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DRANO Revisited: Further Updates on the Doctrine of Clogging the Equity of Redemption

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On June 2, 2020, in *HH Mark Twain LP v. Acres Capital Servicing LLC*,[1] the Supreme Court of the State of New York (the "Court") denied the defendant's motion to dismiss the plaintiff's "clogging" claim, thereby providing a piece of an answer to a cliffhanger from two years ago regarding whether a lender can safely structure a loan that is secured by both a mortgage and an equity pledge without violating a borrower's equitable right of redemption. Previously, in June 2018, the Court refused to issue a preliminary injunction to prevent the foreclosure sale of the equity interests in HH Cincinnati Textile L.P. and HH KC Mark Twain, L.P. (together, the "Borrowers").[2] Some saw the June 2018 decision as an answer to the "clogging" question that has long puzzled lenders and practitioners, but as the June 2, 2020 decision makes clear and as discussed in a Clients & Friends Memo from July 27, 2018 entitled *Unclogging the Equity of Redemption Without "DRANO": Recent New York State Decision Sheds Light on Mortgage Loans Additionally Secured by Equity Pledges*[3] (the "2018 Memo"), the earlier decision was a narrow one that left the question unanswered for now.

Background

The Borrowers owned and financed redevelopment projects on real property located out of state in Cincinnati and Kansas City.[4] Instead of entering into a mortgage loan secured by real property and entering into a separate mezzanine loan secured by limited partnership interests in the Borrowers, Acres Capital Servicing LLC, as agent for DW Commercial Finance, LLC (the "Lender") and the Borrowers entered into a single loan secured by both forms of collateral.[5] Ultimately, the Borrowers failed to repay the loan, and the Lender sought to conduct a UCC foreclosure sale of the limited partnership interests in the Borrowers.[6] The Borrowers then filed a suit claiming, among other things, that by conducting a UCC foreclosure sale of the limited partnership interests, the Lender unlawfully "clogged" the Borrowers' equity of redemption.[7] The Court, in June 2018, did not decide on the merits of the "clogging" claim, but instead ruled against Borrowers' motion for a preliminary injunction because the Borrowers failed to show that they would suffer irreparable harm without the preliminary injunction.[8] Shortly thereafter, the Lender completed the UCC foreclosure sale, and acquired control of the properties.[9]

As one might expect, that was not the end of the story.

One of the Borrowers, along with Andrew Greenbaum and Steven Michael, the principals of Hudson Holdings, LLC (the "Guarantors"), brought a complaint alleging, among other things, "that in conducting the sale of the collateral securing the loan, the [Lender] acted in a commercially unreasonable manner" and "that [the Lender's] purported right to sell certain security interests under the contracts at issue also vitiated [the Borrower's] right to equitable redemption in violation of longstanding New York public policy."[10]

Mezzanine Financing

In typical commercial real estate finance, a borrower grants a mortgage on its real property as the principal collateral which secures its obligation to repay a loan.[11] A mortgage is a security interest in real property that is owned by a borrower (the mortgagor) and granted to a lender (the mortgagee) as assurance for the payment of the debt between them.[12] In the event the mortgagor defaults on the payment of the debt underlying the mortgage, the mortgagee has

the right of foreclosure —the right to take possession and ownership of the real property in order to satisfy the debt. [13]

If a financing secured by a first mortgage does not provide sufficient funds, second lien financing may be used to borrow additional funds against the property.[14] Mezzanine debt is the most common form of second lien financing in commercial real estate finance.[15] It is the level of debt between traditional debt secured by a mortgage on a property and equity ownership. A mezzanine loan is made to a pledgor that is the equity holder of a mortgagor.[16] The loan is secured not by the real property itself, but by a pledge of the mezzanine borrower's equity interests in the mortgagor. [17] Upon a default, the mezzanine lender has the ability to foreclose on the equity interests in the mortgagor, and thus, assume effective control of the property.[18] Mezzanine financing is also advantageous because it permits a much faster foreclosure procedure, as the equity interests are considered personal property, and thus subject to a UCC foreclosure rather than a judicial foreclosure.[19] Unlike a judicial foreclosure that may take many months or years to complete in some jurisdictions, a UCC foreclosure can be carried out within a few months.[20] One major distinction between a typical mortgage and mezzanine financing and the structure of the instant case is that in a typical structure, the loans are segregated as separate and distinct loans to separate borrowers by separate lenders.

Equity of Redemption: The Anti-Clogging Doctrine

The equity of redemption, also known as the anti-clogging doctrine, is an indispensable right that protects mortgagors facing foreclosure of their real property interests transferred as collateral.[21] The doctrine holds that every mortgagor has the right, at any time after default, to redeem the collateral by repaying the debt in full before the lender has completed a foreclosure (typically an auction) on the collateral.[22] Traditionally, courts have been hostile to clauses and devices that "clog" the equity of redemption; that is, clauses and devices that purport to recognize the equity of redemption, but whose practical effect nullifies or restricts the doctrine's operation.[23]

HH Mark Twain LP v. Acres Capital Servicing LLC

The Facts

The Borrowers were established by Hudson Holdings to own and seek financing in connection with Hudson Holdings' redevelopment projects on real property located in Cincinnati and Kansas City.[24] On February 29, 2016, the Borrowers entered into a loan agreement with the defendants, Acres Capital Servicing LLC and DW Commercial Finance, LLC.[25] The loan was in the principal amount of $20,300,000, and was secured primarily by two forms of collateral: (i) a mortgage on the real property associated with each project; and (ii) a pledge by HH Mark Twain LP and Hudson KC Real Estate Manager (the "Pledgors") (plaintiffs in the June 2018 decision) of their limited partnership interests in the Borrowers.[26]

The loan and pledge agreements provided that if the Borrowers failed to repay the loan by August 29, 2017, the Lender was entitled to foreclose upon any part of their collateral.[27] The Borrowers failed to repay the loan, and thus defaulted.[28] Afterwards, the Lender initiated a marketing campaign regarding a potential UCC foreclosure sale of the limited partnership interests in the Borrowers.[29] As discussed in the 2018 Memo, the Borrowers filed suit seeking a preliminary injunction, which the Court ultimately denied.[30] The UCC foreclosure sale went on, and the Lenders took control of the property.

Pledgors and the Guarantors (the "Plaintiffs") filed suit in *HH Mark Twain LP* alleging that in conducting the sale the Lenders (the "Defendants") had acted in a commercially unreasonable manner and that the structure of the loan "clogged" the Borrowers' right of redemption by including both a mortgage and an equity pledge. The plaintiffs brought four causes of action: "(1) for a declaration that the Loan Agreements are null and void because they violate Borrowers' and Guarantors' equitable right of redemption; (2) violation of UCC § 9-610 (UCC sale was unreasonable); (3) breach of implied covenant of good faith and fair dealing; [and] (4) breach of 'duty:'" The Lenders moved to dismiss the complaint, which the Court granted as to the third and fourth causes of action and denied as to the first and second causes of action.

The Decision

In rendering its decision as to the first cause of action, the Court noted that the Defendants' motion to dismiss was based on the argument that the "clogging" claim was rejected by the Court in the June 2018 decision. The Court rejected this argument and reiterated that it had not ruled on the merits of the Plaintiffs' clogging claim in 2018, and that the June 2018 decision rejecting the preliminary injunction was based on the fact that the Plaintiffs' claims could be adequately remedied by monetary damages, and therefore an injunction was not an appropriate remedy.[31] The

Court also permitted the second cause of action to continue as the Court determined that commercial reasonableness or unreasonableness of the UCC sale is a question of fact that cannot be determined on a motion to dismiss.**[32]**

The third and fourth causes of action were dismissed as being substantially related to the underlying contracts (*e.g.*, the loan documents), and therefore were substantially duplicative to the breach of contract claims and facts alleged in the first and second causes of action.**[33]**

Conclusion

In denying the Defendants' motion to dismiss the clogging claim, the Court in *HH Mark Twain LP* clarified that its June 2018 decision had not answered the longstanding question of whether under New York law, a loan can be secured by both a mortgage and an equity pledge. Perhaps a trial on the merits of the Plaintiffs' claim in *HH Mark Twain LP* will provide an answer. Until then, lenders should exercise caution in structuring loans with both a mortgage and equity pledge. Given the current judicial landscape, a dual collateral loan can expose a lender to years of litigation as exemplified by the instant case.

[1] *HH Mark Twain LP v. Acres Capital Servicing LLC*, Index No. 656280/2019, 2020 N.Y. Misc. LEXIS 2515 (N.Y. Sup. Ct. June 2, 2020).

[2] *HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC*, No. 652871/2018, 2018 N.Y. Misc. LEXIS 2472 (N.Y. Sup. Ct. June 19, 2018) (order denying preliminary injunction).

[3] *Unclogging the Equity of Redemption Without "DRANO": Recent New York State Decision Sheds Light on Mortgage Loans Additionally Secured by Equity Pledges*, July 27, 2018, available at **https://www.cadwalader.com/resources/clients-friends-memos/unclogging-the-equity-of-redemption-without-drano-recent-new-york-state-decision-sheds-light-on-mortgage-loans-additionally-secured-by-equity-pledges**

[4] *HH Cincinnati Textile L.P.*, 652871/2018, at 1–2.

[5] Id.

[6] Id. at 2.

[7] Id.

[8] Id. at 3–4.

[9] *HH Mark Twain LP*, Index No. 656280/2019 at 2.

[10] Id.

[11] Andrew R. Berman, "Once a Mortgage, Always a Mortgage" - *The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, 11 Stan. J.L. Bus. & Fin. 76 (2005).

[12] *See* Restat 3d of Property: Mortgages, § 1.1 (3rd 1997).

[13] Id.

[14] *See* Berman, *supra*.

[15] Adam J. Levitin & Susan M. Wachter, "The Commercial Real Estate Bubble", 3. Harv. Bus. L. Rev. 83, n. 51 (2013).

[16] Id.

[17] Id.

[18] Georgette Chapman Poindexter, "Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing", 2 Berkeley Bus. L.J. 233, 240 (2005).

[19] Levitin, *supra* at n. 51.

[20] *See* id.

[21] *See* Restat 3d of Property: Mortgages, § 3.1 (3rd 1997).

[22] *See* id.

[23] Id.

[24] Complaint at 4, *HH Cincinnati Textile L.P.* (652871/2018).

[25] Defendant's Memorandum at 4, *HH Cincinnati Textile L.P.* (652871/2018).

[26] Id.

[27] Id. at 5.

[28] Id.

[29] *HH Cincinnati Textile L.P.*, 652871/2018, at 2.

[30] *HH Mark Twain LP*, Index No. 656280/2019 at 2.

[31] *HH Mark Twain LP*, Index No. 656280/2019 at 4.

[32] Id.

[33] Id.