

New York State Trial Court Holds That Moratorium on Foreclosures Does Not Bar UCC Foreclosure

May 19, 2020

PRACTICES Real Estate, Commercial Real Estate Leasing

In a decision issued on Monday, May 18, 2020, Justice Frank P. Nervo of the Supreme Court of the State of New York, New York County, held that a UCC foreclosure pursuant to Article 9 was not barred by New York State’s moratorium on foreclosures of commercial real property. The decision paves the way for additional UCC foreclosure auctions to occur even as the COVID-19 pandemic continues, but leaves open the possibility that foreclosing lenders may be liable for damages if the time, place, method or manner of a sale is later determined to be commercially unreasonable.¹

The plaintiff in the action, 1248 Associates Mezz II LLC (“Borrower”), is a single purpose vehicle that borrowed funds from 12E48 Mezz II LLC (“Lender”) pursuant to a junior mezzanine loan agreement. The purpose of the loan was to finance the construction of a mixed-use hotel and timeshare project located at 12 East 48th Street in Manhattan (the “Property”). As collateral for the mezzanine loan, Borrower pledged its membership interests in sole owner of the Property owner.

Borrower defaulted on the junior mezzanine loan by not achieving substantial completion of the construction by December 31, 2019. Lender issued a default notice to Borrower on January 16, 2020, prior to the onset of the pandemic.

On March 31, 2020, Lender notified Borrower that it would be disposing of Borrower’s membership interests at an auction to be held on May 1, 2020. Thereafter, Borrower sought a temporary restraining order from the Supreme Court to prevent the UCC foreclosure from going forward. However, due to restrictions on filing new cases in New York state courts as a result of the COVID-19 pandemic, Borrower was first required to petition the Court to have the matter designated as “essential.” On April 23, 2020, the Court rejected that application, noting the “preliminary injunction relief requested is encompassed by the [G]overnor’s Executive Orders.” The implication of the Court’s rejection was that Executive Order 202.8 – which provides that “[t]here shall be no enforcement of a foreclosure of any . . . commercial property for a period of ninety days” – barred dispositions of collateral pursuant to Article 9 of the UCC.

Nevertheless, Lender took the position that it intended to go forward with the UCC foreclosure, and Borrower went back to the Court for relief. The second time around, the Court designated the action as “essential” for the purpose of determining whether a preliminary injunction was appropriate, and issued a temporary restraining order temporarily enjoining the UCC foreclosure pending a hearing on Borrower’s application for a preliminary injunction.

In support of its motion for a preliminary injunction, Borrower argued that Lender inappropriately seized on the COVID-19 pandemic to conduct a commercially unreasonable sale, and that the foreclosure was unlawful under Executive Order 202.8. Borrower further argued that the foreclosure process would cause “devastating irreparable injury” to Borrower by stripping it of its ownership interests in a unique piece of real estate.

In response, Lender argued, among other things, that none of the Governor’s Executive Orders barred a lender from disposing of a membership interest pledged as collateral in a non-judicial Article 9 sale, that the proposed sale was commercially reasonable, and, in any event, the remedy for a commercially unreasonable sale is monetary damages, not an injunction.

The Court largely sided with Lender. Specifically, the Court explained that “[w]hile the terms of Executive Order No. 202.8 prohibit foreclosure of any commercial property for a period of ninety days without limitation to mortgages, that provision addresses enforcement of a judicially ordered foreclosure.” Because a UCC foreclosure is not a judicial foreclosure, Court reasoned that Executive Order No. 202.8 did not apply to bar the auction, even though the ultimate asset was commercial real property. Further, the Court vacated the notation on its previous order indicating the preliminary injunctive relief was encompassed by the Governor’s Executive Orders.

Additionally, consistent with prior New York case law, the Court held that Borrower did not show irreparable harm because, “where harm to a plaintiff’s commercial property interest is the loss of investment as opposed to a loss of an unquantifiable interests, damages suffice” However, as the Court noted, “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” and that “any such damages may be properly remedied subsequent to the sale” Therefore, while the Court’s decision allowed the UCC foreclosure auction to proceed, it left open the possibility that Lender would be responsible for damages if the time, place, method or manner of the sale are determined to be commercially unreasonable.

¹ At the time that this alert was published, the trial court’s decision was still subject to appeal.