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LENDING & RESTRUCTURING ALERT
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Foreclosure on UCC Collateral Speeds Lender's Takeover of Troubled Real Estate

A recent bankruptcy New York court decision[1] highlights a less commonly used option for lenders to take control of troubled real estate projects. The lender obtained relief from the automatic stay to foreclose on membership interests pledged to secure its mezzanine loan instead of foreclosing on its mortgage against the underlying real property.

Here is the case, and what lenders can learn from it.

The Case

The facts follow a familiar arc. YL West 87th Street LLC ("West"), a subsidiary of YL West 87th Holdings I LLC (the "Debtor"), purchased a property in New York City in 2005 with a plan to convert it into a condominium. To finance its project, West obtained $75 million in financing secured by the real property. At the same time, the Debtor obtained a $20 million mezzanine loan secured by a pledge of the Debtor's interest in West. A hedge fund (the "Fund") acquired both the mortgage and mezzanine loans.

The Debtor missed payments on the mezzanine loan, so the Fund sent a default notice. The Fund notified the Debtor that it intended to foreclose on the pledged membership interests in a UCC sale. The Fund chose that route because a UCC foreclosure on membership interests can be accomplished more quickly than a foreclosure on real property. A UCC foreclosure sale can be accomplished in a few weeks, whereas a contested mortgage foreclosure in New York can take one to three years.

Because the Debtor defaulted on the mezzanine loan, construction on the project stopped and New York State Attorney General's office required the abandonment of the previously filed condominium plan offering. These events also constituted events of default under the mortgage loans.

Before the scheduled commencement of the Fund's UCC foreclosure process, West and the Debtor sued the Fund in the New York state court to halt the UCC sale. The Debtor then filed an emergency motion for a temporary restraining order, which was granted on the condition that the Debtor post a $20 million bond. Rather than post the bond, the Debtor filed for chapter 11.

Five days later, the Fund moved to dismiss the Debtor's chapter 11 case as having been filed in bad faith. Alternatively, it sought relief from the automatic stay to complete its foreclosure on the membership interests in the Debtor, contending that the Debtor had no equity in the membership interests.

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The Bankruptcy Court held an evidentiary hearing on the Fund's motion, conducting it just as if it were a motion by a lender seeking to foreclose on the underlying real estate where the issue was whether there was equity above the mortgage loan. At the hearing, the Fund and the Debtor presented expert testimony regarding the project's value. The Fund's expert testified that the Fund was substantially undersecured, while the Debtor's expert testified that there was $8 million of equity in the project. After carefully evaluating the evidence, the Bankruptcy Court found the Fund's expert to be substantially more credible and granted the Fund relief to foreclose—four months after the Debtor filed for chapter 11.

Lessons Learned

This case is instructive for several reasons:

1. Where a lender has the option to choose between a UCC foreclosure on pledged membership interests and foreclosing on the underlying real property, a UCC foreclosure will always be substantially faster.

2. Faced with a litigious borrower, a lender must be prepared to combat the borrower's attempt to forestall foreclosure by filing a chapter 11 case. Here, the Fund was clearly prepared in advance; it filed its motion for dismissal or relief from the automatic stay just five days after the Debtor commenced its chapter 11 case.

3. Part of being prepared is having an appraiser ready to provide expert testimony on the value of the collateral. Although the opinion does not state when the Fund's appraisal was completed, the Fund was ready to put on its trial just two months after the Debtor filed for bankruptcy protection, which means that the appraisal work was done well in advance.

For more information on these issues or other lending & restructuring matters, please contact **Stephen Selbst** at **(212) 592-1405** or sselbst@herrick.com or **Paul Rubin** at **(212) 592-1448** or prubin@herrick.com .

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[1] In re YL West 87th Holdings I LLC, 2010 Bankr. Lexis 43, Case No. 09-15445 (Bankr. S.D.N.Y. 2010).