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MEZZANINE REAL ESTATE LOAN FORECLOSURES: WHAT IS COMMERCIALLY REASONABLE DURING AN EMERGENCY?

ABSTRACT

Owners of commercial real estate frequently use mezzanine debt as an additional source of financing. In contrast to mortgage loans, which are secured by real property, the collateral for mezzanine real estate loans is the mezzanine borrower's ownership interest in the entity that owns the property. This ownership interest is considered personal property, and thus foreclosure and disposition of the collateral is governed by the Uniform Commercial Code, which requires foreclosure sales to be "commercially reasonable." During COVID-19, mortgage loan foreclosures were stayed in New York pursuant to executive order. Despite the fact that, in a practical sense, mezzanine loan foreclosures achieve substantially the same effect as mortgage loan foreclosures (in both situations, the lender can either take over the property or sell the collateral to satisfy the debt), the executive orders did not, on their face, restrict mezzanine foreclosures. As mezzanine creditors initiated foreclosure proceedings during the pandemic, and their defaulted debtors sought preliminary injunctions against foreclosure sales, courts were faced with two crucial questions. First, did the executive order prohibit mezzanine loan foreclosures? If not, how can a foreclosing lender conduct a commercially reasonable foreclosure sale during a pandemic?

This Note proposes that while a moratorium on commercial mortgage loan foreclosures exists to protect borrowers that can demonstrate financial hardship due to the applicable emergency, a parallel moratorium should also protect mezzanine debtors facing the same financial hardships. If the mezzanine borrower cannot demonstrate that it has defaulted on its loan obligations because of the emergency, then its lender should be free to commence foreclosure proceedings. In such a case, courts should generally apply well-settled precedent to determine if a preliminary injunction is appropriate but must take the existing emergency into account when determining whether a proposed foreclosure sale is commercially reasonable.

INTRODUCTION

Commercial real estate property owners and developers often desire to secure additional financing to supplement their mortgage loan,[1] the amount of which is typically limited to a certain percentage of the appraised value of the underlying property.[2] Historically, a mortgage borrower could secure

1. Jon S. Robins, David E. Wallace & Mark Franke, *Mezzanine Finance and Preferred Equity Investment in Commercial Real Estate: Security, Collateral & Control*, 1 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 93, 104 (2012).

2. Jana L. Armstrong, FLA. REAL PROP. COMPLEX TRANSACTIONS §5.4(C) (9th ed. 2018).

additional funds by granting a second mortgage on its property to a subordinate lender.[3] However, due to the emergence of securitized loans, which typically prohibit second mortgages,[4] and senior lenders' increased aversion to sharing collateral with secondary creditors,[5] borrowers were forced to supplement their mortgage loans with more complex financing structures.[6] Perhaps the most prevalent form of subordinate debt to take the place of second mortgages has been mezzanine financing, which is structured as secondary debt secured by an equity interest in the entity that owns the underlying property.[7] Because most mezzanine loan agreements are governed by New York law and permit a foreclosure and sale of the pledged ownership interests in the state, New York law is considered crucial in resolving disputes between mezzanine debtors and creditors in the industry,[8] and is therefore the focus of this Note.

Mezzanine financing is classified as "secondary" debt because of its position in the "capital stack;"[9] it is structurally subordinate to the mortgage loan in terms of lien and payment priority.[10] In other words, the mortgage lender must be repaid in full first and therefore bears the least risk.[11] The

3. Steven Horowitz & Lise Morrow, *What You Need to Know About Mezzanine Financing*, 16 PRAC. REAL EST. L. 9, at 1 (May 2000).

4. *Mezzanine Financing in Relation to CMBS Loans*, CMBS.LOANS CAP. MKTS. ADVISORS (October 5, 2018), https://cmbs.loans/blog/mezzanine-loans-for-cmbs-properties#:~:text=Since%20CMBS%20loans%20typically%20prohibit%20second%20mortgages%2C%20many,company%20in%20the%20case%20of%20a%20loan%20default.

5. Peter E. Fisch & Harris B. Freidus, *Mezzanine Loan Foreclosures*, PRAC. L. PRAC. NOTE 8-385-3969 (2019) https://www.friedfrank.com/siteFiles/Publications/Mezzanine%20Financing.pdf.

6. *Id.*

7. Suzanne deVries Decker, *Mezzanine Financing*, LEXIS PRAC. ADVISOR.

8. Matthew Goldstein, *Worried Lenders Pounce on Landlords Unable to Pay Their Loans*, N.Y. TIMES (Aug. 13, 2020), https://www.nytimes.com/2020/08/13/business/commercial-landlord-loan-foreclosure.html; Jessica Bula, Laura Ciabarra, & Gary J. Mennitt, *Mezzanine Foreclosures in the Time of Coronavirus*, DECHERT LLP (May 10, 2020), https://www.jdsupra.com/legalnews/mezzanine-foreclosures-in-the-time-of-89739/.

9. The capital stack is a representation of the complete financing structure used to fund a real estate transaction, typically comprised of multiple layers of debt and equity, and used to demonstrate the relationship between payment priority (risk) and interest rate (return). *See The Commercial Real Estate Capital Stack: How it Works*, EQUITYMULTIPLE (May 10, 2020), https://www.equitymultiple.com/blog/learning-series/cap-stack-commercial-real-estate-works#:~:text=The%20%E2%80%9Ccapital%20stack%E2%80%9D%20refers%20to%20the%20full%20set,involving%20numerous%20parties%20and%20a%20variety%20of%20structures.

10. 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, 115 (2005) [hereinafter Berman, *Once a Mortgage*]. Mezzanine financing is senior to the equity portion of the capital stack, meaning the mezzanine lender will be repaid before the equity investors. *See* Andrew R. Berman, *Risks and Realities of Mezzanine Loans*, 72 MO. L. REV. 993, 998 (2007) [hereinafter Berman, *Risks and Realities*] ("Like a theater, mezzanine debt sits in the mezzanine section between senior debt in the more expensive orchestra, and equity sitting in the cheaper section of the balcony.").

11. Decker, *supra* note 7.

mezzanine lender is repaid only with the excess cash flow remaining after payment of the senior debt service.[12]

Further, mezzanine debt—unlike a mortgage loan—is not collateralized by a lien on the underlying property.[13] Instead, the mezzanine loan is secured by the ownership interest in the mortgage borrower: the entity which owns the real property.[14] In its most simple form, the mezzanine lender provides financing to the mezzanine borrower in exchange for a pledge of the mezzanine borrower's ownership interest in the mortgage borrower.[15] Both the mortgage and mezzanine borrower entities will typically be structured as single (or special) purpose, bankruptcy-remote entities to limit risk to the lender.[16]

Pursuant to the mezzanine loan structure, upon default the lender can exercise its remedies by foreclosing on the collateral and taking over the ownership interest in the mortgage borrower.[17] The mezzanine lender (or purchaser of the mezzanine loan collateral at a foreclosure auction) then "steps into the shoes" of the owner of the mortgage borrower and indirectly becomes the owner of the mortgaged property.[18] Unlike the senior lender, the mezzanine lender cannot make a direct claim against the underlying property itself in the event of default.[19] If the senior lender forecloses on the mortgage loan collateral, the collateral for the mezzanine loan can be left worthless.[20] This is because the mezzanine lender will retain its security interest in the

12. "The mezzanine lender as a subordinate lender will be paid only from excess cash after payment of the following items in their 'waterfall' priority: 1. Taxes, 2. Insurance, 3. Ground rent, if a leasehold, 4. First mortgage debt service, 5. Operating expenses in accordance with approved budgets, 6. All capital reserves, and 7. Discretionary reserves in accordance with approved budgets." Joseph P. Forte, *Mezzanine Finance: A Legal Background*, COM. SECURITIZATION FOR REAL EST. LAW. 437, 444 (2005).

13. Berman, *Once a Mortgage*, *supra* note 10, at 79.

14. Armstrong, *supra* note 2.

15. Morrow, *supra* note 3, at 11.

16. While generally beyond the scope of this Note, single purpose entity means that the only asset that the mortgage borrower holds is the underlying property and the only asset the mezzanine borrower holds is its interest in the mortgage borrower. They are generally prohibited from incurring any debt other than their respective loans. Bankruptcy-remote entities limit, but do not eliminate the risks associated with insolvency and both voluntary and involuntary bankruptcy actions. *See Bankruptcy Remote Entities in Commercial Real Estate Transactions*, PRAC. L. PRAC. NOTE 8-606-5185.

17. Joshua Stein, *Fast Foreclosures For Mezzanine Loans – Borrower Beware*, FORBES (June 29, 2020), https://www.forbes.com/sites/joshuastein/2020/06/29/fast-foreclosures-for-mezzanine-loans—borrower-beware/#4e96bf0d7147.

18. Berman, *Risks and Realities*, *supra* note 10.

19. Armstrong, *supra* note 2.

20. Georgia Kromrei, *Experts take issue with proposed tax on mezzanine loans*, THE REAL DEAL (January 23, 2020), https://therealdeal.com/2020/01/23/experts-take-issue-with-proposed-tax-on-mezzanine-loans/.

mortgage borrower, but the mortgage borrower will no longer own the property.[21]

These features of mezzanine debt mean that from the creditor's perspective, it is substantially more risky than senior financing; as such, mezzanine lenders demand higher interest rates.[22] Senior loans typically have a 4%–8% return, while mezzanine loans are typically in the 12%–20% range.[23] Because the interests of the mortgage and mezzanine lenders naturally conflict, especially when the loan is nonperforming, the two lenders negotiate an intercreditor agreement to govern payment priority and the interaction of their respective rights and remedies under the loan documents.[24]

The ownership interest pledged to secure the mezzanine loan is considered personal property, therefore the perfection[25] and foreclosure of the collateral is governed by the Uniform Commercial Code (as codified in New York, the NY UCC).[26] The relative speed and efficiency of the foreclosure process is an important advantage for mezzanine lenders.[27] A mezzanine foreclosure under the NY UCC is a nonjudicial process[28] that typically takes between 30 and 60 days, compared to a foreclosure on real property in New York, which takes nearly three years on average and is subject to a judicial proceeding.[29] The disposition of collateral by a secured party under the NY UCC must generally be "commercially reasonable"[30] and performed in good faith.[31]

Prior to the COVID-19 pandemic, commercial real estate market conditions were strong and real estate lenders' balance sheets were largely

21. Mezzanine lenders will typically include provisions in the intercreditor agreement to mitigate this risk by allowing the mezzanine lender certain protections to preserve the value of its collateral, including notice and cure rights. *See* Decker, *supra* note 7.

22. Patrick Graham, *The Capital Stack Explained*, PROPERTYMETRICS (last updated September 14, 2019), https://propertymetrics.com/blog/capital-stack/.

23. *Id.*

24. Morrow, *supra* note 3, at 11.

25. "Perfection" of a security interest protects the creditor from other parties claiming to have an interest in the same collateral. The most common way to perfect a security interest is by filing a UCC-1 financing statement naming the debtor, creditor, and collateral. *See* Eric Gros-Dubois, *Perfecting the Security Interest*, EPGD BUS. L. (May 13, 2019), https://www.epgdlaw.com/perfecting-the-security-interest/#:~:text=A%20secured%20party%20can%20perfect%20a%20security%20interest,3%20Controlling%20the%20collateral%3B%20or%204%20Automatic%20perfection.

26. Fisch and Freidus, *supra* note 5.

27. Stein, *supra* note 17.

28. Weiss & Weiss, *Foreclosures – Judicial and Non-Judicial*, N.Y. REAL EST. LAWS. BLOG (September 23, 2020) https://www.newyorkrealestatelawyersblog.com/foreclosures-judicial-and-non-judicial/.

29. Stein, *supra* note 17. *See also* Benjamin M. Lawsky, *Report on New York's Foreclosure Process*, N.Y. STATE DEP'T OF FIN. SERVS. (May 2015), https://www.dfs.ny.gov/system/files/documents/2020/03/fore_proc_report_052015.pdf.

30. NY UCC § 9-627(b).

31. NY UCC § 1-304.

healthy.[32] However, the government-mandated closures, stay-at-home orders, and other regulations deployed to mitigate the spread, together with the subsequent economic recession and uneven recovery, had a rapid and largely detrimental impact on the industry.[33] Industry experts predict that there is a "reckoning" coming for commercial real estate, and that loan defaults may not peak until 2022.[34] What has the pandemic shown us about the mezzanine financing market in an emergency? In short, mezzanine lenders have limited patience for their defaulted borrowers and will seek to foreclose on and dispose of their collateral; and mezzanine borrowers will petition the courts to try to stop them.[35]

Inconsistent court decisions regarding the availability of mezzanine loan foreclosures during the pandemic have created substantial uncertainty as to creditors' rights and debtors' protections. To provide clarity and fairness, there is a need for an executive order in New York to temporarily prohibit mezzanine real estate loan foreclosures against borrowers that have defaulted due to the effects of a declared emergency. For foreclosure sales that are exempt from the proposed moratorium but otherwise challenged by debtors, New York courts should conduct fact-intensive analyses to determine whether proposed foreclosure dispositions are commercially reasonable during the continuance of an emergency, while otherwise adhering to established law where appropriate to protect the lawful rights and remedies of mezzanine lenders.

This Note argues that the New York court decisions addressing this issue are inadequate and proposes new guidance. Going forward, mezzanine real estate borrowers facing foreclosure actions should be divided into two distinct categories: (1) those in default due to a declared emergency, and (2) those in default for unrelated reasons. Debtors in default due to the emergency should be protected by an executive order that temporarily prohibits mezzanine loan foreclosures. Borrowers in default for unrelated reasons should not be excused for the mismanagement of their finances, and lenders should have the right to exercise their lawful remedies to foreclose

32. Jim Berry, *COVID-19 implications for commercial real estate*, DELOITTE (May 1, 2020), https://www2.deloitte.com/us/en/insights/economy/covid-19/covid-19-implications-for-commercial-real-estate-cre.html.

33. Michael Gerrity, *Commercial Mortgage Delinquencies in U.S. Dip in September*, WORLD PROP. J. (Oct. 2, 2020), https://www.worldpropertyjournal.com/real-estate-news/united-states/new-york-city-real-estate-news/commercial-real-estate-news-mortgage-bankers-association-mba-cref-loan-performance-survey-commercial-mortgage-delinquency-rates-september-2020-jamie-woodwell-12157.php.

34. Noah Buhayar, John Gittelsohn, & Jackie Gu, *Commercial Real Estate's Pandemic Pain Is Only Just Beginning*, BLOOMBERG (Dec. 22, 2020), https://www.bloomberg.com/graphics/2020-commercial-real-estate/; Mack Burke, *Where Are We? Where Are We Headed? CRE Industry Experts Opine on 2020*, COM. OBSERVER (Dec. 9, 2020), https://commercialobserver.com/2020/12/where-are-we-where-are-we-headed-cre-industry-experts-opine-on-2020/.

35. Keith Larsen, *Rising UCC foreclosures are "the tip of the iceberg,"* THE REAL DEAL (Dec. 17, 2020), https://therealdeal.com/issues_articles/the-tip-of-the-iceberg/.

and dispose of the loan collateral, subject to a commercial reasonableness standard that takes the effects of the emergency into account.

Part I of this Note outlines the NY UCC rules governing disposition of loan collateral and the established case law regarding the commercial reasonableness in the context of mezzanine real estate loan foreclosure. Part II then discusses the court decisions regarding foreclosure sales during the COVID-19 pandemic, in which judges have shown varying degrees of sympathy to defaulted borrowers in providing injunctive relief to stay foreclosure auctions of mezzanine loan collateral. Lastly, Part III proposes a two-part solution, utilizing executive action together with judicial guidance to provide clarity and equity to both lenders and borrowers that can be applied in future disaster emergency scenarios.

I. WHAT GUIDANCE DOES ARTICLE 9 OF THE NY UCC AND EXISTING CASE LAW PROVIDE?

Under the NY UCC, a lender can only enforce its security interest in the pledged collateral after default.[36] While the exact definition of "after default" is not provided in the UCC, Comment 3 to NY UCC § 9-601 states that the terms of the parties' agreement is the determining factor with respect to what constitutes a default at any given point.[37] Generally, default is the ultimate consequence of extended payment delinquency,[38] or failure by the borrower to pay the amounts due to the lender pursuant to the loan agreement.[39] Upon the determination that default has occurred under the applicable mezzanine loan documents, the mezzanine lender can enforce its rights by initiating one of three foreclosure actions available under the NY UCC: strict foreclosure, private disposition, or public disposition.[40]

Strict foreclosure is the process in which the secured party takes title to the collateral in partial or full satisfaction of the outstanding debt.[41] This remedy has several advantages over public and private dispositions, including reduced costs, a shorter timeline, and a lower likelihood of litigation.[42] However, strict foreclosure can only proceed if (1) the debtor consents to the secured party's acceptance of collateral and (2) the secured

36. Fisch & Freidus, *supra* note 5.

37. Unless otherwise indicated, all references hereinafter to the NY UCC are to the Official Text with Comments. Comment 3 to NY UCC § 9-601.

38. ("Payment delinquency is commonly used to describe a situation in which a borrower misses their due date for a single scheduled payment…Usually, [default] involves missing several payments over a period.") Christina Majaski, *Delinquency vs. Default: What's the Difference?*, INVESTOPEDIA (last updated Apr. 14, 2019), https://www.investopedia.com/ask/answers/062315/what-are-differences-between-delinquency-and-default.asp

39. Fisch & Freidus, *supra* note 5.

40. *Id.*

41. *Id.*

42. W. Bryan Rakes, *Foreclosure Remedies: Knowing Them is the First Step*, VENABLE LLP (July 31, 2009), https://www.venable.com/insights/publications/2009/07/foreclosure-remedies-knowing-them-is-the-first-ste.

party does not receive a notification of objection from other secured parties with an interest in the applicable collateral.[43] Ultimately, strict foreclosure is difficult to attain because the borrower or another relevant party is likely to object to the secured party's proposal.[44]

Alternatively, a secured party may dispose of collateral by public or private proceedings.[45] A private foreclosure sale is available "only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations."[46] The pledged collateral for mezzanine loans—consisting of privately held limited liability company or partnership interests, or shares of stock in a closely held corporation[47]—is not customarily sold on a recognized market, thus precluding private disposition in most cases.[48] Additionally, the foreclosing creditor generally may not purchase the underlying collateral at a private disposition.[49]

Due to the consent required for strict foreclosure and the nature of mezzanine loan collateral typically precluding the option of a private sale (together with the limitations on the secured party purchasing the underlying collateral itself), public disposition of collateral is the most common remedy for foreclosing mezzanine creditors.[50] A public disposition is "…one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. 'Meaningful opportunity' is meant to imply that some form of advertisement or public notice must precede the sale…and that the public must have access to the sale."[51] For a secured party to adequately create a meaningful opportunity for competitive bidding, it should market its collateral in a manner consistent with how a non-foreclosing seller would market the underlying property.[52] To dispose of collateral under NY UCC § 9-610, a secured party must also provide a reasonable authenticated notice of disposition to the debtor, plus any secondary obligor and certain other parties.[53] The notice must be reasonable as to its manner, timeliness, and content.[54]

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43. NY UCC. §§ 9-620, 9-621.
44. Fisch & Freidus, *supra* note 5.
45. NY UCC § 9-610(b).
46. NY UCC § 9-610(c)(2).
47. Mitchell J. Berg & Harris B. Freidus, *Statute Benefits Lenders, But Protects Borrowers*, N.Y. L. J. (Jan. 14, 2009), https://plus.lexis.com/search?pdsearchterms=LNSDUID-ALM-NYLAWJ-1202427423329&pdbypasscitatordocs=False&pdisurlapi=true&pdmfid=1530671&crid=961633e8-8173-4278-b92e-fde8633d6fcd.
48. Fisch & Freidus, *supra* note 5.
49. Comment 7 to NY UCC § 9-610.
50. Fisch & Freidus, *supra* note 5.
51. Comment 7 to NY UCC § 9-610.
52. Fisch & Freidus, *supra* note 5.
53. *See* NY UCC § 9-611.
54. Comment 2 to NY UCC § 9-611. *See also* NY UCC § 9-612 (timeliness) and NY UCC § 9-613 (content).

Most importantly, public and private collateral sales are subject to a "commercial reasonableness" requirement: "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable."[55] The standard is clarified to some degree in NY UCC § 9-627(a), which provides that "[a] disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition."[56] Ultimately, the NY UCC reiterates its deference to the provisions of the parties' agreement in governing the terms of the sale, so long as they are not "manifestly unreasonable."[57]

New York courts have generally interpreted commercial reasonableness as requiring the secured party to act "in good faith and to the parties' mutual best advantage."[58] However, the determination of whether a disposition of collateral was made in a commercially reasonable manner is ultimately fact-specific: "[t]he right inquiry is whether a particular method of sale was the commercially reasonable way to proceed under *these* circumstances with *this* [collateral]."[59]

Vornado PS L.L.C. v. Primestone Inv. Partners, L.P. is one of the few cases that considered commercial reasonableness in the context of a public foreclosure sale of the ownership interests used to secure a mezzanine real estate loan,[60] and is considered an important guide in the industry to interpreting the standard.[61] In *Vornado*, the mezzanine lender, upon the borrower's default, sought to dispose of the underlying collateral at a public auction.[62] After the lender's financial advisor conducted a "significant marketing process," the lender purchased the units at a public auction.[63] There were no other bidders.[64] The lender then moved for summary judgment, seeking a declaration that the foreclosure disposition was conducted in a commercially reasonable manner.[65] Ultimately, the Delaware Chancery Court, applying New York law, granted summary judgment and

55. NY UCC § 9-610(b).
56. NY UCC § 9-627(a).
57. NY UCC § 9-603(a).
58. 108th St. Owners Corp. v. Overseas Commodities Ltd., 238 A.D.2d 324, 325 (N.Y. App. Div. 1997); MTI Sys. Corp. v. Hatziemanuel, 151 A.D.2d 649, 650 (N.Y. App. Div. 1989).
59. *In re* Excello Press, Inc., 890 F.2d 896, 905 (7th Cir. 1989) (emphasis added).
60. Vornado PS L.L.C. v. Primestone Inv. Partners, L.P., Del.Ch., 821 A.2d 296, 315–316 (2002).
61. Jeffrey J. Temple, *Mezzanine Loan Foreclosure*, N.Y. L. J. (Mar. 12, 2007), https://media2.mofo.com/documents/070312nylawjournal.pdf.
62. *Vornado*, 821 A.2d at 300.
63. *Id.*
64. *Id.*
65. *Id.*

issued a declaration that the sale of the limited partnership interests for $8.35 per unit—despite the net asset value being $15 per unit—was reasonable because the foreclosure disposition was conducted in a commercially reasonable manner.[66] In doing so, the court outlined a two-factor test to determine whether the foreclosure sale was commercially reasonable: examination of (1) price and (2) procedure.[67]

With respect to price achieved for the collateral, the *Vornado* court held that the sale price could be significantly lower than the market value of the collateral and nonetheless be considered commercially reasonable.[68] Other New York courts have similarly held that a seemingly low return on the sale is not dispositive to a finding of commercial reasonableness.[69] However, a substantial discrepancy between the sale price and the value of the collateral will lead to greater judicial scrutiny.[70]

Regarding procedure—the methods used to market and complete the sale[71]—the fact that the creditor hired a prominent brokerage firm (Goldman, Sachs & Co.) to market the foreclosure sale, and that such brokerage firm was "consistent in all material respects with actions it has taken in the past in connection with other marketing processes relating to real estate-related companies and equity interests therein" was sufficient to support a declaration that the sale was conducted in a commercially reasonable manner.[72]

NY UCC § 9-625 also provides remedies for noncompliance with Article 9. For the purposes of this Note, noncompliance is the failure to adhere to the requirement of a commercially reasonable disposition of collateral. Under § 9-625(a), "[i]f it is established that a secured party is not proceeding in accordance with this article, a court may order or restrain collection, enforcement, or disposition of collateral on appropriate terms and conditions."[73] Debtors may challenge the commercial reasonableness of a sale either before or after the disposition has taken place.[74] However, due to courts' interpretation of "proceeding" in § 9-625(a), injunctive relief may only be granted by the court before the sale has taken place.[75] If the challenge

66. *Id.*
67. *Id.*
68. *Id.*
69. *In re* Zsa Zsa Ltd., 352 F. Supp. 665, 671 (S.D.N.Y. 1972).
70. *Id.*
71. Berg & Harris, *supra* note 52.
72. *Vornado*, 821 A.2d at 316.
73. NY UCC § 9-625.
74. Atlas MF Mezzanine Borrower, LLC v. Macquarie Texas Loan Holder LLC, 174 A.D.3d 150, 162–163 (2019).
75. *Id. See also In re* Enron Corp., No. 01-16034 (AJG), 2005 WL 3873890 (Bankr. S.D.N.Y. June 16, 2005).

occurs post-disposition, money damages are the only available remedy; the court may not invalidate the sale.[76]

Under New York law, the party seeking preliminary injunction must satisfy a three-prong test. First, it must demonstrate a likelihood of success on the merits of the case.[77] Second, the party must establish that it will suffer irreparable harm if the relief is not granted.[78] The harm must be deemed "actual," as opposed to merely remote or speculative.[79] Lastly, the movant must show that the "balance of the equities" tips in favor of the moving party.[80] In essence, this requires the movant to show that the harm it will suffer if the court does not grant the injunction would outweigh the harm caused to the non-moving party if the court does grant the injunctive relief.[81]

II. WHAT ARE THE EFFECTS OF NEW YORK COURT DECISIONS DURING COVID-19?

In *1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC*, the Supreme Court of the State of New York (the New York Supreme Court) rejected a motion by a defaulted mezzanine borrower seeking to preliminarily enjoin a sale of the loan collateral, ostensibly paving the way for UCC foreclosure dispositions to take place despite the moratorium.[82] The defendant lender planned to conduct a sale of the plaintiff's membership interest in the entity that was pledged as collateral for the loan, namely the mezzanine borrower's interest in 1248 Associates Mezz LLC.[83] Because the loan in question was a "junior" mezzanine loan, the pledged entity has ownership of the "senior" mezzanine borrower entity, which in turn has ownership of the entity that owns real property (the mortgage borrower), in this case, a development site on East 48th Street in Manhattan, New York.[84]

The borrower defaulted under the terms of the junior mezzanine loan agreement when it failed to achieve "substantial completion" of the project's

76. *Atlas*, 174 A.D.3d at 162–163. Money damages for noncompliance are governed by NY UCC § 9-625(b).

77. This prong of the test requires the party to "state a prima facie case that success on the merits is likely by demonstrating 'that the right on which it seeks to ultimately prevail is plain from undisputed facts.'" *The Standards for Preliminary Injunction in Federal and New York State Court*, 14 J. SUFFOLK ACAD. L. 55 (2000).

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. Emilie B. Cooper, *New York State Trial Court Holds That Moratorium on Foreclosures Does Not Bar UCC Foreclosure*, HAYNES BOONE (May 19, 2020), https://www.haynesboone.com/alerts/ny-state-trial-court-holds-moratorium-on-foreclosures-does-not-bar-UCC-foreclosure.

83. 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 1 (N.Y. Sup. Ct. May 18, 2020).

84. Emma Cueto, *Lender Accused Of 'Sham' Auction Plan At Paul Hastings Site*, LAW360 (May 4, 2020), https://www.law360.com/articles/1269761/lender-accused-of-sham-auction-plan-at-paul-hastings-site.

construction by December 31, 2019.[85] Consequently, the lender issued a default notice to the debtor on January 16, 2020, and planned to hold a foreclosure sale of the collateral on May 1, 2020.[86] The borrower then turned to the court for relief, contending that Executive Order No. 202.8 (EO 202.8)[87] issued by then-New York Governor Andrew Cuomo—which temporarily prohibited foreclosures of any commercial property—was applicable to the foreclosure of the membership interests that secured the mezzanine loan.[88] The court agreed, holding that "the preliminary injunction relief requested is encompassed by [EO 202.8]."[89]

Despite this initial ruling, the lender decided to move forward with the foreclosure process, prompting the borrower to return to the court in an effort to enjoin the sale.[90] This time, however, the court sided with the defendant lender and vacated the prior relief of a preliminary injunction on the collateral auction.[91] In doing so, the court reversed its holding regarding the applicability of EO 202.8 and further held that the borrower failed to establish the requisite elements for a preliminary injunction.[92] Justice Frank Nervo of the New York Supreme Court first rejected the borrower's contention that EO 202.8 temporarily prohibited mezzanine loan foreclosures, holding that "[the] provision addresses enforcement of a judicially ordered foreclosure. [In contrast], [t]he sale of the pledged interests in this matter results from the parties' agreement, as guided by the UCC."[93] He concurred with the defendant that had EO 202.8 intended to prohibit the sale of this collateral type, it would have been explicitly stated as it was for several other areas of law affected by the pandemic.[94]

The court further held that a preliminary injunction was not appropriate because the borrower was unable to demonstrate that a denial of the relief sought would lead to irreparable harm.[95] The court held that the plaintiff's anticipated economic loss due to the notice, manner, or timing of the foreclosure disposition was deemed to be speculative and could be remedied as necessary after the sale took place.[96] Because the theoretical harm to plaintiff was the loss of investment, as opposed to an "unquantifiable

85. Cooper, *supra* note 87.
86. *Id.*
87. N.Y. Exec. Order No. 202.8.
88. Cooper, *supra* note 87.
89. 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 3 (N.Y. Sup. Ct. May 18, 2020).
90. Cooper, *supra* note 87.
91. 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 3 (N.Y. Sup. Ct. May 18, 2020).
92. *Id.* at 2–3.
93. *Id.* at 2.
94. *Id.* (including New York Vehicle and Traffic Law, Business Corporation Law, Civil Practice Law and Rules and other statutes).
95. *Id.* at 2–3.
96. *Id.* at 2.

interest" such as the loss of title to real property, the availability of monetary damages was sufficient and did not support a claim of irreparable harm if relief was denied.[97] Ultimately, the plaintiff did not demonstrate a likelihood of success and therefore the issuance of injunctive relief was not appropriate.[98]

Although the decision in *1248* was significant in that it rejected the application of EO 202.8 to mezzanine UCC foreclosures and held that the availability of monetary damages was dispositive to a showing of irreparable harm, the court largely declined to examine the commercial reasonableness of the proposed sale.[99] In contrast, the Commercial Division of the New York Supreme Court in *D2 Mark LLC v. OREI VI Investments LLC* thoroughly examined each element of the proposed disposition process for commercial reasonableness under UCC § 9-610(b).[100] In *D2 Mark*, the plaintiff mezzanine borrower pledged its equity interest in D2 Mark Sub LLC as collateral for a $35 million mezzanine loan, which supplemented a $230 million senior loan.[101] D2 Mark Sub LLC is the indirect owner of the Mark Hotel, its affiliated restaurant and bar, certain cooperative units in the hotel, certain retail units in the vicinity of the hotel, and the building known as 1000 Madison Avenue in Manhattan, New York.[102]

The Mark Hotel was forced to temporarily close on March 27, 2020, and has generally suffered significant financial hardship due to the pandemic.[103] When the plaintiff borrower failed to pay the senior debt service in April or May, it caused a cross default of the mezzanine loan pursuant to the provisions in the loan documents.[104] Despite participating in negotiations for a forbearance agreement (a temporary postponement of debt payments), on May 18, 2020, the mezzanine lender gave notice to the debtor of its plan to sell the collateral on June 24, 2020, only 36 days from when the notice was provided.[105]

The notice provided the terms of the sale, which was to be held either virtually or in a law firm's office in New York City.[106] Under the terms of sale, the winning bidder was to immediately provide a non-refundable deposit of 10% of the total purchase price and would be further required to pay the balance of the purchase price and close the transaction within 24

97. *Id.* at 2–3.
98. *Id.*
99. Kimberly Brown Blacklow et al., *New York Court Grants Injunction on Mark Hotel Mezzanine Foreclosure Sale: Implications for Mezzanine Lenders*, CLEARY GOTTLIEB (June 29, 2020) https://www.clearygottlieb.com/news-and-insights/publication-listing/new-york-court-grants-injunction-on-mark-hotel-mezzanine-foreclosure-sale.
100. *Id.*
101. D2 Mark LLC v. OREI VI Invests., LLC, No. 43, slip op. at 2 (N.Y. Sup. Ct. June 23, 2020).
102. *Id.*
103. *Id.*at 3.
104. *Id.*
105. *Id.* at 4.
106. *Id.*

hours of the conclusion of the sale.[107] The foreclosing lender engaged a broker from Jones Lang LaSalle (JLL) who had "significant experience with hotel financing, loan sales and UCC foreclosures" to conduct the sale process.[108] The broker contacted 700 potential bidders and created a virtual due diligence data room populated with over 100 documents concerning the loan collateral.[109] The sale was advertised in both the Wall Street Journal and a trade publication.[110] Despite the JLL broker opining that the marketing process went "well beyond what is required for a commercial reasonable sale," only two of the 115 entities that signed the nondisclosure agreement required to access the data room submitted documentation demonstrating the financial ability to bid on the collateral.[111]

On June 6, 2020, the mezzanine borrower initiated an action seeking preliminary injunction, alleging in relevant part that the proposed sale process was commercially unreasonable under the current circumstances and market conditions, and therefore in violation of UCC § 9-610(b).[112] On June 8, JLL modified the terms of the sale, which served to: (1) limit the defendant's ability to "credit bid" (bidding the amount of the outstanding debt plus interest and costs owed by the borrower)[113] after accepting the highest and best bid from a third party; (2) require the defendant to consider a request for more than 24 hours to close in good faith; and (3) provide the defaulted borrower access to the data room and the ability to bid on the collateral if it could show that it was financially qualified.[114] These modifications were not enough to establish a commercially reasonable disposition.[115] Noting that "what is reasonable during normal business times, may not be reasonable during a pandemic," the court sided with the plaintiff and granted the preliminary injunction.[116] In doing so, it used the three-prong test for preliminary injunctions that was considered in *1248*.[117]

With respect to the first prong, the court held that the plaintiff established a likelihood of success on its claim that the 36-day period between notice and sale may be commercially unreasonable.[118] Because the Mark Hotel was closed for 27 of those 36 days, it largely precluded potential bidders the

107. *Id.* at 4–5.
108. *Id.* at 5.
109. *Id.*
110. *Id.*
111. *Id.* at 7.
112. *Id.* at 6.
113. *Rights and duties of parties at foreclosure—Full credit bids as a bar to post foreclosure recourse*, 2 L. REAL EST. FIN. § 12:84 (Nov. 2020).
114. *D2 Mark* at 5.
115. The Court stated that "…the current structure of defendant's sale is not commercially reasonable, even with [the] modifications.". *Id.* at 7.
116. *Id.* at 13–14.
117. *Id.* at 7–12.
118. *Id.* at 10.

opportunity to inspect the property and conduct necessary due diligence.[119] The proposed diligence period was also deemed inadequate in length because it would essentially prevent parties from preparing a current valuation report; the property was last appraised in 2017 and had, according to expert testimony, likely increased in value.[120]

Regarding the second prong, the provision of the applicable mezzanine loan agreement limiting the plaintiff's remedies to injunctive relief without the availability of money damages was sufficient to establish irreparable harm.[121]

Third, the court held that the balancing of the equities tipped in favor of the plaintiff and therefore satisfied the third prong for injunctive relief.[122] It reasoned that the injury suffered by the plaintiff as the result of a denial of the injunction would be irreparable due to the plaintiff being deprived of its ownership and control rights in the entities that own, operate, and manage a unique property.[123] Such deprivation would also eliminate the plaintiff's ability to control public perception and trademark rights relating to the underlying asset.[124] On the other hand, the defendant's injury if the injunction were granted was mere "conjecture."[125] The foreclosing lender had posited that delaying the sale could be harmful, but the court declined the defendant's "invitation to predict the future."[126]

Ultimately, the court granted the preliminary injunction and ordered the sale to be stayed for 30 days, reasoning that "expanding the time to market the [c]ollateral and make a market for this unique hotel property is an elegant solution."[127] It further directed the lender to re-notice the sale in order to notify the market of the changes which may affect bidding at the foreclosure auction.[128] The modified notice was required to unequivocally state that bidders may participate virtually and otherwise conform to current CDC, state, and local regulations.[129] Additionally, a copy of the proposed notice must be given to the defaulted mezzanine borrower at least 24 hours before it is distributed to the market of potential bidders.[130] Lastly, the modified notice was required to be disseminated in a substantially similar manner as it was initially (by contacting 700 potential bidders and advertising in the Wall Street Journal and a trade publication).[131] Thus, although the temporary

119. *Id.*
120. *D2 Mark* at 10–11.
121. *Id.* at 11.
122. *Id.* at 11–12.
123. *Id.*
124. *Id.*
125. *Id.* at 12.
126. *D2 Mark* at 12.
127. *Id.*
128. *Id.* at 12.
129. *Id.* at 13.
130. *Id.*
131. *Id.* at 14.

injunction was granted, the court provided specific actions that a mezzanine lender could take to conduct a commercially reasonable foreclosure sale during the pandemic and was therefore not a complete victory for debtors in default.[132]

In *Shelbourne BRF LLC v. SR 677 BWAY LLC*, the Appellate Division of the New York Supreme Court reversed the lower court and held that preliminary injunctions on mezzanine loan foreclosures on the basis of commercial reasonableness are inappropriate because the availability of monetary damages precludes the necessary finding of irreparable harm.[133] The plaintiff in *Shelbourne* is the owner of the equity interests in two entities that together own a property in Albany, New York; those interests were pledged as collateral to secure the mezzanine loan.[134] Shortly after the plaintiff's default of the mortgage loan in May, the defendant mezzanine lender notified the plaintiff that it would be proceeding with a foreclosure auction via video conference on July 20, 2020.[135] In response, the mezzanine borrower initiated an action for a preliminary injunction on the grounds that the proposed disposition of the collateral was not commercially reasonable.[136]

Without reference to either *1248* or *D2 Mark*, the New York Supreme Court initially granted the preliminary injunction,[137] holding that although Administrative Order 157/20 (AO 157/20), which temporarily prohibited property auctions in connection with commercial foreclosure,[138] did not apply by its terms, the *logic* behind it did apply.[139] It reasoned that the value of an equity interest in a company that owns real property is based on the value of the underlying property itself, and thus it would be unreasonable to permit the foreclosure sale to proceed when there is severe turmoil in the real estate market that will likely discount the bids below fair market value.[140] The court ordered that the defendants were enjoined from proceeding with a foreclosure auction until the expiration of AO 157/20.[141] On appeal, the Appellate Division held that "[n]otwithstanding the existence of the COVID–

132. Caroline A. Harcourt, et al., *Distressed Real Estate During COVID-19: Court Finds UCC Foreclosure "Commercially Unreasonable" Because of Coronavirus-Related Market Turmoil*, PILLSBURY WINTHROP SHAW PITTMAN LLP, at 2 (Aug. 21, 2020), https://www.pillsburylaw.com/en/news-and-insights/UCC-foreclosure-court-decision-distressed-real-estate.html.

133. Shelbourne BRF LLC v. SR 677 BWAY LLC, 192 A.D.3d 444 (N.Y. App. Div. 2021).

134. Steven M. Herman & Nicholas E. Brandfon, *New York State Supreme Court Temporarily Halts UCC Foreclosure of Mezzanine Loan*, CADWALADER (Aug. 31, 2020), https://www.cadwalader.com/ref-news-views/index.php?nid=20&eid=99 [hereinafter Herman & Brandfon, *Supreme Court Halts UCC Foreclosure*].

135. *Id.*

136. Shelbourne BRF LLC v. SR 677 BWAY LLC, No. 38, slip op. at 1 (N.Y. Sup. Ct. Aug. 3, 2020).

137. *Id.* at 1–2.

138. State of New York Unified Court System, Administrative Order 157/20.

139. *Shelbourne*, No. 38, slip op. at 1 (N.Y. Sup. Ct. Aug. 3, 2020).

140. *Id.* at 1–2.

141. *Id.* at 2.

19 pandemic, the feared loss of an investment can be compensated in money damages."[142] On its face, this decision adheres to settled precedent.[143] The issue? The damages clause in the mezzanine loan agreement was "almost identical" to the corresponding provision in *D2 Mark*. Both clauses expressly prohibited money damages for the mezzanine lender's failure to act reasonably.[144]

In sum, the decisions in *D2 Mark*, *1248*, and *Shelbourne* leave multiple crucial questions unanswered. Will the courts ask—as a determinative threshold question—whether monetary damages are available to the mezzanine debtor for the lender's failure to act reasonably? Is that determination made based solely on the damages provision in the mezzanine loan agreement? If monetary damages are available, thus precluding *per se* the granting of a preliminary injunction, should the court review the proposed sale to determine whether it is commercially reasonable? To what extent is the commercial reasonableness standard affected by a disaster emergency like COVID-19? These questions must be answered by the courts to provide clarity to market participants and their stakeholders.

The common thread among the three decisions is that the executive order halting mortgage loan foreclosures does not apply to mezzanine loans. Based on the language of the executive order and the legal distinction between the collateral securing mortgage and mezzanine loans, it is difficult to argue otherwise. However, this is neither a just outcome nor does it accomplish the stated purpose of the moratorium because many borrowers in default due to the financial effects of the emergency remain susceptible to losing their properties by foreclosure. The solution thus not only demands clarity from the New York courts, but also requires affirmative steps to be taken by the Governor to ensure that the purpose of a commercial foreclosure moratorium is not negated in future emergency situations due to a legal technicality.

III. PROPOSED SOLUTIONS TO PROVIDE CLARITY AND FAIRNESS

A. EXECUTIVE ORDER

In future disaster emergencies where commercial mortgage loan foreclosures are halted in New York by executive order, the Governor should issue a parallel executive order temporarily prohibiting foreclosure actions against mezzanine borrowers (the Proposed EO). The Proposed EO would track the commercial mortgage loan foreclosure moratorium in both scope (it would not bar any mezzanine foreclosure action where foreclosure would be

142. Shelbourne BRF LLC v. SR 677 BWAY LLC, 192 A.D.3d 444 (N.Y. App. Div. 2021).

143. *See* Broadway 500 W. Monroe Mezz II LLC v. Transwestern Mezzanine Realty Partners II, LLC, 80 A.D.3d 483, 484 (1st Dep't 2011).

144. Herman & Brandfon, *Supreme Court Halts UCC Foreclosure*, *supra* note 139.

available to the senior lender in the same capital stack) and duration (it would expire when the prohibition on commercial mortgage loan foreclosures expires). The primary purposes of the Proposed EO would be: (1) to resolve any residual uncertainty from the *D2 Mark*, *1248*, and *Shelbourne* decisions as to the applicability of mortgage loan foreclosure moratoriums to mezzanine loans; (2) to "level the playing field" between senior and mezzanine lenders; and (3) to provide temporary protection for debtors that have defaulted on their loans due to financial hardship resulting from a disaster emergency.

As discussed in Part II, New York courts have not ruled consistently as to the extent by which mezzanine loan foreclosures are limited by legislative prohibitions on commercial mortgage foreclosures (collectively, Mortgage Foreclosure Orders).[145] The *1248* court held that EO 202.8 did not apply to the sale of the pledged interests because they are governed by the UCC and such an application was not explicitly provided for.[146] In contrast, the court in *D2 Mark* noted that "regardless of how the Governor's [executive orders] are interpreted in the future, they are persuasive authority that support plaintiff's contention [that the proposed foreclosure sale may not be commercially reasonable during a pandemic]."[147] Similarly, the initial *Shelbourne* decision held that although the commercial foreclosure moratorium (here, pursuant to an administrative order) did not technically apply by its terms, the reasoning of the prohibition did.[148] Accordingly, the court ordered the collateral disposition to be stayed until the expiration of the commercial foreclosure moratorium.[149]

The *1248* holding is correct in determining that the prohibition on foreclosures of commercial property does not encompass the foreclosure and disposition of the pledged interests securing a mezzanine real estate loan. To reiterate, a mezzanine loan is not a mortgage because it does not grant the creditor a lien on the debtor's property.[150] Further, mezzanine loan foreclosures are not judicially enforced; they are nonjudicial proceedings governed by Article 9 of the UCC.[151] Therefore, Mortgage Foreclosure Orders do not apply to mezzanine loan foreclosures and do not suspend or override the governing provisions of the UCC or the parties' agreements.

145. For the purposes of this Note, "Mortgage Foreclosure Orders" means any executive, legislative, or administrative order in the State of New York enacted during the COVID-19 pandemic to prohibit or limit the foreclosure of a commercial real estate property owner.

146. 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 2 (N.Y. Sup. Ct. May 18, 2020).

147. D2 Mark LLC v. OREI VI Invests., LLC, No. 43, slip op. at 11 (N.Y. Sup. Ct. June 23, 2020).

148. Shelbourne BRF LLC v. SR 677 BWAY LLC, No. 38, slip op. at 1 (N.Y. Sup. Ct. Aug. 3, 2020).

149. *Id.* at 2.

150. Armstrong, *supra* note 2.

151. Weiss & Weiss, *supra* note 28.

Although resolving uncertainty is a worthwhile goal in and of itself, mezzanine lenders will almost certainly contend that an explicit clarification by Governor Hochul or the New York legislature that Mortgage Foreclosure Orders do not apply to mezzanine foreclosures would be equally as valuable as the Proposed EO. However, the Proposed EO would accomplish more than merely providing clarity to lenders and borrowers.

First, the Proposed EO would ensure fairness to all creditors in the capital stack. Senior lenders are currently at a significant disadvantage because they are precluded from accessing their loan collateral through the remedies set forth in their agreements and under the law until Executive Order 202.81 (the Current EO)[152] expires. Conversely, if the terms of the Current EO are interpreted properly, mezzanine lenders can access their collateral and dispose of the pledged ownership interest in the property owner just as they did prior to the start of the emergency. Therefore, the New York Supreme Court's reasoning in *Shelbourne* is much more equitable, despite technically being an incorrect interpretation of the law. As Justice Schecter stated, "[V]aluation of an equity interest in a company that owns real estate is based on the value of the real estate itself."[153] Legal technicalities aside, it is difficult to justify an argument that mezzanine lenders should be able to foreclose on the ownership control of a property while the mortgage lender is prohibited from foreclosing on the title to the same underlying property during the continuance of a declared emergency. Because the result of a mezzanine and mortgage loan foreclosure is that the property owner forfeits its ownership to the foreclosing secured party, the Proposed EO should endeavor to temporarily "level the playing field" between senior and mezzanine lenders during this unprecedented emergency period. The Proposed EO would accomplish this by precluding mezzanine loan foreclosure actions until judicial foreclosures once again become available to mortgage lenders.

Second, the Proposed EO would align with a policy goal of the original moratorium: giving borrowers a chance to renegotiate the terms of their existing debt obligations.[154] This is especially pertinent because a large

152. For the purposes of this note, the "Current EO" means New York Executive Order 202.81 and any extensions thereof, which provides that no commercial foreclosure may be commenced for nonpayment until August 31, 2021, if the borrower is eligible for unemployment insurance, other benefits under state or federal law or otherwise facing a financial hardship due to COVID-19. The Current EO is largely derived from the language in Executive Order 202.28. Subsequent Executive Orders have extended (or modified, in ways not relevant to this note) Executive Order 202.28, and the Current EO can be seen as the most recent extension of Executive Order 202.28 (through January 31, 2021). *See COVID-19: Commercial Mortgage Foreclosure and Payment Relief Programs State Tracker (US)*, PRAC. L. PRAC. NOTE (last updated Sept. 28, 2021).

153. Shelbourne BRF LLC v. SR 677 BWAY LLC, No. 38, slip op. at 1 (N.Y. Sup. Ct. Aug. 3, 2020).

154. *Cuomo Extends Moratorium On COVID-Related Commercial Evictions And Foreclosures Through Jan. 1*, ROCKLAND CNTY. BUS. J. (Oct. 21, 2020), https://rcbizjournal.com/2020/10/21/

percentage of mezzanine real estate lenders are hedge funds and private equity firms with inadequate expertise in operating and managing commercial real estate properties.[155] It does not serve the interests of any party, including the public, for real estate owners and developers to relinquish their ownership interests during a period of severe uncertainty to investment funds lacking the experience to manage development projects or operate existing properties effectively. Mezzanine debt holders that are unwilling or unable to modify loan terms would remain free to sell their debt in the secondary market, either to firms with the management expertise to step into the shoes of the property owner, or to investors seeking the higher yields of distressed mezzanine debt. This trend has started to gain significant momentum in the industry.[156]

It is crucial to note that the mezzanine foreclosure prohibition would be a temporary measure enacted due to a state of emergency. Upon the expiration of the foreclosure moratorium, mezzanine lenders will once again be able to enjoy the advantage of their ability to conduct swift foreclosures and collateral dispositions under Article 9. As discussed in Part I, this is an attractive feature of mezzanine financing to creditors that has a substantial impact on interest rates. On the other hand, upon the final expiration of any applicable Mortgage Foreclosure Order, senior lenders will remain subject to the unfavorable timeline of the judicial foreclosure process in New York.

Mezzanine lenders insist that the attempts to access their loan collateral through foreclosure are due to their obligations to their own lenders and investors, as opposed to a manifestation of predatory "loan to own" strategies.[157] Such obligations would be protected by two key nuances in the proposed legislative action.

First, as opposed to a blanket prohibition on mezzanine real estate loan foreclosures, the Proposed EO should track the language of the Current EO, which only protects debtors that are facing financial hardship due to the COVID-19 pandemic.[158] Mirroring this provision in the Proposed EO would permit mezzanine lenders to foreclose on borrowers that defaulted prior to, or otherwise unrelated to, the declared emergency. The burden would be on the defaulted borrower to make an affirmative showing of financial hardship.

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cuomo-extends-moratorium-on-covid-related-commercial-evictions-and-foreclosures-through-jan-1/ [hereinafter *Cuomo Extends Moratorium*].

155. "For a hedge fund that owns mezz debt on a hotel, the last thing they want to do is own a hotel." Goldstein, *supra* note 8.

156. "Lawyers and lenders said the market for distressed mezzanine debt had sprung to life in recent weeks." *Id.*

157. "Loan to own" is a strategy in which lenders offer mezzanine financing at predatory interest rates in hopes of obtaining indirect ownership of the property through a foreclosure. Goldstein, *supra* note 8. *See also* Adam Pincus, *Shining a light on loan to own*, THE REAL DEAL (Apr. 1, 2009), https://therealdeal.com/issues_articles/shining-a-light-on-loan-to-own/.

158. N.Y. Exec. Order No. 202.28.

Loans that were healthy before March 7, 2020 (the COVID Start Date)[159] and subsequently went into default because the underlying property's cash flow was no longer sufficient to cover debt service payments would provide strong evidence in favor of finding such default was due to financial hardship related to COVID-19. This could be further strengthened by a showing that the borrower itself is owed unpaid rent or other fees, or if the underlying property or business was shut down specifically due to health and safety regulations. On the other end of the spectrum, loans that were either delinquent or in default prior to the COVID Start Date will almost certainly preclude the borrower from making the requisite showing of financial hardship due to the pandemic and would not be protected by the Proposed EO.

Second, the Proposed EO would not prevent debt payments from accruing during the continuance of an event of default. This aligns with another explicitly stated goal of the foreclosure moratorium: to give borrowers the chance to catch up on their financial obligations.[160] Debtors would not be "off the hook" with respect to their debt service payments but would retain indirect ownership of the underlying property until the Proposed EO expired. This provision thus provides protection to creditors by incentivizing borrowers to adequately maintain the value of the collateral. If owners were to let their property—and therefore, the value of the mezzanine loan collateral—deteriorate, it would reduce the surplus amount that the debtor could receive once the foreclosure sale is permitted to take place.[161]

Application of the Proposed EO to the cases discussed in Part II are illustrative of its ability to achieve equitable results. It would protect the owners of the Mark Hotel, who had never missed a debt payment before the start of the pandemic and were owed over $1 million by their retail tenants.[162] The owners would almost certainly be able to adequately show financial hardship due to COVID-19 and thus foreclosure would not be an available remedy for the secured parties until the expiration of the Current EO. It would also likely protect the owners of the property in *Shelbourne* because the missed debt service payment that led to the default was in May 2020,[163] which was after the COVID Start Date. Conversely, the Proposed EO would not apply to the owners of the development property in *1248* because the default occurred due to failure to achieve substantial completion with respect to

159. March 7, 2020 is the date that Governor Andrew M. Cuomo issued Executive Order 202, declaring a disaster emergency in the State of New York.

160. *Cuomo Extends Moratorium*, *supra* note 159.

161. In the case of a surplus of the cash proceeds of a disposition, "after making the payments and applications required . . . the secured party shall account to and pay a debtor for any surplus." NY UCC § 9-615(d)(1).

162. D2 Mark LLC v. OREI VI Invests., LLC, No. 43, slip op. at 3 (N.Y. Sup. Ct. June 23, 2020).

163. Steven M. Herman & Nicholas E. Brandfon, *New York State Supreme Court Temporarily Halts UCC Foreclosure of Mezzanine Loan*, CADWALADER (Aug. 31, 2020), https://www.cadwalader.com/ref-news-views/index.php?nid=20&eid=99.

construction of the project.[164] The Proposed EO only protects default due to nonpayment. While this is a limited scope of protection for mezzanine borrowers, expanding the protections to borrowers under the Proposed EO beyond those in the Current EO (making mortgage loan foreclosures *more* available than mezzanine loan foreclosures) would be catastrophic for mezzanine lenders. Mortgage loan foreclosures can wipe out the entire value of the mezzanine lender's collateral, while a mezzanine loan foreclosure leaves the senior loan intact. Debtors nonetheless remain free to challenge nonmonetary defaults under *force majeure* clauses or other legal doctrines.

B. UCC FORECLOSURES OUTSIDE THE SCOPE OF THE PROPOSED EO: WHEN SHOULD PRELIMINARY INJUNCTION BE GRANTED TO HALT SALES?

Although the Proposed EO would prohibit a substantial number of mezzanine loan foreclosures and subsequent collateral dispositions to proceed until mortgage loan foreclosures are once again permitted in New York, defaulted mezzanine borrowers unable to prove financial hardship due to the pandemic would remain subject to UCC foreclosure actions. If creditors are unwilling to negotiate loan modifications or sell the debt on a secondary market, they will almost certainly exercise their lawful foreclosure remedies. In response, borrowers will likely move for a preliminary injunction on the basis that the disposition would be commercially unreasonable.[165] The plaintiff debtors in *D2 Mark*, *1248*, and *Shelbourne* all moved for a preliminary injunction of the respective proposed foreclosure sales.[166] This aspect of the proposed solution is concentrated on such motions. Under New York law, a preliminary injunction is "an extraordinary provisional remedy to which a plaintiff is entitled only on a special showing."[167]

1. Prong One: Irreparable Harm

The court should first look to determine whether the plaintiff would suffer irreparable harm upon denial of the relief sought because it can be quickly ascertained by examining the remedies available under the parties' agreement. Under NY UCC § 9-625, a court may provide injunctive relief

164. Cooper, *supra* note 87.

165. "Several other borrowers [in addition to Wonder Works Construction and HFZ Capital Group, referenced therein] have taken a similar tact, pinning their arguments on the Uniform Commercial Code's requirement that foreclosures be 'commercially reasonable.'" Sylvia Varnham O'Regan, *Wonder Work Construction sues lender to stop foreclosure*, REAL DEAL (Dec. 4, 2020), https://therealdeal.com/2020/12/04/wonder-work-construction-sues-lender-to-stop-foreclosure/.

166. *See* D2 Mark LLC v. OREI VI Invests., LLC, No. 43, slip op. at 1 (N.Y. Sup. Ct. June 23, 2020); 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 2 (N.Y. Sup. Ct. May 18, 2020); Shelbourne BRF LLC v. SR 677 BWAY LLC, No. 38, slip op. at 1 (N.Y. Sup. Ct. Aug. 3, 2020).

167. Margolies v. Encounter, Inc., 368 N.E.2d 1243, 1245 (1977).

"on appropriate terms and conditions."[168] However, it is well-established under New York law that: (1) irreparable harm is an injury that cannot be sufficiently compensated by money damages and (2) economic loss is generally compensable by money damages.[169] The injury to mezzanine borrowers upon the foreclosure of their ownership interest of the property-owning entity is strictly an economic loss. "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."[170] Because a plaintiff mezzanine borrower's loss is one that can ordinarily be compensated by money damages, irreparable harm can only be shown if money damages are not available to the borrower under the terms of the agreement.[171]

The courts in *D2 Mark* and *1248* appear to adhere to this settled precedent. In *D2 Mark*, the only available remedy in the mezzanine loan agreement was injunctive relief.[172] Accordingly, the court held that this damages provision was sufficient to establish that the plaintiff would suffer irreparable harm if the injunction were denied.[173] In *1248*, money damages were available to the plaintiff.[174] There, the court properly held that this was *per se* dispositive to a showing of irreparable injury upon a denial of the injunctive relief sought.[175] The parties in *Shelbourne* had a provision in their mezzanine loan agreement precluding the borrower from obtaining monetary damages from the lender for a commercially unreasonable action.[176] Inexplicably, the Appellate Division cited *Transwestern* (where the parties had no such provision) and held that injunction was not an appropriate remedy because irreparable harm could not be shown.[177]

However, the *D2 Mark* court erroneously strays from the above-referenced precedent by taking its holding one step further, stating that "interference with an ongoing business, 'particularly one involving a unique product and an exclusive licensing and distribution arrangement, risks

168. NY UCC § 9-625.

169. Di Fabio v. Omnipoint Commc'ns, Inc., 66 A.D.3d 635, 636–637 (2d Dep't 2009).

170. Broadway 500 W. Monroe Mezz II LLC v. Transwestern Mezzanine Realty Partners II, LLC, 80 A.D.3d 483, 484 (1st Dep't 2011).

171. *See* Omni Berkshire Corp v. Wells Fargo Bank, N.A., 2003 WL 1900822, at *4 (S.D.N.Y 2003).

172. D2 Mark LLC v. OREI VI Invests., LLC, No. 43, slip op. at 11 (N.Y. Sup. Ct. June 23, 2020).

173. *Id.*

174. 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 2 (N.Y. Sup. Ct. May 18, 2020).

175. *Id.*

176. Janice Mac Avoy, et al., *New York Supreme Court Issues Preliminary Injunction Halting Another UCC Foreclosure*, FRIED FRANK (Aug. 6, 2020), https://www.friedfrank.com/siteFiles/Publications/FFTOCShelbourne08062020.pdf.

177. Shelbourne BRF LLC v. SR 677 BWAY LLC, 192 A.D.3d 444 (N.Y. App. Div. 2021).

irreparable injury and is enjoinable.'"[178] Judges must not conflate the similar results of mortgage and mezzanine loan foreclosures with the distinct structures and remedies of the two financing types under the law. A mezzanine foreclosure action does not cause the debtor to lose a unique piece of property in which they have an unquantifiable interest, they lose their equity interest in the property-owning entity. Ultimately, the characteristics of the underlying property are irrelevant; regardless of whether the property is an established business or merely a development project with potential profits that are difficult to quantify, money damages are a sufficient remedy if they are available to the borrower.[179]

Because the court can determine whether the plaintiff can establish irreparable harm simply by looking at the remedies available under the parties' agreement, this should be the first prong that the court analyzes when the plaintiff is seeking a preliminary injunction. If injunctive relief is the only remedy offered to the borrower pursuant to the agreement, the court should then evaluate the commercial reasonableness of the proposed foreclosure disposition to determine the likelihood of success for the moving party. If money damages are available to the borrower, the court must dismiss the motion.

2. Prong Two: Likelihood of Success

Upon an adequate showing of irreparable harm, the court then should use a fact-intensive analysis to determine whether a plaintiff has established a likelihood of success on the merits that the proposed sale is not commercially reasonable. This level of scrutiny is necessary to adhere to the language of Article 9 of the NY UCC and prevent foreclosing mezzanine lenders from unfairly "rigging" the process to the detriment of borrowers, either to gain control of the ownership interests themselves or quickly recoup the outstanding debt amount by selling the collateral at a price severely below the market rate. To establish this element in the context of a preliminary injunction, the moving party must make a prima facie showing of a reasonable probability of success.[180]

This section also provides guidance as to how a determination of commercial reasonableness should be made in the context of a challenge for noncompliance with Article 9 where the remedy sought by the plaintiff is money damages under NY UCC § 9-625. For a proper analysis of commercial reasonableness under Article 9, the court must look at the

178. *D2 Mark* at 12 (citing U.S. Ice Cream Corp. v. Carvel Corp., 136 A.D.2d 626, 628 (2d Dep't 1988)).

179. "[E]ven lost profits that are difficult to ascertain can be compensated by money damages." Broadway 500 W. Monroe Mezz II LLC v. Transwestern Mezzanine Realty Partners II, LLC, 80 A.D.3d 483, 484 (1st Dep't 2011).

180. *D2 Mark* at 8 (N.Y. Sup. Ct. June 23, 2020) (quoting Barbes Rest. Inc. v. ASRR Suzer 218, LLC, 140 AD3d 430, 431 (1st Dept. 2016)).

method, manner, time, place, and other terms of the proposed foreclosure.[181] As discussed above, this assessment was absent in both the *1248* and *Shelbourne* decisions.

The court in *1248* appears to follow the proposed solution herein, in that it declined to examine the specifics of the proposed foreclosure sale because the potential harm to the plaintiff was the loss of investment, thus compensable by money damages which were available under the parties' agreement.[182] As discussed, this is an efficient way to approach the test for injunctive relief because the court does not have to examine every aspect of the proposed disposition, which (if done correctly) is an extensive, time-consuming process that typically involves the use of expert testimony on behalf of both the borrower and lender.

Further, the *Shelbourne* holdings—both initially and on appeal—are flawed. The Supreme Court's holding—that it would be unreasonable to permit the foreclosure sale to proceed during a period in which bids are likely to be discounted due to tumultuous market conditions—is inappropriate because the court supplied its own definition of commercial reasonableness that disregards the governing language of the NY UCC.[183] Courts must adhere to established precedent and resist the temptation to conflate a low sale price with a commercially unreasonable disposition. In reversing the lower court's decision, the Appellate Division held that the availability of monetary damages precluded a finding of irreparable harm, despite the fact that monetary damages were explicitly precluded under the applicable mezzanine loan agreement.[184] Because monetary damages were unavailable to the plaintiff in *Shelbourne*, the court should have examined the commercial reasonableness of the proposed sale.

Ultimately, courts must keep in mind that "[w]hether a sale was commercially reasonable is…a fact-intensive inquiry; no magic set of procedures will immunize a sale from scrutiny."[185] In doing so, courts should largely follow the precedent established by the court in both *Vornado* and *D2 Mark*, including reliance on accepted business practices as evidence of commercial reasonableness.[186] It must examine each aspect of the proposed foreclosure sale.[187] For a public disposition of collateral to be commercially

181. *See* NY UCC § 9-610(b) (stating "[t]he fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.").

182. 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 3 (N.Y. Sup. Ct. May 18, 2020).

183. NY UCC § 9-627.

184. Shelbourne BRF LLC v. SR 677 BWAY LLC, 192 A.D.3d 444 (N.Y. App. Div. 2021).

185. *In re* Excello Press, Inc., 890 F.2d 896, 905 (7th Cir. 1989).

186. D2 Mark LLC v. OREI VI Invests., LLC, No. 43, slip op. at 8–9 (N.Y. Sup. Ct. June 23, 2020) (citing Bankers Trust Co v. Dowler & Co., 47 NY2d 128, 134 (1979)).

187. *See* NY UCC § 9-610(b).

reasonable, the foreclosing secured party must create meaningful opportunity for competitive bidding by marketing the collateral as a non-foreclosing seller would.[188] Undoubtedly, the commercial reasonableness of a disposition is affected significantly by COVID-19. Health and safety regulations related to the pandemic or other emergency may make conducting due diligence, attending an in-person sale, and rapidly closing a complex transaction considerably more difficult. Courts should be conscious of the *D2 Mark* court's mantra: "what is reasonable during normal business times, may not be reasonable during a pandemic."[189]

The first general aspect of the sale that the court should examine is the time period between notice and disposition. Before a sale can take place, there must be an adequate amount of time for potential bidders to have access to a current, accurate appraisal of the property's value and to otherwise conduct the necessary due diligence on the collateral and underlying property.

Next, the court should evaluate the marketing strategy for the collateral sale. It should consider the relevant experience of the broker engaged by the foreclosing mezzanine lender to conduct the sale; an established broker in the commercial real estate industry following its typical marketing strategy is strong evidence of commercial reasonableness. In addition to an evaluation of the broker itself, the court should look to where the collateral is advertised. Advertising in both a national newspaper and a real estate trade publication is also strong evidence of commercial reasonableness.

Third, the court must require that the terms of the sale comply with current health and safety regulations with respect to the ongoing emergency. Any aspect of the sale that conflicts with a federal, state, or local regulation must be deemed *per se* commercially unreasonable. However, even if permissible under current applicable health and safety regulations, a sale that is not available to bidders virtually is strong evidence that such sale is not commercially reasonable.

Lastly, New York courts should be conscious of provisions in the notice of sale/proposal that would lead the court to believe that the lender is trying to "rig" the process in favor of itself or to effectuate a "fire sale" to quickly recoup its outstanding debt without regard to the defaulted debtor's interests. These may include unreasonable requirements with respect to deposit amounts, a rushed closing timeline (the time between the payment of the deposit and payment of the remaining balance of the purchase price), restrictions on the defaulting debtor relating to accessing diligence items or bidding on the collateral in general, and the secured creditor's ability to submit a credit bid that would supersede a higher bid by a third party.

188. Fisch & Freidus, *supra* note 5.
189. *D2 Mark* at 11.

If the court conducts the preceding analysis and determines that the plaintiff borrower is likely to succeed on the merits (that is, one or more aspects of the proposed sale are not commercially reasonable), it should proceed to the third element of the preliminary injunction test. If not, the court should deny the motion and permit the scheduled foreclosure to proceed as scheduled.

3. Prong Three: Balancing of the Equities

The third element of the preliminary injunction test is an additional area in which the recent case law cannot coexist without conflict. The *1248* court determined that the balance of the equities tips in favor of the defendant, holding that "[p]laintiff's anticipation of economic damage resulting from the noticing, the manner, or timing of the sale, particularly in light of the current economic shutdown and restrictions on travel as a result of the COVID-19 pandemic, is merely speculative."[190] Conversely, the *D2 Mark* court dismissed the *defendant's* injury as "conjecture," further holding that "[t]he court cannot accept defendant's invitation to predict the future: whether COVID-19 will resurge; whether protests will continue to be peaceful; whether the mayor and governor will together address transportation problems in New York City. The balance of the equities clearly tips in plaintiff's favor."[191]

Any prediction of the future in the midst of an unforeseen emergency is speculative, whether made by a plaintiff or defendant. This is an arbitrary and ineffective way for courts to analyze the third prong of the preliminary injunction test. Because the plaintiff would have already demonstrated that a denial of the injunction would result in irreparable harm, there should be a rebuttable presumption that the harm to the plaintiff would outweigh the harm to the defendant. However, the defaulted borrower should be required to show that it can and will adequately maintain the value of the lender's collateral during the injunction period. Preserving the value of the collateral includes not only maintaining the property, but also paying taxes on the property to prevent a higher-priority lien that would be senior to the mezzanine debt from being attached. If not, the balance of the equities may tip in favor of the secured party despite a previous showing by the borrower of irreparable harm.

4. Providing a Path Forward

Courts that issue a preliminary injunction should nonetheless provide the foreclosing lender and its broker a specific course to achieving a commercially reasonable disposition of the collateral. This path forward

190. 1248 Assoc. Mezz II LLC v. 12E48 Mezz II LLC, No. 58, slip op. at 2 (N.Y. Sup. Ct. May 18, 2020).

191. *D2 Mark* at 12.

should be a direct response to the aspect or aspects of the proposed foreclosure sale that the court deemed to be commercially unreasonable during the pandemic. Ultimately, this ensures that the secured party can exercise its lawful remedies upon loan default and reduces the need for subsequent litigation.

CONCLUSION

The COVID-19 pandemic continues to have a severe and detrimental impact on the commercial real estate industry. The flood of mezzanine loan defaults will likely continue for the foreseeable future. Further, future emergencies—whether pandemic-related or not—are as difficult to predict as they are inevitable. New York courts have addressed the question of whether defaulted mezzanine real estate borrowers should be subject to foreclosure actions during the continuance of COVID-19, but their holdings have largely led to increased uncertainty among borrowers, lenders, and industry experts.

The Proposed EO, explicitly prohibiting foreclosures on mezzanine real estate loans against borrowers able to demonstrate that their default was due to the detrimental financial effects of an emergency, will provide equity and clarity with respect to foreclosure remedies when a statewide emergency has been declared. The moratorium should be lifted once commercial mortgage loan foreclosures are once again available, at which time mezzanine lenders will be able to exercise their remedies under the NY UCC to efficiently foreclose on and dispose of their loan collateral.

For mezzanine loan foreclosures that are not encompassed by the Proposed EO, this Note provides New York courts guidance as to how the pandemic should—and should not—affect well-established case law. Because these loans are necessarily determined to not be in default due to the pandemic, courts should generally adhere to the well-settled precedent with respect to the availability of injunctive relief to temporarily stay foreclosure dispositions. The key exception is the determination of commercial reasonableness, which must be assessed in light of any health and safety regulations related to an emergency.

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