NY Mezzanine Foreclosure Ruling May Limit Borrower Options

By **Christopher Gorman and Maureen Bass** (March 18, 2021)

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Commercial mezzanine lenders are typically not required to go through the judicial foreclosure process after a borrower's default in New York to liquidate collateral, which often consists of the membership interests owned in the limited liability company comprising the borrower entity.

This is a contractual strategic advantage to mezzanine lenders because the judicial foreclosure process in New York state can, at times, be lengthy and unpredictable with procedural and uncontrollable volume delays.

Rather than proceeding with judicial foreclosure, mezzanine lenders often seek to take control of their collateral upon a default by noticing and conducting an auction and sale of the LLC membership interests in conformity with the procedures established by the Uniform Commercial Code.

During the COVID-19 pandemic, several borrowers under defaulted mezzanine loan instruments have successfully frustrated lenders' ability to exercise their rights to a prompt auction by seeking and securing injunctive relief in New York state courts.

On March 4, 2021, the Supreme Court of the State of New York, Appellate Division, First Judicial Department, issued a significant decision that may serve to limit mezzanine borrowers' ability to obtain injunctive relief to restrain and delay mezzanine foreclosure sales under the UCC.

In Shelbourne BRF LLC v. SR 677 Bway LLC,[1] the court reviewed an Aug. 3, 2020, decision of the New York County Supreme Court, which temporarily enjoined a UCC foreclosure sale of interests in LLCs that owned a commercial office building.

The Appellate Division reversed the court below, finding that it erred in granting injunctive relief because the mezzanine borrower plaintiffs were unable to demonstrate the required element of irreparable injury.

As detailed below, the Shelbourne decision may very well stand to limit a borrowers' ability to halt or delay a UCC mezzanine foreclosure sale through the New York state courts.

Thus, because Shelbourne limits the remedies available to mezzanine borrowers facing a UCC auction of their membership interests, it should be seen as a major victory for mezzanine lenders and likely to increase the number of bankruptcy filings in this context.

The Shelbourne Decisions

In Shelbourne, the mezzanine lender scheduled a UCC sale of LLC membership interests in the borrowers for Aug. 19. The borrowers commenced litigation seeking to delay the sale because of the impact the pandemic was having on the logistics of UCC auction sales.

On Aug. 3, the Supreme Court issued a decision in Shelbourne BRF LLC,[2] granting the mezzanine the borrowers' motion for a preliminary injunction precluding the mezzanine

lender from noticing or proceeding with an auction of the collateral prior to Oct. 15.

In granting the requested preliminary injunctive relief, the Supreme Court found that the "valuation of an equity interest in a company that owns real estate is based on the value of the real estate itself," and "[s]evere 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."

The Supreme Court concluded that this, coupled with the fact that "[b]ids will likely be discounted due to uncertainty about the continued length and severity of the pandemic," would cause the mezzanine the borrowers to "suffer irreparable harm if the sale proceeds and they lose their interests." All these factors, according to the Supreme Court, made it "unreasonable to permit the foreclosure sale to proceed on August 19, 2020."

In reversing the Supreme Court, the First Department found, without any additional elaboration, that the borrowers "failed to demonstrate the requisite irreparable harm" showing required in connection with obtaining preliminary injunctive relief.

The First Department reached this conclusion in Shelbourne because, according to the court, citing its own prior decisions, "[n]otwithstanding the existence of the COVID-19 pandemic, the feared loss of an investment can be compensated in money damages."

Conclusions

Since the onset of the pandemic, lenders have faced numerous challenges because of changing laws, executive orders and limited court access.

An example of such a challenge appeared when mezzanine borrowers under defaulted mezzanine loans began routinely seeking refuge in New York state court to try to delay UCC auctions of the membership interests held in the borrower entity.

A number of these challenges, many of which focused upon the alleged unreasonableness of the auction procedures under the UCC considering restrictions that had to be placed on the auction procedures due to the pandemic, were successful.

In other words, during the pandemic in several cases mezzanine borrowers succeeded in having the New York state courts issue preliminary injunctions precluding a proposed UCC sale and, thus, delayed — even temporarily — the auctions of the mezzanine borrowers' membership interests.

Such delays can be very valuable to borrowers, giving them some amount of leverage in their negotiations with lenders and breathing room to negotiate with their lenders.

Given the breadth of the analysis in Shelbourne, however, the New York state courts may no longer be a viable option for the borrowers under defaulted mezzanine loans in which to seek refuge. The First Department did not focus upon the reasonableness, or lack thereof, of the auction procedures proposed to be employed in Shelbourne.

If that was the case, then subsequent cases could be distinguished from Shelbourne, as auction procedures and facts (including, perhaps, the state of the pandemic at the proposed time for an auction) could differ from case to case.

Instead, the First Department set a far higher bar and precedent for enjoining or delaying UCC mezzanine foreclosure sales. In Shelbourne, the First Department issued blanket

statements about mezzanine borrowers' inability to establish irreparable harm when facing a mezzanine loan foreclosure because any losses suffered by the borrowers could, at least according to the First Department, be compensated by money damages.

It would seem, therefore, that Shelbourne is a decision that will not be easy for borrowers to distinguish going forward, since the factors leading to a finding of irreparable harm by the Supreme Court in the face of the foreclosure sale (i.e., the loss of the value of the LLC membership interests due to the pandemic) will be the same in every case involving a proposed mezzanine foreclosure sale.

Shelbourne, therefore, can only be seen as a decision which serves to limit mezzanine borrowers' ability to temporarily delay a UCC auction through the New York state courts (at least within the confines of the First Department, for now).

While the Shelbourne decision should be considered a favorable decision for lenders, it may prompt more mezzanine borrowers to eschew state court litigation in favor of considering the automatic stay provisions found in connection with a bankruptcy filing. In bankruptcy court, a borrower may very well be able to dispute the reasonableness of a lender's actions with respect to maximizing the value of collateral.

In bankruptcy court, a borrower will also likely have breathing room with an opportunity to restructure and, under certain specific circumstances, a bankruptcy court may confirm a Chapter 11 plan and rewrite the terms of a mezzanine lender's debt instrument.

An indirect consequence of Shelbourne's limitation on the availability of injunctive relief, therefore, may be an increase in bankruptcy filings by mezzanine borrowers who may have few, if any, other options.

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[1] Shelbourne BRF LLC v. SR 677 Bway LLC, 2021 WL 816691, --- A.D.3d ----, --- N.Y.S.3d --- (2d Dep't Mar. 4, 2021).

[2] Shelbourne BRF LLC, et al. v. SR 677 Bway LLC, Index No. 652971/2020 (NYSCEF Docket No. 38).