To Our Clients and Friends

Memorandum

August 06, 2020

New York Supreme Court Issues Preliminary Injunction Halting Another UCC Foreclosure

On August 3, 2020, the New York County Supreme Court issued a preliminary injunction in *Shelbourne BRF LLC v. SR 677 BWAY LLC*, Index No. 652971/2020 (N.Y. Cnty. Sup. Ct.) (Schecter, J.), enjoining a foreclosure sale under the Uniform Commercial Code ("UCC"). The Court found that plaintiff borrowers demonstrated a likelihood of success on the merits of their claim that the proposed UCC sale was commercially unreasonable and that plaintiffs would be irreparably injured by the loss of their LLC interests. This marks the second time since June 2020 that a New York County Supreme Court judge has enjoined a UCC foreclosure sale from proceeding in the wake of the COVID-19 pandemic. The decision in *Shelbourne BRF* builds on the Commercial Division's prior decision in *D2 Mark LLC v. Orei VI Investments LLC*, Index No. 652259/2020 (the "*D2 Mark* Case"), where the Court (Masley, J.) found that the proposed foreclosure sale may not be commercially reasonable. The Court in the *D2 Mark* Case based its finding of irreparable injury on the provisions in the mezzanine loan agreement that the Court construed as precluding monetary damages and only providing for injunctive relief.[1] The *Shelbourne BRF* decision is another example of a Court granting a preliminary injunction application by a mezzanine borrower and finding that the borrower would be irreparably injured by the proposed UCC foreclosure auction and that the proposed sale was commercially unreasonable against the backdrop of the Covid-19 pandemic.

Facts

The dispute in *Shelbourne BRF* arose out of a $3,350,000 mezzanine loan that was secured by LLC interests in two entities that owned two non-party special purpose entities that owned a 12-story professional building in Albany, New York as tenants-in-common.[2] In addition to the mezzanine loan, there was an approximately $28.5 million senior mortgage loan on the underlying property. In May 2020, the borrowers under the senior mortgage loan failed to make the required monthly payment—a default that the defendant mezzanine lender allegedly cured.

Plaintiffs alleged that the defendant mezzanine lender sought to proceed with a UCC foreclosure under the mezzanine loan solely because of the missed May 2020 payment on the senior mortgage loan.

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1 We previously wrote about the Supreme Court's decision in *D2 Mark LLC* in a Client Alert published on June 24, 2020 entitled *First New York UCC Foreclosure Halted By A Preliminary Injunction—The Mark Hotel.*

2 The facts are taken from the verified complaint that was filed on July 20, 2020.

Plaintiffs further asserted that the identified default under the senior loan had been cured by the mezzanine lender and there were no other outstanding defaults.

Plaintiffs allegedly received notice that the mezzanine lender intended to proceed with a UCC foreclosure sale on July 20, 2020, approximately one month before the noticed date. Plaintiffs asserted in their complaint that the mezzanine lender failed to adequately market the property by not having bidders visit the property, advertising in only two publications, and failing to provide a copy of the terms of the auction to plaintiffs.

Plaintiffs' Arguments to Enjoin the Foreclosure Sale

Plaintiffs claimed that they would be irreparably harmed by a UCC foreclosure sale because the mezzanine loan prevented them from recovering monetary damages from the mezzanine lender and only provided for injunctive or declaratory relief.[3] In making that argument, plaintiffs relied on the Court's prior decision in the *D2 Mark* Case, where the Court construed an almost identical provision to establish irreparable injury because the Court believed that the provision precluded the availability of monetary damages in connection with a flawed UCC foreclosure sale.

As to the commercial unreasonableness allegations, plaintiffs asserted that the proposed 32-day marketing period was extremely short given the COVID-19 pandemic. Plaintiffs also claimed that the mezzanine lender's effort to lengthen the marketing period to 62 days by issuing a second notice of sale was practically ineffective. Plaintiffs noted that defendant issued the second notice of sale only 28 days before the new auction date, and faulted the mezzanine lender for not advertising in trade publications and not advertising more frequently in newspapers of general circulation. Plaintiffs also highlighted the fact that there were no interested bidders in connection with the originally noticed UCC foreclosure sale, but the mezzanine lender continued to use same playbook for the second auction date. In this regard, plaintiffs noted a comment to the UCC which states that "[i]t may, for example, be prudent not to dispose of goods when the market has collapsed."[4] Additionally, plaintiffs pointed to an appraisal obtained by the mezzanine lender that acknowledged the difficulty of valuing the underlying real property.

As in the *D2 Mark* Case, plaintiffs attacked the terms of sale for the auction, alleging that they represented an attempt to "rig[]" the auction in favor of the mezzanine lender.[5] As in the *D2 Mark* Case, the terms of auction provided that the winning bidder was required to make a deposit of 10% of the winning bid. Closing was conditioned on the prospective acquirer satisfying all conditions of the intercreditor agreement and constituting a qualified transferee under the intercreditor agreement. A failure to satisfy these conditions would preclude a winning bidder from successfully consummating the transaction.

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[3] Section 11.13 of the mezzanine loan agreement provided that "[i]f a claim or adjudication is made that Lender...has acted unreasonably…in any case where by law or under any Loan Documents, Lender or any such agent, as the case may be, has an obligation to act reasonably or promptly, Borrower agrees that neither Lender nor its agents, including Servicer, shall be liable for any monetary damages, and Borrower's sole remedy shall be to commence an action seeking injunctive relief or declaratory relief." Index No. 652971/2020, Doc. No. 4.

[4] Doc. No. 35 at 7.

[5] Doc. No. 35 at 9.

The Court Grants the Preliminary Injunction

Although the Court did not specifically reference the *D2 Mark* decision, the Court appears to substantially rely on the same logic the *D2 Mark* decision used to enjoin the UCC foreclosure sale. The Court's decision also relies on the logic underlying Chief Administrative Judge Marks' recent Administrative Order issued on July 23, 2020 (the "July 23 Administrative Order"), which provides that "no auction or sale in any residential or commercial foreclosure matter shall be scheduled to occur prior to October 15, 2020."[6] The Court acknowledged that the July 23 Administrative Order does not apply to UCC foreclosure auctions, but found its logic persuasive, as the value of the LLC interests that would be the subject of a UCC foreclosure sale was inextricably linked to the value of the underlying real property. Given the COVID-19 pandemic, the Court noted there was "severe turmoil in the real estate market," and thus the ability to receive "fair market value is highly uncertain," especially considering the likelihood that bids would be "discontinued due to uncertainty about the continued length and severity of the pandemic."[7] Accordingly, the Court enjoined the mezzanine lender from proceeding with the UCC foreclosure sale until October 15, 2020, and required plaintiffs to post a bond of $100,000 by August 14, 2020.

The Court explicitly urged the parties "to continue to negotiate in good faith to reach an amicable resolution, especially as the value of the property may be much lower than the total amount due on the loans, making a credit bid inevitable."[8]

Conclusion

Given the brevity of the Court's decision, it is unclear what specific aspects of the proposed UCC foreclosure sale the Court found to be commercially unreasonable. The fact that the mezzanine lender did not seek to use a different marketing strategy in connection with the adjourned sale when the original proposed sale attracted no potential bidders or interest is a potentially unique situation that could help explain the Court's ruling. Although not explicitly stated, the Court appeared to rely on the *D2 Mark* Case's interpretation of the mezzanine loan agreement to find that monetary damages are insufficient to compensate a mezzanine borrower in connection with a commercially unreasonable foreclosure sale. As a result of the ruling, the Court may have weakened what has long been one of the primary obstacles for a mezzanine borrower seeking to obtain injunctive relief against a UCC foreclosure sale: the availability of monetary damages. It is important to note that the *Shelbourne BRF* Court did not prohibit the UCC foreclosure sale from occurring, and instead merely prohibited it from occurring prior to October 15. As a result, mezzanine lenders should be cautious about the timing of UCC foreclosure sales during the COVID-19 pandemic.

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6 Index No. 652971/2020, Doc. No. 38 at 1.

7 Doc. No. 38 at 1-2.

8 Doc. No. 38 at 2.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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