage financing, it provides lenders with, among other benefits, the right to a non-judicial foreclosure by public sale under the UCC. In states such as New York, where the mortgage foreclosure process can take years, a mezzanine loan sale, commonly known as a UCC foreclosure, can be effected in a fraction of the time. In New York State, pursuant to Governor Cuomo's Executive Order, there is a moratorium on all commercial and residential foreclosures, which has been raised as a defense by the borrower in this instance, given that the governing loan documents specifically refer to any such sale as a "foreclosure."

The success of both parties' arguments on this issue hinges upon whether or not the court will ultimately hold that the UCC sale would be commercially reasonable; however, what remains to be seen is what constitutes "commercially reasonable" in our current, untested environment. If the public is prohibited from attending an in-person sale, would it still be commercially reasonable to hold a sale that could be done via some readily available online meeting service, such as Zoom? Recent court filings by the borrower, in arguing that the junior mezzanine lender had not made "any effort whatsoever to market the Collateral" to qualified potential bidders for the proposed sale, also point out that they (as of yet) have no evidence that any potential bidders had taken advantage of any due diligence available to them in advance of the proposed sale of the collateral, much less the traditional site visits that are used to assess the condition and value of the underlying property, and which are currently not possible given the current health and regulatory environment. These challenges are not unique to the case at hand, and the court will ultimately have to consider whether it is even possible for a lender to enforce their rights in the current environment, or whether there are additional steps (for example, conducting virtual tours of the property as part of one's due diligence, or conducting the sale itself through Zoom) that foreclosing lenders may take to account for the current environment are adequate to achieve a commercially reasonable sale.

Given that mezzanine loan documents often designate New York as the choice of law, and in light of the current national economic and health crisis, it seems likely that this case will ultimately provide guidance and precedent for future UCC mezzanine loan foreclosures.

The next hearing on this case is scheduled for May 18, 2020. Our firm will continue to monitor these proceedings for further developments.

If you have questions in the meantime, please contact Steven Coury (courys@whiteandwilliams.com; 212.631.4412), Timothy E. Davis (davist@whiteandwilliams.com; 215.864.6829), Kristen E. Andreoli (andreolik@whiteandwilliams.com; 212.631.1256), or another member of our Real Estate and Finance Groups.

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a



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