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LENDER VS. BORROWER:

With UCC Foreclosures on the Rise, Who's Coming Out on Top?

A court recently ruled that a lender with both a UCC pledge and a real property mortgage could determine which instrument it wanted to foreclose through. Has a standard been set?

BY CATHY CUNNINGHAM • JULY 31, 2018

On July 18, Toby Moskovits and Michael Lichtenstein sat in Brooklyn's Supreme Court for the latest hearing on 564 St. John's Place—their 193-unit multifamily property in Crown Heights, Brooklyn. As Commercial Observer has reported, the owners are locked in a contentious battle with their lender, Benefit Street Partners, which alleges that the borrowers have defaulted on their loan. As a result, Benefit Street scheduled a Uniform Commercial Code (UCC) foreclosure auction on the property's $8 million in mezzanine debt, now adjourned until Aug. 22. If the sale goes ahead, the winning bidder will receive 100 percent equity interest in the entity that owns the building.

And—in seemingly good news for lenders who have the real property mortgage as well as pledged security interests as collateral for their loan—pursuing a UCC foreclosure as opposed to a judicial foreclosure just became even more enforceable thanks to a recent, separate decision in a New York County court. The property is the latest of many to be faced with a potential auction under Article 9 of the UCC, which enforces a borrower's pledged security interests in the entity that owns a property and allows a fast-tracked foreclosure timeline. In the case of 564 St. John's Place, Benefit Street—both the senior and the mezzanine lender—is foreclosing via those pledged equity interests that serve as collateral for the mezzanine loan.


Michael Lefkowitz

On June 20, New York Judge Barry Ostrager denied borrowers H.H. Cincinnati Textile and H.H. KC Mark Twain a preliminary injunction to prevent New York-based Acres Capital Servicing and D.W. Commercial Finance from auctioning off the equity interests in two real estate development projects in Kansas City and Cincinnati. The case heralds a significant standard, some industry insiders say: when parties in commercial real estate financings include a real property mortgage and a pledge of UCC security interests as collateral for the debt, the lender has an option to pursue either a UCC foreclosure on the borrower entity or a foreclosure on the real property.

Attorneys for both the plaintiffs did not return requests for comment. Attorneys for the defendants declined to comment.

Prior to this decision, no other court had explicitly held an opinion that a lender with both a UCC pledge and a real property mortgage could determine which instrument it wanted to foreclose through, nor whether a foreclosure on a UCC pledge wouldn't constitute a clog on a borrower's equity of redemption—in other words, interfere with the borrower's ability to pay off the loan before foreclosure.

The "clogging of the equity of redemption" is a big legal consideration as a practical matter. Since a UCC foreclosure is an accelerated process, it can be difficult for a borrower to come up with alternative financing sources in the significantly reduced timeframe.

"It is an important case because it confirms that there are two valid paths for lenders holding dual collateral instruments to take control of a property interest after a default," explained Matthew Parrott, a partner at Fried Frank and co-chair of the firm's real estate litigation practice group, who has worked on similar cases. "One is the direct path, held by senior lenders who have a real property mortgage and go through a judicial foreclosure proceeding in New York—which can sometimes take two years or more—and the danger of delay associated with that can be significant. A quicker path is often the indirect path where the lender holds a pledge of membership interests in the borrower entity as collateral and under the Uniform Commercial Code a lender is really only bound by commercial reasonableness in terms of the amount of time it takes to market the property and do the auction."

The UCC foreclosure option is therefore understandably often an attractive and less arduous one for a lender. Perhaps the most famous example, and one that Parrott worked on, was the UCC foreclosure auction of Trump Soho in 2014; when the Sapir Organization and Bayrock Group-developed hotel-condominium tower failed to find buyers for the individual units the property was then auctioned off by its lender CIM Group.

In the H.H. Cincinnati Textile case, the borrowers' $20 million defaulted loan matured in August 2017, after which the lenders issued a notice of default and initiated a marketing campaign around the potential UCC foreclosure sale of the equity interests in the borrower entity. Although the loan and pledge agreements stated that the lender may foreclose on the collateral in the event of a default, the borrowers tried to stave off the sale in claiming that the lender had "clogged" their equitable right of redemption to pay off the mortgage debt. But, the court decided that the borrowers' right of redemption is still intact until the collateral is auctioned, and there's nothing to prevent them from bidding at said auction.

"We were pleased with the [H.H. Cincinnati Textile] decision because prior to now, borrowers with sophisticated counsel would often raise the clogging of redemption rights defense and there was no explicit opinion that stated that was just wrong," Parrott said. "The court held that it is not a valid defense because a borrower has the right to repay a mezzanine loan or to redeem under the UCC

just as they have the right to redeem the senior mortgage; it's just a different timeline for the two different security interests that are potentially in play, but both are enforceable."

In New York, another UCC foreclosure auction is also pending on 29 Overlook Terrace, also known as One Bennett Park, a 23-story residential building in the Hudson Heights neighborhood of Manhattan. On Aug. 15, bidders will compete for the 100 percent equity interest of the project's ownership entity. The troubled property has had its fair share of press. In 2014, a Manhattan Supreme Court judge ruled that Ultra Construction Loan Investment Fund, which provided a $95 million loan in the project, must resume funding the condo project after it claimed developer Rutherford Thompson defaulted on the loan's maturity date and ceased funding.

Representatives for the developer didn't respond to requests for comment, and representatives for the lender and Ariel Property Advisors, which is leading the auction, declined to comment.

The 29 Overlook Terrace financing doesn't include a mezzanine loan, but rather a $63 million building loan, a $26 million senior loan and a $6 million project loan. The pledge agreement was structured to include 100 percent of the ownership entity LLC as additional collateral for the debt, thereby allowing for a UCC foreclosure auction.

Despite these recent examples, "I don't believe we're seeing a significant uptick in UCC foreclosures right now," said Neil Shapiro, a partner at Herrick Feinstein, who represents both lenders and borrowers. "I, along with several of my colleagues, am working on several distressed mezzanine loans but very few are in the foreclosure process right now."

Those loans are however, perhaps unsurprisingly, "almost all" transitional loans, Shapiro said.

Michael Lefkowitz, a member of Rosenberg & Estis, who has represented both lenders and borrowers in complex litigation surrounding the workout of distressed loans, said that borrowers are generally focused on getting their projects completed and not on "what happens if everything goes bad." Therefore, they're often willing to pledge what's needed in order to be lent the money to complete their property.

Does a lender's decision to take pledged security interests as additional collateral for a loan, or the decision to pursue a UCC foreclosure as opposed to a judicial foreclosure on a transitional property (or one under construction) indicate that lenders are perhaps taking a tougher stance with their borrowers? The jury is out, but chances are that, given the stage of the real estate cycle (which has been overdue for a correction for some time), lenders are perhaps a little more cautious and have less tolerance for missed deadlines.

In this highly competitive financing environment, many lenders pride themselves on their flexibility around transitional assets' nuances and project timelines but, "whether the lender will work with the borrower really depends on what the delay is and what the default is," Lefkowitz said. "Well-structured loan documents put the lender in the driver's seat to determine whether or not they will continue to work with the borrower or say, 'Time's up.' "

"At this point in the cycle lenders are a bit more cautious because they don't want to continue to leave that capital at risk if they don't have a good faith belief that the borrower is going to be able to execute on their business plan, if not in a timely fashion in some amended fashion that meets the lender's need to have the loan repaid," Lefkowitz explained.

One lender, who spoke with CO on the condition of anonymity, takes a harder line. "We're absolutely less tolerant of any deviation from loan agreements," he said. "I think lenders are starting to push back because they don't want to get caught with their proverbial pants around their ankles. Especially that high in the capital stack, they don't want the exposure."

Lefkowitz said he is aware of several UCC auctions that are currently underway, but said it makes sense, given that in late-term cycles you have construction delays and, "nobody really wants to the be the person without a chair when the music stops," he said.

Despite the H.H. Cincinnati Textile decision, there is still a dearth in case law around lenders taking both senior and mezzanine positions in a financing and successfully being able to foreclose on the mezzanine loan while skipping the longer process of going through a mortgage foreclosure.

"Many in the legal community feel that the [H.H. Cincinnati] decision might not withstand the test of time, because the grounds on which it was decided—the preliminary injunction—maybe wouldn't stand up on an appeal of its merits," Lefkowitz said.

Additionally, while the decision appears to bode well for lenders for now, things could change as more cases are presented before a judge. "As case law develops, and if it is ultimately determined that [pursuing a UCC foreclosure] is a clogging of the equity of redemption and your UCC mortgage could be void or voidable, lenders might think twice about whether taking that additional collateral is even worth it," Lefkowitz said.

Parrott sees it differently: "In my experience you typically see different lenders in different positions in the capital stack holding different security interests and you don't often see the same lender holding both the UCC pledge and the real property mortgage, but now that this decision has come down I think that any senior lender would be well served to insist on holding both types of collateral if it can arrange that," he said. "If you're a single lender on a project, it would make no sense not to have both security interests because you'd have the opportunity to choose which one you'd want to pursue."

Of course, not everyone has the experience to adequately fill both the senior and mezzanine lender roles, seeing as a critical component of being a mezz lender is having the ability to step in and operate real estate.

"A lot of senior lenders simply don't have that capability," said the lender source. "But if you do, you'd be silly not to push for both the senior and lender position as it opens up your options when things go south."

Only time will tell how many more UCC auctions we'll see as we near the end of the cycle, whenever that may be.

"We've all been waiting for when the market is going to turn and, while you see examples here and there of distressed projects, there hasn't been a flood of remedy enforcement actions that you see when the cycle really turns," Parrott said, adding that, "There are a lot of people who think it could happen soon."

For now, Shapiro said he is having discussions with his clients regarding how to deal with potential issues down the road. The two hot areas are high-end condo loans where unit sales are slow, and retail assets. "I don't know how far away we are from the end, but we're certainly in the later innings," he said.

And if a developer does lose a property to foreclosure, time may heal his or her reputation, Parrott said. "There are many famous and very successful developers who have failed on past projects and later returned to the lending markets and developed successful projects over and over again. But if a developer has a reputation for bad faith or fraud, that can make it extremely difficult for them to get financing." ■