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Redefining Commercially Reasonable Foreclosure Sales In NY

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For many years, commercial real estate lenders and borrowers have been structuring commercial real estate financings to include one or more tranches of mezzanine debt in an effort to add more leverage to a property without having to raise more equity capital.

As further described below, the principal remedy for such mezzanine lenders in the case of an event of default is a sale governed by Article 9 of the Uniform Commercial Code, which includes certain commercial reasonableness standards. As with all aspects of life, mezzanine borrowers and mezzanine lenders need to reevaluate said standards in light of the COVID-19 pandemic.

Mezzanine debt typically takes the form of a nonrecourse loan made to the direct or indirect parent entity of a property owner and secured by a pledge of 100% of the direct or indirect equity interest in such property owner.

While a mortgage lender can foreclose on real property and wipe out all subordinate lienholders, a mezzanine lender's primary remedy after an event of default under a mezzanine loan is to foreclose on equity interests in the property owner by conducting a foreclosure sale under Article 9 of the UCC.

Pursuant to Article 9 of the UCC, any secured party, which includes a mezzanine lender, may dispose of any or all of the collateral granted to such secured party pursuant to Section 9-610 of the UCC. Said Section 9-610 states that "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable," and thus the procedures themselves must be commercially reasonable.[1]

As a result, New York courts have previously analyzed commercial reasonableness to see whether the secured party "acted in good faith and to the parties' mutual best advantage."[2]

The UCC defines a commercially reasonable disposition as one that is made: (1) in the usual manner on any recognized market; (2) at the price current in any

recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.[3]

While the foregoing provides some guidance, courts have recognized that whether a sale was conducted in a commercially reasonable manner is ultimately fact specific.[4]

These facts may include but are not limited to, and thus one or more of the following factors are not necessarily dispositive one way or the other as it relates to commercial reasonableness, (1) the method and frequency of publication notifying the market of the upcoming disposition,[5] (2) the method and manner for distributing information about the collateral being sold,[6] and (3) the amount of notice given to a borrower that a sale will take place.[7]

The concept of commercial reasonableness has taken center stage in certain UCC sale litigation in recent weeks and months as a result of the COVID-19 pandemic and the unprecedented shelter-in-place regulations.

Specifically, some defaulted mezzanine borrowers are using the current climate to argue that any UCC sale conducted during this time is, on its face, commercially unreasonable because the pre-COVID-19 customary means for diligencing a property and conducting a UCC sale (e.g., doing both in-person) are prohibited or discouraged in most jurisdictions.

While it is impossible to know for sure how each of these cases of first impression will be decided, an analysis of court precedent and general application of the UCC is instructive.

In a recent New York State Supreme Court ruling,[8] the mezzanine borrower claimed that it would suffer economic damage resulting from the noticing, the manner and timing of the sale, particularly in light of the current economic shutdown and restrictions on travel as a result of the COVID-19 pandemic.

Much attention has been given to this case and Judge Frank P. Nervo's conclusions therein (specifically the holding in the recent decision and order issued by the court on May 18) in the mezzanine lending world, but said recent decision and order generally focused on lifting a previously issued temporary restraining order tied to Gov. Andrew Cuomo's Executive Order No. 202.8 putting an moratorium on enforcing foreclosures.

The order only provided that any harm to a borrower resulting from a sale of the mezzanine collateral during the COVID-19 pandemic is merely speculative and that the mezzanine borrower still reserves its rights to sue for damages after the completion of such sale — in other words, the court did not make any determination about whether the noticing, manner or timing of the UCC sale were commercially reasonable.

More recently in another New York State Supreme Court ruling,[9] the court granted a preliminary injunction to a planned UCC sale citing a number of factors in the disposition as not being commercially reasonable.[10] At least two of the reasons cited as grounds for granting the injunction are directly related to the COVID-19 pandemic: (1) the mezzanine lender's 36-day notice period, which the court stated "may be unreasonable during a global pandemic," and (2) the fact that the global shutdown "deprives interested bidders of the chance to do due diligence" (i.e., property tours).

While some mezzanine lenders may view the granting of the preliminary injunction as a negative, it should be viewed as instructive, as the court went on to lay out certain parameters that would make the

disposition of the collateral commercially reasonable.

Specifically, the court stated that, inter alia, the mezzanine lender needed to (1) send new notices of the sale of the collateral, which set forth an additional 30-day notice period and the revised terms of the sale, and (2) indicate in said notice that bidders may participate virtually to account for the limitations on transportation and people's fear of modes of transportation.

Lastly, the court indicated that the notice of sale needed to, at a minimum, "comport with current CDC, state and local regulations."

In light of the above noted court decisions and fluidity of the current COVID-19 pandemic, including soft openings around the country where some UCC sale participants may be comfortable participating live and others only virtually, we anticipate seeing mezzanine lenders adjust their approaches to certain aspects of UCC sales, many of which are often intertwined.

For example, mezzanine lenders may now be more willing to conduct UCC sales via electronic communication platforms (such as Zoom, WebEx or a similar platform), and will need to consider whether such electronic platforms are sufficient in and of themselves to satisfy the commercially reasonable standard set forth in Section 9-627(b) of the UCC as it relates to the manner of sale, or whether an in-person option needs to be available as well, noting the analysis may change if there is a resurgence of COVID-19.

Related points include what publication notices for UCC sales need to include when conducting a virtual sale (e.g., should the virtual sale language stand out, and does there need to be language specifically addressing the COVID-19 related reason for virtual sale, etc.).

Additionally, from a documentation standpoint, mezzanine lenders and their respective counsel may begin to revisit language in their form pledge agreements, which are the customary agreements that create the security interest that secures a mezzanine loan, in order to address changing standards.

It is becoming clear that the COVID-19 pandemic has created a new normal in most of our lives and will impact many aspects of everyday life, such as what we may or may not consider to then be commercially reasonable, for many months to come. As a result, both mezzanine lenders and mezzanine borrowers will need to take into account the changing landscape as it relates to UCC sales, including the various court rulings then to date, when determining when and how to proceed with, or react to, any UCC sale.

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[1] U.C.C. § 9-610(b); Fed. Deposit Ins. Corp. v. Herald Square Fabrics Corp., 81 A.D.2d 168, 184 (N.Y. App. Div. 1981).

[2] 108th St. Owners Corp. v. Overseas Commodities Ltd., 238 A.D.2d 324, 325 (N.Y. App. Div. 1997); see MTI Sys. Corp. v Hatziemanuel, 151 A.D.2d 649, 650 (N.Y. App. Div. 1989).

[3] U.C.C. § 9-627(b).

[4] In re Excello Press, Inc., 890 F.2d 896, 905 (7th Cir. 1989) (applying New York law); see also Fed. Deposit Ins. Corp. v. Forte, 144 A.D.2d 627,629 (N.Y. App. Div. 1988).

[5] In National Housing Partnership v. Municipal Capital Appreciation Partners I, L.P., 935 A.2d 300, 318 (D.C. 2007), the court stated: "Courts…have recognized that advertising specialized collateral only in newspapers and periodicals of general circulation is likely to be inadequate; such collateral may need to be advertised in specialized trade or commercial publications, and [through] specialized dealers." (internal quotation marks omitted).

[6] Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P. 821 A.2d 296, 316 (Del. Ch. 2002).

[7] There is legal precedent of notice periods as short as 20 days being commercially reasonable (see id. at 306).

[8] 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 651812/2020 (N.Y. Sup. Ct. May 18, 2020).

[9] D2 Mark LLC v. OREI VI Invs. LLC, No. 652259/2020, (N.Y. Sup. Ct. June 23, 2020).

[10] The Court focused on the following factors, several of which were cited in an affidavit submitted on behalf of mezzanine borrower: (1) the mezzanine borrower was initially prohibited from participating in the sale process (although the mezzanine lender ultimately reversed course on this restriction 15 days before the proposed sale date); (2) the notice period for the sale was only 36 days; (3) the published notice indicated that the sale would take place either virtually or at the mezzanine lender's lawyer's office (i.e., it didn't unequivocally provide both options); (4) the proposed sale process was too stringent (as an example, a large deposit was payable on the sale date, with the remainder of the purchase price payable 1 day later); (5) the property was subject to shelter-in-place ordinances for a portion of the 36 day notice period, which prohibited potential bidders from doing a site tour of the physical property; and (6) the mezzanine lender included for itself a right to submit its credit bid either before or after the closing of the third party bidding, which would chill the bidding (according to said affidavit). Id.