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REMEDIES AVAILABLE (OR UNAVAILABLE) TO SECURED LENDERS IN THE COVID-19 ENVIRONMENT

BY **MARC L. HAMROFF** & **DANIELLE J. MARLOW**

New York Governor Andrew Cuomo's Executive Order 202.8 banned foreclosures and secured lenders have felt the impact. Marc Hamroff and Daneille Marlow examine four recent cases and their implications for secured lenders seeking relief.

With the onslaught of the COVID-19 pandemic and the resultant torrent of loan defaults, secured lenders are scrambling to determine their remedies. Of course, foreclosure is a key mechanism of enforcement at the forefront of the minds of secured lenders. But with New York Governor Andrew Cuomo's ban against foreclosures upon residential and commercial real estate, and the flurry of lawsuits alleging *force majeure*, impossibility, impracticability and other defenses to performance, the question arises in the minds of providers of secured finance as to what protections they, in fact, have. Can secured lenders foreclose upon secured loans? Can secured lenders seek other relief for defaults? The answers provided by the courts in New York have been extremely mixed. This article outlines four key New York state court decisions addressing these issues.

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Following entry of Cuomo's Executive Order 202.8, which continued to preclude residential and commercial foreclosures (with some limited exceptions) through Oct. 20, 2020 (with the possibility of further extension), the question inevitably arises in the minds of secured lenders as to whether this foreclosure ban applies to Uniform Commercial Code (UCC) sales of equity interests collateralizing mezzanine financing or standing as additional collateral for lease or loan holders.

At least according to one court, the answer is no. In a May 18, 2020 order in *1248 Associates Mezz II LLC v. 12E48 Mezz II LLC*, a case relating to property located at 12 East 48th St. in Manhattan, which the owner planned to develop into a Hilton Grand Vacations Club, presiding Justice Frank P. Nervo held that UCC sales of equity interests are not subject to Executive Order 202.8, and may proceed.

In his decision, which denied the borrower's motion for a preliminary injunction, Justice Nervo held that Governor Cuomo's executive order does not apply to UCC sales because such sales are non-judicial dispositions of equity interests securing loans — not judicial foreclosures of mortgages upon real property. Further, Justice Nervo held that any harm suffered by the borrower as a result of the sale would not be irreparable but could be addressed by money damages.

MARK HOTEL

While UCC sales of equity interests may be permitted to proceed despite the foreclosure ban, such sales must still be "commercially reasonable," which brings to the forefront issues often confronted by equipment finance companies and other secured lenders. Particularly in the COVID-19 environment, "commercial reasonableness" can be a tricky requirement to meet.

That was certainly true in the case of *D2 Mark LLC v. OREI VI Investments, LLC*.[1] The case involved a mezzanine loan secured by membership interests in an entity that owns the Mark Hotel located at Madison Avenue and East 77th Street. The borrower was late on one payment on the mezzanine loan and failed to make two payments on the senior loan, which resulted in a cross default under the mezzanine loan. The lender declared an event of default and scheduled a UCC Article 9 sale.

Justice Andrea Masley of the Commercial Division of the New York State Supreme Court in Manhattan held in a June 23, 2020 decision that the Article 9 sale — which was 1) to be effected on only 36 days' notice; 2) required that the winning bidder make a non-refundable deposit of 10% of the purchase price and pay the remainder within 24 hours; 3) only allowed potential bidders to physically visit the property during the last few days prior to the auction due to mandatory stay at home orders in effect and 4) did not allow the borrower to bid — was commercially unreasonable. The court ordered that the scheduled June 24, 2020 auction must be canceled, that the sale must be re-noticed, that the auction could not proceed for at least 30 days and that bidders must have the option of participating virtually. This decision highlights the scrutiny that courts are likely to apply to the commercial reasonableness requirement in the present environment.

SHELBOURNE

Another decision that went the same way as Mark Hotel is the case of *Shelbourne BRF LLC and Shelbourne 677 LLC v. SR 677 BWAY LLC*. In that case, the Shelbourne parties took a mezzanine loan in the amount of $3.35 million secured by their equity interests in two entities holding the subject property, a 12-story 180,000 office building in Albany, NY. The property also was encumbered by a secured senior loan in the amount of $28.875 million. The borrower under the senior loan defaulted, which was also an event of default under the mezzanine loan. The mezzanine lender issued a notice of default on May 29, 2020, and on June 18, 2020, sent a notice of UCC Article 9 sale to be conducted on July 20, 2020.

The mezzanine borrower brought suit and sought a preliminary injunction against the sale, arguing that it was commercially unreasonable because 1) the mezzanine lender provided only 32-days' notice; 2) the mezzanine lender failed to adequately market the property, and only advertised in local (as opposed to national) periodicals; 3) the mezzanine lender did not have any buyers come to the property and 4) the mezzanine lender did not provide the terms of the auction to the borrower in a timely manner.

In a short two-page decision issued Aug. 3, 2020, Justice Jennifer G. Schecter of the Commercial Division granted the motion, acknowledging that the foreclosure ban does not by its terms apply to such UCC sales, but holding that "the same logic does," stating, "severe turmoil in the real estate market due to the pandemic makes the notion of a sale resulting in payment of fair market value highly uncertain. Bids will likely be discounted due to uncertainty about the continued length and severity of the pandemic … consequently it would be unreasonable to permit the foreclosure sale to proceed." This decision would appear to preclude any UCC sales during the full term of the pandemic — clearly not a reasonable result. Not surprisingly, the lender in that case has appealed.

THE GAP

The context of leases — which have likewise seen their fair share of pandemic related issues — also provides guidance as to how courts will handle COVID-19 related defaults. For example, the case of *The Gap Inc. et al v. 44-45 Broadway Leasing Co., LLC* involved Gap and Old Navy's 15-year leases for their flagship store locations in Times Square. The combined rent for the two locations was approximately $3 million a month. As a result of the COVID-19 pandemic, Gap and Old Navy failed to pay the rent due in May and June. In response, the landlord sent notices of default and sought to terminate the leases. Gap and Old Navy contended that such termination would force them from the premises but leave them liable for the remaining rent under the leases, totaling tens of millions of dollars.

Gap and Old Nay brought suit, seeking an injunction against termination of the leases, rescission of the leases and/or a declaration that the leases are unenforceable as a result of the COVID-19 pandemic, arguing that as a result of the dramatic decrease in commercial activity in the Times Square area, "the purpose of the leases has been completely frustrated, and the object and purpose of the leases has been rendered impossible, illegal and impracticable."

Pursuant to a decision dated June 21, 2020, presiding Judge Debra A. James granted Gap and Old Navy's motion for an injunction but, significantly, required that Gap and Old Navy post a bond in the amount of $5,842,531, which represented the full amount of the May and June rent in arrears, with only a 10% discount. Further, the court required that Gap and Old Nay pay the full amount of the July rent due. This would suggest that the court was not swayed by Gap and Old Navy's arguments regarding the alleged unenforceability of the leases in light of COVID-19. Discovery will now proceed in the matter, and a full hearing on the merits will likely be made during the upcoming months.

In sum, it is clear that at least some courts have and will likely continue to take a sympathetic stance toward borrowers and lessees in light of the pandemic and will refuse to enforce secured interests — or at least will subject them to strict scrutiny. However, other courts are not so easily swayed and have respected the bargained for protections of secured lenders. It will be increasingly important for secured lenders to ensure that when they do exercise their rights, including by means of UCC sales, that they do so in the most commercially reasonable manner possible. Further, it will be increasingly important that when secured lenders provide any new financing in this environment, consideration be given to ensure the governing agreements address contingencies such as COVID-19. •

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