# *UCC Mezzanine Loan Collateral Sales: Commercial Reasonableness During COVID*

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During the past few months several New York cases involving UCC sales of equity pledged to secure mezzanine loans have underscored whether the concept of commercial reasonableness may apply differently during the COVID-19 pandemic. A typical mezzanine real estate loan structure involves a loan made to a mezzanine borrower that owns all of the equity interests in a special purposes entity (often a limited liability company) that in turn owns a commercial real estate property. The mezzanine borrower pledges its equity interest in the property owner as collateral to secure the mezzanine loan. When a default arises under the mezzanine loan the lender may seek to sell its collateral under the UCC, provided, however, that every aspect of a disposition of collateral, including the method, manner, time and place and other terms of sale must be commercially reasonable. See N.Y. U.C.C. §9-610(b)

## Executive Orders Barring Residential and Commercial Foreclosures

Pursuant to a number of executive orders, New York state barred residential and commercial foreclosures for an initial period of 90 days to June 20, 2020 and subsequently extended that time period to Jan. 1, 2021 (the Executive Orders). These Executive Orders, however, did not expressly bar UCC sales of collateral but the rationale for such orders was considered and/or implicitly adopted by courts in connection with UCC sales.

## 'D2 Mark'

The decision by the court in D2 Mark v. Orei VI Investments, may be the first time in New York that a preliminary injunction preventing a UCC collateral sale has been granted in connection with a mezzanine loan. The court found that the sale procedures that were implemented and proposed were not commercially reasonable under the current circumstances of the pandemic. One other key factor considered by the court was language in the mezzanine loan agreement which the court interpreted as limiting the borrower's remedies to injunctive relief and therefore precluded monetary damages.

This interpretation allowed the court to find irreparable harm as part of the court's preliminary injunction analysis. Whether the court's interpretation of this language was correct is subject to debate. The lender argued that the language in question that limited the borrower's remedies to injunctive relief was itself limited to the lender's failure to

grant consents—and did not apply to sales under the UCC, so that damages would, in fact, be available. However, the court did not accept that argument.
By way of background, the plaintiff borrower entered into a $35 million mezzanine loan transaction with the lender and pledged its equity interest in the indirect owner of the leasehold estate in the Mark Hotel, a landmark hotel located on the Upper East Side of Manhattan.

Due to the COVID-19 pandemic, the Mark Hotel was forced to temporarily close causing the mortgage borrower to fail to make payments on the senior loan. As a result, the mezzanine lender cured the delinquent payments to protect its interests. While the borrower was negotiating a forbearance with the senior lender, the mezzanine lender served a notice of sale of the borrower's pledged equity interest.

The sale notice outlined a virtual and in-office sales process pursuant to which the winning bidder was required to immediately provide a non-refundable 10% deposit and close the transaction within 24 hours of the auction. The record showed that the lender's broker contacted 700 bidders, 115 of whom signed NDAs. The sale was also advertised in the Wall Street Journal and in a trade publication. These efforts generated two pre-qualified bidders.

The mezzanine borrower sought a preliminary injunction to stop the sale, arguing that the sale was not commercially reasonable because, among other things, the borrower was initially excluded from the bidding process and a 36-day notice was too short a time period in light of the COVID-19 pandemic. The court granted the borrower's motion for a preliminary injunction, finding that the borrower had sufficiently demonstrated a likelihood of success on the merits that it would be irreparably harmed because it could not recover money damages and that the equities weighed in favor of the borrower who stood to lose control of its sole asset, related trademarks, and operating control of related businesses if relief were denied.

The court, however, never considered whether the sale was barred by the Executive Orders, instead noting that the Executive Orders may be persuasive authority demonstrating that what may be reasonable during normal times may not be reasonable during a pandemic. The court relied on various aspects of the sale, noting that 36 days was too short a time to allow for a robust auction and that a period of 60-90 days was more reasonable. The court also noted that of the 36 days in question, the hotel was closed for 27 of those days, depriving potential bidders of any meaningful opportunity to conduct on-site inspections.

The court gave little weight to the 115 NDAs, instead finding that the fact that only two bidders emerged as better evidence of whether the process was reasonable. The court was also troubled by the onerous transaction terms requiring an immediate 10% deposit and a 24 hour closing deadline which effectively precluded bidders other than the lender from complying with the sale requirements. Finally, the court was concerned as to where and how the sale was to be conducted, it being unclear whether the sale would be conducted virtually or in person, the latter situation potentially causing bidders not to participate because of COVID-19.

The court stayed the sale for 30 days to give the market more time to evaluate the transaction and for the lender to re-notice the sale and develop a more commercially reasonable sale process. Pursuant to a Stipulation and order dated July 27, 2020 the action commenced by the borrower was discontinued with prejudice and on the merits.

**'Shelbourne BRF'**

The *Shelbourne* case involved a $3.35 million mezzanine loan secured by the borrower's equity interest in two special purpose entities that owned a 12-story commercial building in Albany. In addition, there was a senior secured mortgage loan of approximately $28.5 million on the underlying real property. The mortgage borrowers defaulted which caused the mezzanine lender to cure the default and to give a UCC notice to the borrower of its intent to sell the equity pledged to secure the mezzanine loan. The borrower sought a preliminary injunction arguing that it was commercially unreasonable to provide only 32 days' notice in light of the pandemic and that the lender failed to adequately market the property, did not allow visitors to conduct on-site inspections and failed to provide the borrower with the terms of the auction sale. The borrower alleged that it would suffer irreparable harm based on a provision in the loan agreement which provided only for injunctive relief and precluded recovery of money damages—similar to the provision in the *D2 Mark* case.

The court granted the borrower's motion for a preliminary injunction and prohibited the lender from proceeding with a UCC sale until Oct. 15, 2020. The court did not, however, provide any specific guidance as to what could make a UCC sale commercially reasonable during the COVID-19 pandemic. Instead the court extended the logic of the Executive Orders which prohibited only mortgage loan foreclosures to cover mezzanine loans on the theory that the "valuation of the equity interests in a company that owns real estate is based on the value of the real property itself." The court further stated that the "severe turmoil in the real estate market due to the pandemic makes the notion of a sale resulting in payment of fair market value highly uncertain." Subsequently, by order dated Oct. 27, 2020 the court denied the borrower's request to further extend the preliminary injunction, noting that it would be unreasonable to further enjoin the sale, that mezzanine foreclosures are proceeding and the previously cited administrative order is no longer in effect. The court authorized the sale to proceed as scheduled on Oct. 30, 2020. On Nov. 5, 2020 the borrower filed a notice of appeal from the court's Oct. 27, 2020 order.

**Takeaways**

Mezzanine lenders need to make extra efforts to ensure that UCC sales are difficult to attack as commercially unreasonable by engaging in active marketing efforts, giving sufficient notice to the borrower and potential bidders, and scheduling the sale to attract as many bidders as possible and afford them a reasonable opportunity to conduct due diligence and to close a transaction. All of this should be treated from the perspective that what is reasonable during normal times may not be reasonable during a pandemic. Finally, from a drafting perspective, lenders may want to clarify loan agreement language that could be interpreted to prevent the borrower from recovery of money

damages—clarifying that any limitation on remedies contained in the relevant provision should not apply to any claim by a borrower that the lender has failed to properly conduct any sale or exercise any remedies under the UCC or applicable law.

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