To Our Clients and Friends

Memorandum

December 13, 2021

New York Supreme Court Casts Doubt on Viability of Claims That a Pledge Agreement Clogs the Equity of Redemption

A recent decision from the Commercial Division of the New York State Supreme Court addresses one of the most discussed issues in real estate financing circles: whether an accommodation pledge agreement in connection with a mortgage loan interferes with or "clogs" the borrower's right to redeem the mortgage under the equity of redemption. Although no court had ever enjoined a UCC foreclosure sale on the basis that the pledge was a clog on the equity of redemption, prior court decisions left open the possibility that a borrower could succeed on such a claim. However, in *Atlas Brookview Mezzanine LLC v. DB Brookview LLC*,[1] Justice Borrok finally squarely addressed the issue and granted a motion to dismiss a declaratory judgment claim based on the theory that the pledge agreement, which was granted as an accommodation to the mortgage lender and not in connection with a mezzanine loan, clogged the mortgage borrower's right to redeem the property under the mortgage.[2] Justice Borrok held that permitting such a claim to proceed would be inconsistent with the agreement between sophisticated investors represented by counsel and that the debt could be paid off at any time prior to the foreclosure sale under the Uniform Commercial Code ("UCC"). The rationale underlying Justice Borrok's decision casts doubt on the ability of a borrower to successfully bring a claim premised on the argument that a pledge agreement, voluntarily entered into, interfered with its equity of redemption.

Background

The litigation in *Atlas Brookview* arose out of the acquisition of a real estate project in Illinois by Atlas Brookview LLC (the "Borrower"). In order to finance the project's acquisition, the Borrower obtained a $65 million loan that was secured by a mortgage and an assignment of leases and rents. The loan agreement and note were governed by New York law, while the mortgage was governed by Illinois law.

As additional security for the loan, Atlas Brookview Mezzanine LLC ("Atlas Mezzanine"), which owned all of the equity interests in the Borrower, entered into a guaranty agreement and a pledge and security agreement with the lender. Upon an event of default, the guaranty permitted the lender to exercise its rights and remedies with respect to Atlas Mezzanine's interest in the Borrower. Pursuant to the pledge

1 Index No. 653986/2020 (N.Y. Cnty. Sup. Ct.).

2 We previously addressed the Justice Borrok's decision denying a preliminary injunction with respect to a contemplated UCC foreclosure sale in our prior alert titled New York Supreme Court Allows Previously Enjoined UCC Foreclosure Sale to Proceed (Oct. 29, 2020).

and security agreement, Atlas Mezzanine pledged its 100% equity interest in the Borrower and gave the lender the rights and remedies of a secured party under the UCC with respect to those interests. Both the guaranty and pledge and security agreement were governed by New York law.

Following a series of defaults by the Borrower, on June 23, 2020, the lender scheduled a UCC foreclosure sale on August 25, 2020. The day before the scheduled UCC foreclosure sale, Atlas Mezzanine and the Borrower commenced an action in New York State Supreme Court seeking a temporary restraining order and a preliminary injunction to enjoin the sale. In their complaint, Atlas Mezzanine and the Borrower sought a declaratory judgment that the pledge agreement was invalid because providing a pledge agreement enabling a lender to proceed with a UCC foreclosure sale in connection with a mortgage loan violated the equity of redemption, which is the concept that a mortgage loan borrower has the right to retain ownership of the property by paying off the mortgage loan prior to the completion of the mortgage foreclosure.

Atlas Mezzanine and the Borrower were granted a temporary restraining order that prevented a UCC foreclosure sale from occurring prior to the expiration of the maturity date of the loan. Justice Borrok, however, later denied Atlas Mezzanine and the Borrower's request for a preliminary injunction. With respect to the equity of redemption argument, Justice Borrok commented that "no Court has sustained [Plaintiffs'] argument in the State of New York yet,"[3] noting that "the equitable right of redemption has not been clogged by the operative agreements because you retain the right of redemption under UCC 9-623."[4] Following Justice Borrok's denial of the preliminary injunction, the UCC foreclosure sale was rescheduled for January 2021 and the lender accommodated certain changes to the sale process requested by Atlas Mezzanine and the Borrower.

The Ruling on the Motion to Dismiss

Following the consummation of the UCC foreclosure, Borrower continued to pursue one cause of action: its claim that providing a pledge agreement in connection with the mortgage loan violated the Borrower's equity of redemption. The Borrower did not amend its complaint to pursue damages following the completion of the UCC foreclosure sale, but elected to proceed with a declaratory judgment claim seeking in effect to unwind the completed UCC foreclosure sale. Importantly, New York does not permit a borrower to waive the equity of redemption;[5] while Illinois permits the equity of redemption to be waived in certain circumstances, including in commercial real estate transactions.[6]

Despite the fact that Illinois law allowed a commercial borrower to waive the equity of redemption, the parties' briefing on the motion to dismiss extensively discussed New York law on the equity of redemption. One of the central issues in the briefing was the applicability of Justice Ostrager's decisions in *HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC*,[7] which denied a motion for preliminary

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3 Index No. 653986/2020, Doc. No. 72 at 24:13-19.

4 *Id.* at 25:4-14.

5 *See Mooney v. Byrne*, 57 N.E. 163, 165 (N.Y. 1900).

6 735 ILCS 5/15-1601(b). The mortgage executed by Borrower expressly waived "any and all rights of redemption from sale...."

7 No. 652871/2018, 2018 WL 3056919 (Sup. Ct. N.Y. Cnty. June 20, 2018).

injunction that was premised on the ground that an identical loan structure violated the equity of redemption, and *HH Mark Twain LP v. Acres Capital Servicing LLC*,[8] which allowed a claim premised on clogging the equity of redemption to proceed past a motion to dismiss.[9] Justice Ostrager's ruling at the preliminary injunction stage in *HH Cincinnati* found that there was not a likelihood of success on the merits of a claim involving the equity of redemption because the borrower had a right of redemption under the UCC "if Plaintiffs can fulfill their obligations under the applicable agreements." However, Justice Ostrager denied a motion to dismiss that relied on his preliminary injunction ruling because that ruling did not constitute a "rul[ing] on the merits of plaintiffs' clogging claim."[10]

Borrower placed heavy reliance on Justice Ostrager's decision on the motion to dismiss in *HH Mark Twain*. However, Justice Borrok found that decision of limited use to the Borrower because the decision merely stood for the proposition that the denial of the preliminary injunction "didn't foreclose the issue at the motion to dismiss stage."[11] Justice Borrok further noted that the ruling in *HH Mark Twain* did not "find…that the dual collateral structure necessarily violates" the equity of redemption.[12]

The Borrower argued that providing a pledge in connection with a mortgage loan was problematic because the pledge enabled "a lender to get around all the real property statutes and around the redemption period that would run there," and potentially enable a lender to proceed with a UCC foreclosure sale in as little as 30 days.[13] The Court did not accept the Borrower's argument, noting that the UCC foreclosure occurred substantially after all of the defaults had occurred—four months after the loan's maturity date and approximately eight months after the lender originally sent a notification of disposition of collateral for the UCC foreclosure sale.

The Court rejected the Borrower's claim regarding the equity of redemption because permitting that claim to proceed would require the Court to hold that "the fact that you entered into the structure voluntarily with the advice of good counsel, that it necessarily from the moment go, was void because [the lender] could foreclose on the pledge and [the lender] didn't have to foreclose on the real estate."[14] In rejecting Borrower's claim, Justice Borrok specifically noted that it "was a business term and business deal that [Borrower] entered into," and that nothing prevented Borrower from paying off the loan prior to the UCC foreclosure sale.[15] Justice Borrok's ruling does not explicitly rely on the fact that it is permissible in Illinois for a borrower to waive the equity of redemption or that declaratory relief is not available in connection with attempts to unwind a completed UCC foreclosure sale.[16]

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8 2020 WL 2857649 (Sup. Ct. New York Cnty. June 2, 2020).

9 We previously addressed Justice Ostrager's preliminary injunction in an article in the New York Law Journal titled *New York Court Confirms Enforceability of UCC Equity Interest Pledges* (July 16, 2018).

10 Index No. 656280/2019, 2020 WL 2857649, at *2.

11 Index No. 653986/2020, Doc. No. 120 at 13.

12 *Id.* at 14.

13 *Id.* at 15.

14 *Id.* at 18.

15 *Id.*

16 *Atlas MF Mezzanine Borrower, LLC v. Macquarie Texas Loan Holder LLC*, 174 A.D.3d 150, 153 (1st Dep't 2019).

Conclusion

Justice Borrok's decision underscores that a borrower seeking to assert a claim that a pledge agreement clogs the borrower's equity of redemption will face an uphill battle. As Justice Borrok noted, such pledges have consistently been used in the commercial real estate industry and are often part of the business negotiations between parties represented by counsel. Justice Borrok's reluctance to interfere with the freely bargained for loan structure and remedies provided to a lender is consistent with New York's long-standing policy of enforcing agreements in the commercial real estate context according to their terms, given that "commercial certainty is a paramount concern, and where... the instrument was negotiated between sophisticated, counseled business people negotiating at arm's length." *Vt. Teddy Bear v. 538 Madison Realty Co.*, 1 N.Y.3d 470, 475 (2004).

There are aspects of the *Atlas Brookview* decision that may encourage borrowers to continue to pursue claims that a pledge agreement interferes with their equity of redemption, such as the application of Illinois law to the mortgage and the lack of a damages claim (neither of which were addressed by Justice Borrok in his ruling). Rather, the considerations underlying Justice Borrok's ruling appear to be generally applicable to claims of clogging the equity of redemption where the mortgage is governed by New York law. Nevertheless, we anticipate that borrowers will continue to pursue claims regarding pledge agreements clogging the equity of redemption until the viability of such a claim is definitely resolved by the appellate courts. We will continue to monitor this area of the law for new developments and bring you updates.

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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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