Protection Dissolving for Borrowers in NY Seeking to Halt UCC Sales

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As COVID-19 moves into the rearview, pandemic-related judicial protections for borrowers seeking to avoid UCC sales are dissipating. Photo: Getty Images

The coronavirus pandemic made the legal system in New York much friendlier toward commercial property owners with assets in default who are facing a foreclosure sale under the Uniform Commercial Code (UCC).

But, it looks as though the empathy is starting to run out.

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A ruling by Justice Jennifer Schecter in the First Department of the Appellate Division of the New York Supreme Court last month has made it more difficult for borrowers and their counsel to claim hardship and economic uncertainty caused by the pandemic as a reason to enjoin, or avoid, a UCC Article 9 foreclosure auction.

The decision, in *Shelbourne BRF LLC et al. v. SR 677 Bway LLC,* has also likely "opened the floodgates" to a potential wave of last-resort Chapter 11 bankruptcy filings from borrowers who fail to receive injunctive relief to stop UCC auction sales and save their interests in properties, according to lawyers and brokers who spoke to Commercial Observer about the decision.

Through the pandemic, market volatility made it easier for courts to deem a UCC foreclosure sale "commercially unreasonable," thus hampering a lender's ability to work through default scenarios. Typically, if a borrower seeks injunctive relief to halt a UCC foreclosure sale, it's up to them to showcase the possibility of irreparable harm as a result of it — by detailing to the court the negative effects of the loss of equity interest in a property's controlling entity from the foreclosure sale.

Judge Schecter essentially stamped that out last month, determining that a borrower's threatened loss of equity interest does not represent irreparable harm.

The *Shelbourne* decision "will increase UCC sales, and because these sales won't be enjoined, it will open the floodgates to more Chapter 11 filings," said Greg Corbin, the President of bankruptcy and restructuring at Rosewood Realty Group. Typically, if a UCC sale fails, due to a Chapter 11 bankruptcy filing, the real property in question then hits the block — rather than the ownership entity securing the defaulted mezzanine debt that would be sold at a UCC auction.

"In order to prevent the loss of their membership interests in the borrowing entity, many debtors have, and will continue to file Chapter 11 on the eve of a UCC auction," said Corbin, whose team sold 19 buildings in Chapter 11 last year, and is currently working on the bankruptcy sale of 18 other properties. "Over the past few months, we experienced this firsthand on UCC auctions we were scheduled to conduct, including The Tillary Hotel in Downtown Brooklyn, Marker 27 in Irvington, and 159 Broadway in Williamsburg."

Schecter reversed herself in this most recent decision, having previously established a thesis on Aug. 3, 2020, that market turmoil caused by the pandemic made the outlook for a foreclosure sale at a fair market value "highly uncertain," and that the likelihood of irreparable harm to the borrower caused by the loss of equity interest from the sale was enough of a reason to enjoin a UCC proceeding — in that decision in August, she halted the UCC action until Oct. 15.

Throughout the pandemic, many borrowers have benefitted from a backdrop of government support and have found it easier to make the case for stymying UCCs or, more recently, have found unique ways to try to avoid UCC law altogether.

“The Appellate Division’s decision in *Shelbourne* properly protects lenders by recognizing that foreclosure proceedings do not impact a borrower’s dwelling, and the potential loss of equity value by an owner is not a reason to enjoin a UCC foreclosure,” said Stephen Selbst, a co-chair of Herrick Feinstein’s restructuring and finance litigation division.

Gov. Andrew Cuomo’s numerous executive actions last year that established moratoriums on commercial and residential mortgage foreclosures started on March 20, 2020, but the courts later found that his order did not fully extend to UCC sales. That’s because they are not judicially ordered and are not straightforward mortgage foreclosures on real property — hence why it became a battleground between mezzanine lenders and defaulted borrowers. (Even still, Cuomo’s final executive action prohibiting mortgage foreclosures on commercial property expired on Jan. 31.)

In Justice Schecter’s Aug. 3, 2020 decision in the *Shelbourne* case, she referred to Chief Administrative Judge Lawrence Marks’ July 23, 2020 administrative order that held that foreclosure auctions of residential and commercial real property were not to take place before Oct. 15. Almost two weeks later, after the shackles on mezz proceedings fell away and Shecter’s two-week-long temporary restraining order expired, the lender set a date for another auction on Oct. 30. The borrower again attempted to halt the action, only to have Schecter deny the motion in a key reversal.

Michael Davis, a Founding Principal of multifaceted real estate private equity firm Plymouth Group, which provides services for distressed or transitional situations, said that while “significant liquidity” still exists in the broader market, the “artificial or regulatory constraints on moving traditional judicial foreclosure processes forward” have meant that “pledge and mezzanine remedies have emerged as not just the fastest but — for at least the time being — in some ways really the only path to the asset in the near term.”

Davis added that recent rulings that have opened the door for UCC processes to proceed “should only accelerate that trend in the absence of alternative timely remedies for lenders and creditors.”

The goal of the lender in these situations is to showcase that a reasonable enough market exists for a potential UCC sale — to make the marketing processes “bulletproof,” Corbin said. Prior to the pandemic, the typical timeline used by lenders to market the equity interest in a property would’ve been around 30 days.

“Before [the pandemic], no one would blink at 30 days,” Corbin added. “Lenders are now extending that out to 90-plus days” in order to have more time to make a “commercially reasonable” sale defensible.

Brokers charged with leading UCC sales on behalf of lenders said that oftentimes, despite extensive and exhaustive marketing work, very few third-party bidders show up at the auction, a caveat that doesn't help the lender's case for a "commercially reasonable" sale, especially in a depressed market with little activity.

Oftentimes a prospective UCC buyer will make an initial call to whomever is marketing the equity interest in the ownership entity asking about the cost of the property, rather than focusing on the mezz position they're actually buying into — subordinate to the senior lender in the capital stack. And they would "rather not be beholden" to the senior secured note holder, Corbin said, adding that "if a borrower owes $20 million on a property that's now worth $17 million, they also don't want to be in that position with the property underwater … and there is a significant interest rate plus default interest rate often ticking at 24 percent."

"Many traditional investors aren't used to these alternative UCC proceedings, and have been working quickly to get smart on the process and the potential opportunities that exist," Corbin added.

Last year was full of instances where the courts stopped UCC proceedings, but the tide has certainly been turning since last fall, when moratoriums started to fall and market activity gradually began to pick up.

"We've experienced an uptick," Corbin said. "We expect to see more groups [seeking] to partner … with professionals who have unique domain expertise in these alternative proceedings as well as bankruptcy liquidations in order to remain competitive."

In July 2020, a New York court blocked a mezzanine lender's UCC foreclosure sale on The Mark Hotel on the Upper East Side in *D2 Mark LLC v. OREI VI Invests*. The judge in that case granted injunctive relief to the plaintiff, after concluding that a UCC sale was not commercially reasonable for a variety of reasons related to market dislocations, and also because the lender hadn't allotted enough time to properly market and expose the equity interest — 36 days.

"If we show we widely [marketed something] and made it reasonable, lender liability [lessens]," Corbin said. "Borrowers were able to claim COVID hardship for a while. Judges would give them the benefit of the doubt. Turmoil in the market meant it was hard to establish a price, and also, people couldn't visit the property."

And in some cases, borrowers have waited until just hours before an auction was to take place to file for Chapter 11 protection.

"I have recently filed high-profile bankruptcy cases due to UCC sales, which normally would have used a state-level legal strategy," said FIA Capital Partners Principal David Goldwasser. "The dollars at stake were too high and the sponsors felt strongly about their equity positions,

so they chose to file Chapter 11 bankruptcies in order to work through the issues and not just try to extend the inevitable. At the end of the day, state court challenges will only delay the process and not extinguish it."

Goldwasser has spearheaded more than 50 bankruptcy proceedings and is currently embroiled in around $1 billion of workouts, including the restructuring of Isaac Hager's Cornell Realty Management's 159 Broadway and The Tillery Hotel in Brooklyn, both of which avoided UCC auctions via Chapter 11 filings in December, just hours before the sales were to take place.

He said the last 12 months have shown that the "legal system has seemed to be as stuck as much of the rest of the world. The advent of using UCC sales and lawsuits against personal guarantees has risen dramatically, which has given way for lenders to get some traction in their cases, whereas the regular foreclosure route seems to be a patch of three to five years as it stands."

"The courts upholding the law to allow UCC sales to occur makes sense," Goldwasser added. "People actually signed documents that allow for this to happen. Now, they try to claim it is unjust. Since the fuse is so short, there is a lot to lose. This is just the reason lenders started to use this process in their paperwork. It is not to circumvent the system, but to use it for the purpose it was meant for. If you don't pay your loan, you will lose ownership to the entity that owns the membership in the entity that owns property. The only solution to slow down the train is to file bankruptcy, which brings its own share of complications along with it."

Y. David Scharf, chair and co-managing partner of law firm Morrison Cohen, doesn't think this stops at *Shelbourne*, having found an approach that sticks — a "double-barrelled" approach to protect a borrower.

A couple years after the Great Financial Crisis, Scharf was on the losing side of a UCC case, concerning 500 West Monroe Street in Chicago, in the First Department of the New York Supreme Court's Appellate Division, the result of which ended in the courts deciding that there's no irreparable harm in a commercial foreclosure, because you can ascertain money damages for a commercial property versus a residential property.

"I've been concerned throughout the pandemic as I've followed UCC litigation about the 500 Monroe case," Scharf said, adding that New York state legislation provides a remedy to borrowers around being able to ascertain money damages for a commercial property, regardless of whether the loan documents prohibit them from suing the lender for such damages.

Twice in *Shelbourne,* "the trial courts said that language in the loan documents was such that borrowers couldn't sue lenders for damages, but the consequence of that is there's irreparable injury," Scharf said. "The appellate court in *Shelbourne* had that provision in it, but

it wasn't addressed in its decision; they skipped over that whole analytic."

Scharf added that, "You're saying to the borrower, 'You can get damages, but the loan documents say you can't,' which leaves the borrower with no remedy. It's an unaddressed issue. Bad facts make bad law, and bad lawyering makes worse law."

"Therefore, my briefing in all of my cases had a double-barrelled approach," Scharf added. "No. 1, UCC law says if you have an unreasonable sale, you have a reason to grant an injunction. And, No. 2 is, under typical injunction law, I meet the standard because I'm likely to succeed and I can establish irreparable harm, because the loan documents say I can't get damages, so, therefore, I'm entitled to that remedy."

Scharf brought two cases following the *Shelbourne* decision last month that ultimately succeeded in getting an injunction to stop a UCC.

"We argued the *Shelbourne* decision was an improvident exercise of judicial authority that was unconstitutional," Scharf said. "The court is essentially taking power away that was granted to the court by the Legislature."

The New York Supreme Court's Commercial Division has been wrestling with the *Shelbourne* appellate decision in its aftermath, according to Scharf, who said that it's now been established that "once the sale happens, it will be difficult to ascertain damages, as the 'market' for damages will be flawed by the unreasonable process — and where you cannot ascertain damages, an injunction can be proper."

Despite the maneuvering, many observers are looking at *Shelbourne* as the final crack that's broken the dam.

"I believe this is a necessary evil for the purge that has to happen in every cycle," Goldwasser said. "It will bring things in order in a faster manner and get the results the lenders are looking for, which are a resolution, one way or another."

This story has been updated since publication to include a quote from Plymouth Group Founding Principal Michael Davis.