

New York Court Grants Injunction on Mark Hotel Mezzanine Foreclosure Sale: Implications for Mezzanine Lenders

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Introduction

On June 23rd, the Supreme Court of New York, Commercial Division, issued a preliminary injunction temporarily halting a UCC mezzanine foreclosure sale on the grounds that the proposed sale may not be commercially reasonable. In its order, the court confronts the issue of what constitutes a commercially reasonable sale during the COVID-19 pandemic, thereby offering important instruction for lenders and defaulting borrowers under mezzanine loans or any other loan that includes an equity pledge as part of its collateral package.

Unlike in a recent case, *1248 Associates Mezz II LLC v. 12E48 Mezz II LLC* (“1248 Associates”), in which the New York Supreme Court held that the New York foreclosure moratorium did not apply to UCC foreclosure sales but mostly declined to examine questions concerning commercial reasonability in a preliminary injunction hearing, the Commercial Division was far more willing to examine each element of the proposed sale process for commercial reasonability. Although not a win for lenders, it does offer a useful examination and best practices guide for carrying out UCC auctions in the COVID environment by ensuring compliance with Section 9-610(b) of the New York UCC which requires that “every aspect of a disposition of collateral, including method, manner, time, place and other terms be commercially reasonable.”

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Case Background

The plaintiff in this case is D2 Mark LLC (“Mezz Borrower”), the borrower under a \$35 million mezzanine loan originated by OREI IV investments, LLC (“Mezz Lender”), secured by Mezz Borrower’s 100% equity interest in D2 Mark Sub LLC (“Hotel Owner”). Hotel Owner is the indirect owner of the leasehold estate in the Mark Hotel, a landmarked hotel on the Upper East Side of Manhattan with restaurant, bar, cooperative units, and Madison Avenue retail spaces, that was appraised for \$427 million in 2017. The Mark Hotel suffered significant financial hardship as a result of COVID-19, and the retail shops owed over \$1 million in rent to Hotel Owner. Hotel Owner failed to make payments on its senior mortgage loan during the months of April and May, causing a cross default on the mezzanine loan. As Hotel Owner was finalizing a forbearance agreement with Wells Fargo, the mortgage lender, Mezz Borrower received notice from Mezz Lender of a sale of Mezz Borrower’s membership interest in Hotel Owner on June 24th – 36 days from when notice was given.

The Sale Process

Mezz Lender’s notice of sale outlined a virtual and in-office sales process, whereby the winning bidder was to immediately provide a non-refundable deposit equal to 10% of the purchase price and close within 24 hours of the auction. The Mezz Lender engaged a respected broker from Jones Lang LaSalle with significant experience in hotel financing, loan sales and UCC foreclosures to lead the process. The broker contacted 700 bidders, 115 of whom signed NDAs to gain access to a virtual due diligence data room comprised of over 100 documents concerning the collateral. The sale was advertised in the national edition of the Wall Street Journal from May 22 to May 29 and in a trade publication. These efforts resulted in two pre-qualified bidders, although other parties who signed the NDA could potentially bid if they showed the financial ability to timely close.

On June 6, the Mezz Borrower initiated a preliminary injunction action alleging a violation of UCC 9-610(b) on the grounds that the 36 days’ notice to market and

other aspects of the sale were commercially unreasonable under the circumstances.

The Court’s Decision

The Court granted Mezz Borrower’s motion for a preliminary injunction, finding that Mezz Borrower had sufficiently demonstrated a likelihood of success on the merits that the proposed foreclosure sale was not commercially reasonable. The Court cited numerous aspects of the sale in making this determination. First, the Court favorably cited an expert opinion submitted by the Mezz Borrower that 36 days was too short a time to allow for a robust auction, when complex commercial assets such as the Mark Hotel would generally require 60 to 90 days’ notice. The Court found that 36 days’ notice was unreasonable particularly in light of the global pandemic with onsite inspection impossible for 27 of the 36 days, depriving interested bidders of meaningful due diligence. The Court noted that this is important in an uncertain real estate market. When there is no established market, the defendant must make the market by providing bidders time to make their own appraisals, especially because the Mark Hotel was last appraised in 2017 and had likely appreciated in value since then. Second, the Court gave little weight to defendant’s reliance on 115 signed NDA’s as evidence of robust interest due to the fact that only two bidders submitted financials and were pre-qualified to bid. Third, the Court was concerned with two elements of the sale, which could suggest “rigging” on the part of the Mezz Lender: that the terms of sale required the winning bidder to deposit 10% at the auction and then close 24 hours later and that the plaintiff was initially precluded from bidding. Finally, the Court found that the advertisements were not sufficiently clear whether the sale would be conducted virtually or in person at counsel’s office, which might cause potential bidders to stay away given COVID fears. Ultimately, the court noted that “what is reasonable during normal business times, may not be reasonable during a pandemic.”

In 1248 Associates Mezz, the Court declined to issue a preliminary injunction in part because an absence of irreparable harm – any loss of investment resulting

from an unfair sales process could be remedied by money damages subsequent to the sale. However, in this case, the loan agreement limited Mezz Borrower to seeking injunctive relief. Because money damages would not be available to Mezz Borrower, the Court held that the failure to offer provisional relief could result in irreparable harm.

In granting the injunction, the Court stayed the sale for 30 days from June 24 during which time Mezz Lender can re-notice the sale, giving the market at least 30 additional days of notice and time for Mezz Lender to develop a plan for a commercially reasonable sale.

High-Level Ramifications

- What is reasonable during normal business times, may not be reasonable during a pandemic. Courts will consider factors such as the time between notice and sale, the ability to inspect the collateral in person and virtual access to auctions in light of the global pandemic and related shutdown orders.
- 60 to 90 days between notice and sale appears to be a reasonable time for a complex commercial real estate asset. The time period between notice and sale on UCC sales are often around 45 days, so if this decision becomes a trend and/or accepted by other courts whether during COVID or post-COVID, the time periods for a UCC sale in the real estate context may get pushed out.
- Regardless of the pandemic, courts may consider the number of pre-qualified bidders in the auction and will inspect any terms of sale for things that may appear to chill bidding or potentially “rig” the auction in favor of the lender.
- Provisions in loan agreements limiting the borrower to injunctive relief may increase lender’s exposure to preliminary injunctions in a UCC sale. As a result, Lenders should review the language in their loan documents in order to minimize the risk of a similar decision by another court.

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