Clients&FriendsMemo

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

On June 19, 2018, in HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC,[1] the Supreme Court of the State of New York refused to issue a preliminary injunction to prevent the foreclosure sale of the equity interests in two borrowers under Article 9 of the Uniform Commercial Code ("UCC").[2] HH Cincinnati Textile L.P. and HH KC Mark Twain, L.P. (together, the "Borrowers") owned and financed redevelopment projects on real property located out of state in Cincinnati and Kansas City.[3] 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, the parties to the litigation entered into a single loan secured by both forms of collateral.[4] Ultimately, the Borrowers failed to repay the loan and Acres Capital Servicing LLC, as agent for DW Commercial Finance, LLC (the "Lender") sought to conduct a UCC foreclosure sale of the limited partnership interests in the Borrowers.[5] 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.[6]

The court in HH Cincinnati Textile L.P. did not rule on the Borrowers' clogging claim, rather, the court decided on the Borrowers' motion for a preliminary injunction. Writing for the court, Justice Barry Ostrager found that the Borrowers failed to show that they would suffer irreparable harm without the preliminary injunction.[7] Even so, the case serves as a precautionary tale to lenders of the dangers of securing a single mortgage loan with both a mortgage and a pledge of equity. With

1 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).

2 See N.Y. U.C.C. Law § 9-610 (Consol., Lexis Advance through 2018 Chapters 1-120).

3 HH Cincinnati Textile L.P., 652871/2018, at 1–2.

4 Id.

5 Id. at 2.

6 Id.

7 Id. at 3–4.

a structure of a mortgage coupled with an equity pledge, a lender exposes itself to a potential claim of clogging the equity of redemption when it seeks to enforce its right to foreclose on the equity pledge. While a typical UCC foreclosure sale of limited partnership interests can be completed in 30-60 days, years of litigation resulted when a mortgage loan was combined with a pledge of equity.

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.[8] 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.[9] 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.[10]

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.[11] Mezzanine debt is the most common form of second lien financing in commercial real estate finance.[12] It is the level of debt between traditional debt secured by a mortgage on a property and corporate equity. A mezzanine loan is made to a pledgor that is the equity holder of a mortgagor.[13] The loan is secured not by the real property itself, but by a pledge of the mezzanine borrower's equity interests in the mortgagor.[14] In the event of 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.[15] 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.[16] 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.[17] One major distinction between a typical mortgage and mezzanine financing and the structure of the instant case is that in

8 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).

9 See Restat 3d of Property: Mortgages, § 1.1 (3rd 1997)

10 Id.

11 See Berman, supra.

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

13 Id.

14 Id.

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

16 Levitin, supra at n. 51.

17 See id.

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.[18] 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.[19] 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.[20] However, New York statutory law protects lenders against issues related to clogging the equity of redemption when the lender has also obtained an option to acquire an equity interest in the mortgagor/property owner.[21] In order for lenders to receive such protection: (i) the loan amount must be at least $2,500,000; and (ii) the option right cannot be triggered by the mortgagor/property owner's default.[22] If these two requirements are met, the statute expressly validates a lender's option to purchase the equity interest in the mortgagor/property owner.[23]

HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC

The Facts

Two of the plaintiffs—HH Cincinnati Textile L.P. and HH KC Mark Twain, LP—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

18 See Restat 3d of Property: Mortgages, § 3.1 (3rd 1997).

19 See id.

20 Id.

21 N.Y. Gen. Oblig. Law § 5-334 (2008).

22 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).

each project; and (ii) a pledge by HH Mark Twain LP and Hudson KC Real Estate (two additional plaintiffs and together, the "Pledgors") 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]

The Analysis

The court's decision is limited solely to whether to grant the Borrowers' motion for a preliminary injunction to prevent the UCC foreclosure sale of the limited partnership in the Borrowers. Thus, the court focused on whether the Borrowers would suffer irreparable harm without the preliminary injunction. In addition, the court made note of the fact that monetary damages were available to the plaintiffs and consequently a preliminary injunction was not warranted. In concluding that the Borrowers would not suffer irreparable harm and thus were not entitled to a preliminary injunction, the court quoted a decision by the First Department of the Appellate Division of the Supreme Court of New York.[30] The appellate court stated that:

> Since "[plaintiffs'] interest in the real estate is commercial, and the harm [they] fear is the loss of [their] investment, as opposed to loss of [their] home or a unique piece of property in which [they have] an unquantifiable interest, they can be compensated by damages and therefore cannot demonstrate irreparable harm."[31]

The statement itself is a quote from a decision by the U.S. District Court for the Southern District of New York, which cited no federal nor state law in support of its assertion.[32]

The court's measure of the uniqueness of the Borrower's interest in real property runs afoul of the New York Court of Appeals' test. In *Van Wagner Advertising Corp. v. S & M Enterprises*, the trial court previously denied the plaintiff-lessee's request for specific performance regarding a lease for commercial space.[33] The lessee contended that the property was unique because of its location

26 Id.

27 Id. at 5.

28 Id.

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

30 Broadway 500 W. Monroe Mezz II LLC v. Transwestern Mezzanine Realty Partners II, LLC, 915 N.Y.S.2d 248 (N.Y. App. Div. Jan. 13, 2011).

31 Id. at 249.

32 SK Greenwich LLC v. W-D Grp. (2006) LP, 2010 U.S. Dist. LEXIS 112655, at 8–9 (S.D.N.Y. Oct. 21, 2010).

33 Van Wagner Adver. Corp. v. S & M Enters., 67 N.Y.2d 186, 191 (1986).

and particular use for the lessee's advertising business.[34] The Court of Appeals rejected the lessee's measure for uniqueness and affirmed the denial of specific performance.[35] The Court clarified that uniqueness in the sense of physical difference does not itself dictate the propriety of equitable relief.[36] Uniqueness is measured by the uncertainty of valuing the property.[37] A determination of uniqueness means that a court cannot obtain, at reasonable cost, enough information about substitutes to permit the court to calculate an award of monetary damages.[38]

Regardless of the erroneous notion that an interest in commercial property is not unique simply because of its nature and therefore its loss does not constitute irreparable harm, the *HH Cincinnati Textile L.P.* court's reliance on *Broadway 500 W. Monroe Mezz II LLC* is misplaced.[39] The case at hand focuses on the equity interests in the Borrowers and not the real property interests (i.e., title) that the Borrowers hold. Under New York's Partnership Law, a limited partnership interest is considered personal property.[40] Thus, a sale of the limited partnership interests in the Borrowers is subject to UCC foreclosure and not judicial foreclosure. Consequently, the court's focus on the nature of the residential or commercial uniqueness of the real property seems misguided.

New York's Court of Appeals recognized the distinct treatment between a limited partnership interest versus a real property interest in Reiter v. Greenberg.41 Similar to the case at hand, Reiter involved a limited partnership that was formed solely for the purpose of acquiring title to, operating, and managing real property.42 The Court of Appeals stated that individuals who held an interest in the limited partnership acquired no title to the real property and merely acquired a pro rata share of the limited partnership's profits and surplus.[43] Thus, an interest in a limited partnership—even a partnership that deals solely in real estate—is personal property and not real property.[44] Since a

34 Id. at 192.

35 Id. at 192, 195.

36 Id. at 192.

37 See id. at 193.

38 Id.

39 Interestingly, the complaint clarifies that the redevelopment projects are two buildings that were accepted and placed on the National Register of Historic Places, and the Borrowers sought to preserve and redevelopment the buildings.

40 N.Y. Partnership Law § 107 (Consol., Lexis Advance through 2018 Chapters 1-120).

41 Reiter v. Greenberg, 21 N.Y.2d 388 (1968).

42 Id. at 391.

43 Id.

44 Id.

personal property interest is not governed by real property law, the "uniqueness" of the underlying property seems irrelevant.[45]

Since the court, in dicta, stated that the Borrowers' equitable right of redemption had not been clogged by the operative agreements because they still retained a right of redemption under UCC § 9-623, this case has received much attention and is cited by some as a reason to include pledges as additional collateral in typical mortgage financings. For the reasons outlined herein, we believe such course of action fails to account for significant risks.[46]

Conclusion

In denying the motion for a preliminary injunction, the court in *HH Cincinnati Textile L.P.* confirmed the enforceability of a lender's right to opt for a UCC foreclosure of the equity interests of a property owner rather than a judicial foreclosure on the property itself. While this is a welcome decision to further solidify the reliance in the lending community of equity pledges securing mezzanine loans, it is still a troubling decision when a pledge is combined with the grant of a mortgage. The case also demonstrates the dangers that lenders expose themselves to by not separating forms of collateral between a mortgage loan and a mezzanine loan. Failure to establish mezzanine financing while securing a mortgage loan in part with a pledge of equity interests in the mortgagor may expose lenders to potential clogging claims that can be avoided by separating real property interests from equity interests in the property owners. As demonstrated in *HH Cincinnati Textile L.P.*, the case is still ongoing and the Lender may face years of litigation and related costs.

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45 See id.

46 HH Cincinnati Textile L.P., 652871/2018, at 3–4.