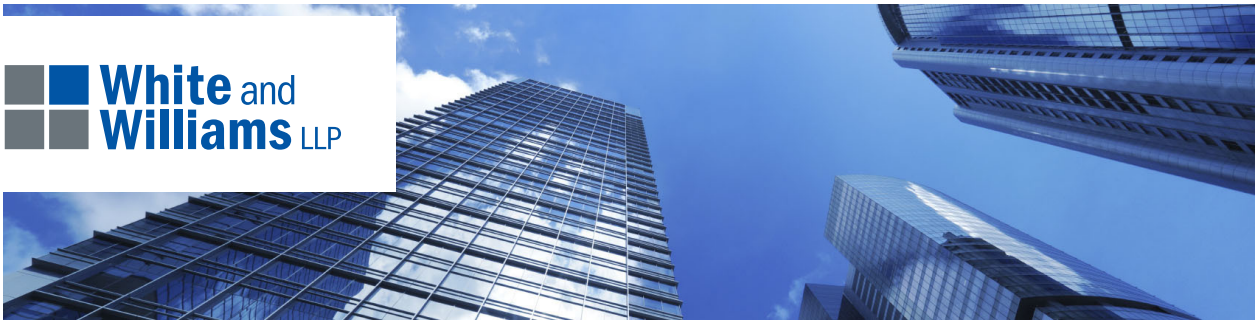

How COVID-19 Mezzanine Foreclosures May Fare In NY Courts

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The recent trajectory of a case before Judge Frank P. Nervo of the New York State Supreme Court offers important guidance with regard to the projected wave of upcoming borrower defaults and foreclosure sales under the Uniform Commercial Code.

On May 18, Nervo vacated a temporary restraining order preventing the public sale of collateral securing a junior mezzanine loan, and permitting the sale to move forward.

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 mezzanine lender, 12E48 Mezz II LLC, had sent a default notice to the borrower on Jan. 16, due to the failure of the construction project to be substantially completed by Dec. 31, 2019, pursuant to the terms of the junior mezzanine loan documents.

It is noteworthy that the default notice was dated weeks before Gov. Andrew Cuomo declared a state of emergency in the state of New York on March 7, which halted all nonessential construction work. The borrower, 1248 Associates Mezz II LLC (the plaintiff in the matter before Nervo), did not dispute the fact that the project had not achieved substantial completion by the date required in the loan documents, although there was some dispute of fact between the parties as to how far the project was from attaining that goal at the time of the default.

Notably, the borrower had also 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 during the beginning of the height of the pandemic.

Despite this, one of the borrower's key arguments in court against the sale proceeding was that substantial completion of the property was not possible in the current environment, citing certain executive orders issued by Cuomo, and the declared state of emergency in New York. Notably, the borrower raised Cuomo's Executive Order No. 202.8, which created a moratorium on all commercial and residential foreclosures, as a defense in this instance, citing the fact that the governing loan documents specifically refer to any such sale as a foreclosure.

The failure of the proposed sale to be commercially reasonable was the crux of the borrower's other major argument against the sale going forward. An advertisement for the sale of the collateral (there is some dispute of fact between the parties as to whether this was the sole published notice of the sale prior to that date) was published in the Commercial

Mortgage Alert on April 17, inviting potential bidders to the auction to be held at the offices of the junior mezzanine lender's counsel on May 1.

The junior mezzanine lender argued that such notice constituted the commercially reasonable notice required. The borrower, of course, argued the opposite position, citing the fact that the notice failed to mention the possibility of participating in the sale without being physically present in an office at a time when all nonessential gatherings were banned, and the offices of all nonessential businesses were closed in New York.

It should be noted that more recently published UCC sale notices, including subsequent notices related to the case at hand, have designated online platforms as the venue for the UCC sale. In some instances, subsequent UCC sale notices have gone on to explicitly state that appropriate measures to protect public health and safety would be taken, including the implementation of electronic and telephonic bidding.

The borrower alleged that the nature of the sale and the wording of the UCC sale notice were constructed so that the junior mezzanine lender could gain control of the collateral (and as such, control of the underlying project), rather than to permit potential bidders the meaningful opportunity to conduct their due diligence, and to bid on the collateral at a public auction for the highest possible price.

The junior mezzanine lender argued that it had electronic means available for collecting bids at the auction, however, the borrower argued that the failure of the sale notice to mention such possibility would prevent potential qualified bidders from conducting their customary due diligence and physically attending an in person sale, and was, as a result, commercially unreasonable.

The borrower's contention begs an important question that is likely to arise in future cases — 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?

The borrower, in arguing that the junior mezzanine lender had not sought out purchasers for the proposed sale, also pointed out that they had no evidence that any potential bidders had taken advantage of any due diligence available to them in advance of the proposed sale, much less the traditional site visits that are often used to assess the condition and value of the underlying property, and which were not possible at the time given the then-current health and regulatory environment.

Despite the current staged reopening of New York, the increasing prevalence and acceptance of conducting business via Zoom or Webex meetings — as further evidenced by recently published UCC sale notices — seems likely to continue for the foreseeable future as a means to continue business in a socially distant society.

The court ultimately rejected the borrower's arguments as to the nature and timing of the sale having been designed to take advantage of the current COVID-19 crisis. Nervo held that such arguments were speculative, and that the borrower's request for relief relied upon anticipated economic damage which could result from such a sale, but that the borrower had failed to demonstrate that the holding of such a UCC sale would cause it irreparable harm.

Instead, the order provided that the appropriate recourse in the event that such a sale ultimately caused the borrower a loss of its investment opportunity would be a cause of action for monetary damages at that time. One wonders if the underlying default had occurred during or due to the COVID-19 pandemic, rather than late last year, if such factor would have impacted the court's analysis and ultimate conclusion in permitting the sale to go forward. In at least one other recent decision, examined below, this factor seems to have impacted the court's analysis.

In the case at hand, the default predated the COVID-19 pandemic, and the declared state of emergency in New York, but it will be interesting to see if courts in the future will ultimately be more sympathetic to a borrower who had similarly defaulted, but due to factors directly related to the pandemic itself.

The borrower's argument related to the foreclosure moratorium also suffers due to more recent developments in New York. On May 7, Cuomo issued Executive Order 202.28, which, in part, extended the existing moratorium on the foreclosure of residential and commercial mortgages, a word not contained in the previous Executive Order 202.8, which had been cited in Nervo's earlier decision.

Tellingly, in the May 22 decision, the court rejected the borrower's contention that Executive Order 202.8 applied to the potential foreclosure of a junior mezzanine loan, on the basis that the sale is subject to the UCC, and is a nonjudicial proceeding, unlike a New York state foreclosure proceeding, and the Executive Order itself did not address nonjudicial proceedings.

As the borrower noted, mezzanine loan documents, including in the case at hand, refer to the potential UCC sale as a "foreclosure," but the issuance of Executive Order 202.28 provides further clarification that such customary wording will not be sufficient to subject future UCC sales to the New York foreclosure moratorium.

It is clear that for the time being, any current foreclosure moratoriums in New York do not apply to mezzanine loan foreclosures. Given the fact that mezzanine loan documents often include provisions designating governance under New York law, the ultimate outcome of this case could have implications far beyond projects physically located in New York.

The borrower filed an appeal of the May 18 decision just days later, on May 22. More recently, on June 23, Judge Andrea Masley of the New York County Supreme Court temporarily halted a mezzanine foreclosure related to the Mark Hotel, a luxury hotel on the upper east side of Manhattan.

In that instance, the mezzanine lender, OREI VI Investments LLC, declared a default under the mezzanine loan due to cross-default provisions in the mezzanine loan documents — the senior borrower had failed to make payments on the senior loan in April and May of 2020. Based upon that default, the mezzanine lender issued a notice of a sale to be held just 36 days later.

In her decision temporarily staying the sale, Masley cited several arguments of the borrower, D2 Mark LLC, against the commercial reasonableness of the sale, including the fact that the hotel had been forced to close during the pandemic, and a short period of time from the issuance of the sale notice until the specified sale date.

Given the then-current phased reopening in New York, the hotel asset was not available to be examined by potential qualified bidders until just prior to the sale, and would likely require individuals to take public transportation and risk potential exposure to COVID-19.

The June 23 decision included numerous requirements for the mezzanine lender to conduct a future sale of the collateral, including, without limitation, revising the notice and enjoining the sale until at least July 23. It will be interesting to follow each of these cases for guidance on future UCC sales in New York courts, particularly as the pandemic and related loan defaults continue to develop over time.