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Dual Collateral Loans and Clogging the Equity of Redemption

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Since the market downturn in 2008, dual collateral loans have become more common in real estate financing. By taking two forms of collateral – a mortgage lien on real property and a pledge of the equity interests in the borrower – real estate lenders ostensibly have a choice in pursuing remedies in the event of a default, and can proceed by a judicial foreclosure on the mortgage or a UCC foreclosure on the equity interests.

Despite the increasing prevalence of dual collateral loans, many practitioners questioned whether such arrangements could be enforced under New York law. Specifically, practitioners were concerned that dual collateral loans were void because they clogged (or impaired) a borrower's equitable right of redemption, *i.e.* a borrower's right to redeem the mortgaged property by paying off the outstanding debt. No court (in New York or nationwide) had ruled on the issue and, indeed, there was a general dearth of case law applying the centuries old anti-clogging doctrine in the modern commercial real estate financing context.

However, in June 2018, a New York court held – for the first time in a written decision – that a borrower's right of redemption was not clogged where a lender holding both a mortgage lien and a pledge of the equity interests sought to sell the equity interests in a UCC foreclosure sale. While many have heralded the decision as a conclusive determination that lenders are not at risk by taking both forms of collateral as security for a loan, as set forth below, there are a number of reasons to be more circumspect about the implications of the decision.

The Differences Between a Judicial Foreclosure on the Mortgage and a UCC Foreclosure on the Equity Interests

In New York, to foreclose on a mortgage, a lender must commence (and pursue) a litigation in court. As a result, the foreclosure process may take a number of years to complete and, until the gavel falls on the foreclosure sale, the borrower retains the right to pay off all outstanding amounts due on the loan and reclaim the mortgaged property. However, at the end of the process, a foreclosing lender takes title to the property free and clear of all subordinate liens and debts.

By contrast, the process of foreclosing on equity interests pursuant to the UCC can be accomplished in a matter of months (if not weeks), and is considerably less expensive. Pursuant to the UCC, a foreclosing lender has the right to sell the collateral, or accept the collateral in full or partial satisfaction of the debt. However, in either case, the collateral is taken subject to all pre-existing liens and pre-existing liabilities (including existing contracts, accounts payable, and other debts).

What Is the Equity of Redemption and How Is It Clogged?

The equity of redemption is the right of a defaulting mortgagor to redeem or reclaim the mortgaged property prior to the completion of a foreclosure by paying off the entire outstanding debt. This right of redemption is considered an integral part of a mortgage, and cannot be impaired – or "clogged" – even by agreement of the parties. As a result, under New York law, an agreement that obstructs the borrower's right of redemption is void.[1]

Dating back to the 1800s, courts in New York have repeatedly affirmed the sanctity of a borrower's right of redemption.[2] Additionally, in New York, the right of redemption upon a default is protected by several statutory provisions.[3]

Despite the clear intention of both the legislature and the courts to protect the equitable right of redemption, there is scant case law on the application of the doctrine to modern commercial real estate financing arrangements. Although, in recent years, several borrowers have brought suits challenging the enforceability of financing arrangements on the basis that they obstructed the borrowers' equity of redemption, the courts involved did not rule on the issue.[4] That is, until the recent New York trial court decision in *HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC*….[5]

The *HH Cincinnati* Decision

In *HH Cincinnati*, the borrowers/plaintiffs defaulted on a $20 million loan secured by (i) mortgages on the underlying properties, which were located in Kansas City, Missouri and Cincinnati, Ohio;[6] and (ii) a pledge of the equity in the borrowers, who were the owners of the underlying properties. It was undisputed that the loan matured in August 2017 and, because the borrowers failed to pay off the loan, they were in default under the loan agreement.

After the lenders issued a notice of default, the lenders initiated a marketing campaign to sell the equity interests in a UCC foreclosure sale. In June 2018, ten months after the default, the borrowers commenced an action against the lenders seeking to void the loan documents, and obtain a temporary restraining order ("TRO") and preliminary injunction to prevent the sale of the equity interests.

In support of their application for a TRO/preliminary injunction, the borrowers asserted several arguments based on their equitable right of redemption: (i) they had a likelihood of success on the merits of their underlying claim because the arrangement clogged their right of redemption and was void pursuant to New York public policy,

[1] *See, e.g., Clark v. Henry*, 2 Cow. 324, 327 (N.Y. Sup. Ct. 1823) ("all agreements of the parties, tending to alter in any subsequent event the original nature of the mortgage and prevent the equity of redemption, are void").

[2] *See, e.g., Slee v. Manhattan Co*., 1 Paige Ch. 48, 56 (N.Y. Ch. 1828) (holding that "the right of redemption" is "inseparable incident" to a mortgage that "cannot be restrained or clogged even by the stipulation of the parties"); *Lawrence v. Farmers' Loan & Tr. Co.*, 13 N.Y. 200, 205 (1855) ("A right to redeem premises mortgaged is incident to, and inseparable from every mortgage, until such right is released or canceled by the person entitled thereto, or is duly foreclosed or barred. No stipulation or agreement in the mortgage, or between the parties at the time of making it, can in any way destroy, impair or clog this right.")

[3] N.Y. Real Prop. L. § 320; N.Y. Gen. Oblig. L. § 5-334.

[4] For instance, in *Symphony Space, Inc. v. Pergola Props., Inc.*, 214 A.D.2d 66 (1st Dep't 1995), *aff'd*, 88 N.Y.2d 466 (1996), the court was faced with an agreement granting defendants an option to purchase certain real property. Instead of addressing whether the agreement was void because it clogged the equity of redemption, the court invalidated the agreement on a different theory. 214 A.D.2d at 80. Additionally, in *Sutton 58 Owner, LLC, v. Sutton 58 Assocs. LLC*, Index No. 650832/2016 (Sup. Ct. N.Y. Cty. February 17, 2016), the court did not rule on plaintiffs' claim that, by having a single lender on a mortgage and mezzanine loan, secured by a mortgage lien on real property and a pledge of the equity interests, their equity of redemption was clogged.

[5] 2018 N.Y. Misc. LEXIS 2472 (N.Y. Sup. Ct. June 19, 2018).

[6] While the properties were located in Missouri and Ohio, the underlying loan documents, including the pledge agreement, were governed by New York law.

and (ii) they would be irreparably harmed if the lenders were permitted to foreclose on the equity interests because the borrowers would lose their equitable right of redemption.

In opposition, the lenders made several arguments in support of their position that the dual collateral loan structure did not clog the borrowers' right of redemption. The lenders submitted an affidavit from a practitioner who attested to the extensive use of the dual collateral structure within the commercial real estate financing context, and asserted that, given this pervasiveness, the commercial real estate marketplace obviously did not believe that such arrangements violated the equitable right of redemption. Further, the lenders pointed out that, despite the widespread use of dual collateral loans, the borrowers could not cite to a single case – in New York or anywhere else in the nation – where a dual collateral loan was held to violate a borrower's right of redemption. Finally, the lenders argued that, pursuant to UCC § 9-623, the borrowers had a statutory right to redeem at any time before the lenders disposed of the collateral, and thus their equity of redemption was not clogged.

While the court granted the borrowers a short reprieve in the form of a TRO, ultimately, after a hearing on the motion for a preliminary injunction, the court denied the borrowers' request for further injunctive relief and vacated the TRO. Specifically, the court determined that the borrowers had not demonstrated irreparable harm, one of the essential requirements for a preliminary injunction.

The court's determination was based, in part, on its rejection of the borrowers' argument that they were irreparably harmed because their equity of redemption was clogged. In so holding, the court explicitly stated that borrowers' equitable right of redemption was <u>not</u>, in fact, clogged because the borrower retained the right to redeem under the UCC. The court explained:

> Plaintiffs, at this very moment, retain a right of redemption under UCC § 9-623, which provides that redemption may occur at any time before a secured party disposes of the collateral at a foreclosure sale. Thus, the UCC provides a right of redemption if Plaintiffs can fulfill their obligations under the applicable agreements. Additionally, there is nothing to prevent Plaintiffs from taking part in the bidding process at the UCC sale.

After *HH Cincinnati*, Are Lenders on Dual Collateral Loans in the Clear?

In light of the dearth of case law applying the anti-clogging doctrine in the context of modern commercial real estate financing, when the court issued the decision in *HH Cincinnati*, many heralded it as finally answering the question – in the affirmative – as to whether dual collateral loans are permissible. However, while *HH Cincinnati* represents a step towards confirming the permissibility of dual collateral loans, for several reasons, it does not fully and finally resolve all issues with respect to dual collateral loans and a lender's exercise of remedies in connection therewith.

First, the decision in *HH Cincinnati* was issued by the lowest level court in New York state, and was not reviewed by the Appellate Division.[7] As such, the *HH Cincinnati* decision is not binding law in New York state (or anywhere else), and does not have to be followed by any other court. While it would be considered persuasive authority, another judge faced with the same facts would be free to reach a different conclusion.

[7] Notice of Entry of the decision was filed on June 21, 2018. Plaintiffs had 30 days thereafter to file a notice of appeal, but did not do so.

Second, the court's decision in *HH Cincinnati* was necessarily based on the specific facts of the case, including that a maturity default had occurred ten months earlier, the parties had engaged in months of workout negotiations, and the borrowers were provided with a notification of the UCC foreclosure sale three weeks before it was scheduled to occur. As such, as a matter of fact, the borrowers had significant time to redeem their equity prior to the UCC foreclosure sale.

However, similar circumstances may not exist in all cases where a lender chooses to exercise its remedies under the UCC. Indeed, pledge and security agreements often permit the sale of the collateral in as little as 10 days. Alternatively, pursuant to the UCC (and subject to the notice requirements therein), a lender may exercise its right to take the equity interests in full or partial satisfaction of the debt. In both these circumstances, it is likely that there is no meaningful opportunity for borrower to refinance the loan or sell the asset after the default and prior to foreclosure. As such, even though there is technically a right to redeem under the UCC, query whether, in either of these circumstances, a court would find that a borrower's right of redemption was truly protected.

Third, the decision does not distinguish any of the prior case law in New York regarding a borrower's equitable right to redemption, and the court's analysis of the borrowers' clogging argument is limited to a single paragraph. As such, the *HH Cincinnati* decision does not meaningfully aid practitioners in understanding how a court would apply the anti-clogging doctrine to modern commercial real estate financing arrangements more generally, and does little to fill the gap in the case law.

Conclusion

While the court's decision in *HH Cincinnati* is a useful persuasive precedent if a borrower challenges a dual collateral loan, the propriety of taking both a mortgage and an equity pledge has not been finally determined under New York law. As such, lenders should be aware that the enforceability of dual collateral loans is still an open question, and should carefully consider whether taking (and enforcing) a pledge of equity is worth the risk.