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Real Estate Alert

NY Court Ruling Binds Mezzanine Lender's Ability to Foreclose on Collateral Following Acceleration of Mortgage Loan

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Summary

On September 16, 2010, a New York judge issued a preliminary injunction blocking a UCC foreclosure sale of Manhattan's Stuyvesant Town-Peter Cooper Village property on the grounds that the venture formed for this purpose had first to repay in full $3.66 billion owed lenders from a senior mortgage. The judge's decision, based on an intercreditor agreement that he considered "unambiguous," would obligate the venture to "cure all senior defaults" before proceeding. The consequence of the decision is that, practically speaking, a mezzanine lender's ability to foreclose on collateral now seems contingent on whether the underlying mortgage loan has been accelerated.

Background

On August 6, 2010, Pershing Square Capital Management and Winthrop Realty Trust, joined as PSW NYC LLC, sought to gain control of Stuyvesant Town-Peter Cooper Village—a combined development that comprises Manhattan's largest apartment complex—through the acquisition, for $45 million, of $300 million in defaulted senior mezzanine debt. The next day, PSW commenced a UCC foreclosure action to acquire the equity in the fee owners of the property. On August 18, Bank of America Corp. and U.S. Bancorp, as trustees for the senior creditors of the property, sued to block PSW's foreclosure sale. Separately, they had sought, through CW Capital Asset Management, to foreclose on the complex after a January default by the concerns that purchased it in 2006 in a then-record $5.4 billion real estate deal. CW Capital Asset Management is the special servicer on the commercial mortgage-backed security (CMBS) trusts that owns mortgages in the amount of $3 billion encumbering the property.

CW Capital alleged that (i) pursuant to Section 6(d) of the intercreditor agreement, PSW was required to pay off the senior mortgage loans as a condition to PSW completing its foreclosure upon the equity in the fee owners because the senior loans are in default and have been accelerated and (ii) PSW is prohibited from orchestrating a bankruptcy of Stuyvesant Town and Peter Cooper Village unless the senior loans have been paid in full.

The Court's Decision in Favor of CW Capital

On Thursday September 16, 2010, Judge Richard Lowe sitting in the Supreme Court of the State of New York – New York County issued a ruling in connection with CW Capital's action against PSW. Judge Lowe agreed with CW Capital's position regarding clause (i) and granted injunctive relief preventing PSW from continuing with its action to foreclosure upon the pledged collateral unless PSW paid off the full amount of the mortgage loan (approximately $3.66 billion presently outstanding). Judge Lowe did not substantively rule on CW Capital's position set forth in clause (ii).

Judge Lowe's ruling is based solely upon his interpretation of Section 6(d) of the intercreditor agreement, which provides as follows (emphasis in original):

> To the extent that any Qualified Transferee acquires the Equity Collateral pledged to a Junior Lender pursuant to the Junior Loan Documents in accordance with the

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> provisions and conditions of this Agreement (including, but not limited to Section 12 hereof), such Qualified Transferee shall acquire the same subject to (i) the Senior Loan and the terms, conditions and provisions of the Senior Loan Documents and (ii) the applicable Senior Junior Loans and the terms, conditions and provisions of the applicable Senior Junior Loan Documents, in each case for the balance of the term thereof, which shall not be accelerated by Senior Lender or the related Senior Junior Lender solely due to such acquisition and shall remain in full force and effect; *provided*, *however*, that (A) such Qualified Transferee shall cause, within ten (10) days after the transfer, (1) Borrower and (2) the applicable Senior Junior Borrowers, in each case to reaffirm in writing, subject to such exculpatory provisions as shall be set forth in the Senior Loan Documents and the related Senior Loan Documents, as applicable, all of the terms, conditions and provisions of the Senior Loan Documents and the related Senior Loan Documents, as applicable, on Borrower's or the applicable Senior Junior Borrower's, as applicable, part to be performed and (B) all defaults under (1) the Senior Loan and (2) the applicable Senior Junior Loans, in each case which remain uncured or unwaived as of the date of such acquisition have been cured by such Qualified Transferee or in the case of defaults that can only be cured by the Junior Lender following its acquisition of the Equity Collateral, the same shall be cured by the Junior Lender prior to the expiration of the applicable Extended Non-Monetary Cure Period.

PSW took the position that clauses (A) and (B), which follow the "*provided*, *however*" language, were intended merely to qualify the provision that immediately precedes the "*provided*, *however*". Specifically, PSW argued that the provision in Section 6(d) that provides that the "Senior Loan Documents…shall not be accelerated by Senior Lender…solely due" to the acquisition by PSW of the pledged equity would apply only if the conditions in clauses (A) and (B) were satisfied and that because clause (B) has not been satisfied, CW Capital is free to pursue its remedies under the senior loan documents; however, the failure of PSW to cure the defaults would not prevent PSW from completing its foreclosure on the equity collateral.

To support this reading of Section 6(d), PSW further argued that Section 6(a) of the intercreditor agreements sets forth the seven conditions that PSW must satisfy in order to foreclose upon the equity collateral and that, because the curing of all defaults under the senior loan was not specifically listed as a condition to PSW's completion of its foreclosure, then this was clearly not a condition precedent and not the correct way to read Section 6(d).

According to Judge Lowe, "the Intercreditor Agreement is unambiguous. Its plain language obligates PSW to cure all Senior Loan defaults if PSW acquires the Equity Collateral, which includes the $3.6 billion Indebtedness resulting from the Default." He also noted, in reference to clause (B), that, "Because the default on the senior loan is not a default that can 'only be cured following [PSW's] acquisition of the Equity Collateral,' PSW must cure the default…PSW's argument that Section 6(d) is not a pre-condition to acquisition of Equity Collateral is undermined by the plan language of the contract ."

Regarding acceleration of the senior loan, Judge Lowe noted, "PSW's argument that section 6(d) is designed to prevent the Senior Lenders from accelerating the Senior Loans due to a transfer of the Equity Collateral is not grounded in the terms of the Intercreditor Agreement. The last clause of section 6(d)(ii) prevents the Senior Lender and the related Senior Junior Lender from accelerating the Senior Loan or outstanding Senior Junior Loans solely due to a Qualified Transferee's acquisition of Equity Collateral. However, nothing in section 6(d) suggests that this provision is focused solely, or even primarily, upon acceleration."

Judge Lowe was similarly unsympathetic to PSW's "*provided*, *however*" argument, stating that "PSW's reading of section 6(d) cherry-picks the acceleration language while ignoring all of the additional language preceding the semicolon, which applies more generally to an acquisition of Equity Collateral. PSW's interpretation of section 6(d) was clearly not intended by the parties."

Finally, regarding PSW's assertion that, had the parties intended a cure of a default on the senior loan to be a precondition to a junior lender's foreclosure, 6(a) would have expressly stated so, Judge Lowe, reiterated a point he had made regarding antecedent language by noting that none of the subsections in section 6 is individually titled and all of them relate to foreclosure of separate collateral. As a consequence, the judge, having noted earlier that "nothing contained in the Intercreditor Agreement permits PSW to acquire its Equity Collateral without complying with section 6(d)," the differing "obligations, conditions and rights," such as those contained in subsection (d) are equally applicable throughout, and PSW's argument is "contradicted by the plain language of the Intercreditor Agreement."

As to CW Capital's claim that Section 11(d)(ii) of the Intercreditor Agreement prohibits PSW from orchestrating a senior borrower's bankruptcy unless the senior loan is paid off, PSW, in its paper, acknowledged that, as the holder of a junior loan, PSW

would not be permitted to solicit or cause senior borrowers to institute bankruptcy proceedings, However, PSW's arguments focused on what PSW could do as an owner of the senior borrowers once a transfer of the equity collateral occurs. According to PSW, Section 11(d)(ii) of the Intercreditor Agreement does not apply after PSW were to foreclose upon the separate collateral and to further support this argument, PSW pointed out that Section 31 of the Intercreditor Agreement provides that the Intercreditor Agreement terminates upon PSW's acquisition of the separate collateral. Accordingly, following PSW's acquisition of the separate collateral, PSW would have a constitutional right to file the fee owners of the property into bankruptcy, notwithstanding anything in the fee owners' organizational documents to the contrary.

Because PSW acknowledged that PSW had no right to cause senior borrower to file for bankruptcy so long as it was the holder of the junior loan, and because Judge Lowe had, earlier in his ruling, stated that the only way that PSW could continue with the foreclosure on the equity collateral would be to pay off the senior loan, Judge Lowe stated that CW Capital's "request to enjoin PSW concerning section 11(d)(ii) of the Intercreditor Agreement is moot … and, therefore, nonjusticiable."

The Peculiar Consequences of the Ruling

Our opinion is that Judge Lowe's reading of the intercreditor agreement is not correct and that PSW had the better of the argument by stating that PSW's foreclosure upon the equity collateral would have no impact upon CW Capital's ability to complete its foreclosure of the senior loan. PSW, in its papers, never came out and expressly stated that its strategy was to foreclose on the equity collateral and, thereafter, file the fee owners for bankruptcy; however, this threat permeated the filings. Perhaps Judge Lowe's decision was influenced by the fact that CW Capital had been working with Tishman Speyer for a significant period of time for an orderly transition of management of the properties and that were PSW successful in foreclosing upon the equity collateral, a subsequent bankruptcy of the property would have a significant chance of throwing the property into disarray.

The bottom line is that Judge Lowe's decision (unless overturned on appeal) will force a mezzanine lender to exercise its rights under its mezzanine loans sooner rather than later because the longer the mezzanine lender waits, the greater the likelihood that a significant monetary default might exist under the mortgage loan. If such a default occurs, the mezzanine lender might not be in a position to exercise remedies under its mezzanine loan because it will not want, or have the ability, to cure the monetary defaults under the senior loan.

Nothing in Judge Lowe's decision says that a mezzanine lender cannot foreclose on its collateral. Therefore, why would a mezzanine lender, through its failure to timely exercise its remedies under its loan, put itself in a position where it is, for all practical purposes, prevented from exercising its remedies under the loan documents? For example, had PSW completed its foreclosure prior to the acceleration of the senior loan, the results of this case would have been very different. In such case, the issue of the lawsuit would have focused solely on Section 11(d)(ii) of the intercreditor agreement and whether a foreclosing mezzanine lender, after it acquired the equity collateral, would be precluded from thereafter filing the fee owner for bankruptcy. Judge Lowe's ruling did not address this point, and his ruling may very well have been influenced by his recognition that, if PSW were to have successfully foreclosed on the equity collateral, PSW would have been able subsequently to file the fee owner for bankruptcy. Judge Lowe's creative reading of the intercreditor agreement may have been intended to preclude this result.

As a consequence, Judge Lowe's ruling leaves mezzanine lenders in a peculiar situation where the benefits of the bankruptcy law might be available to the mezzanine lender if it exercises its remedies prior to the acceleration of the underlying mortgage loan. Why the ability of the mezzanine lender to avail itself of the bankruptcy laws should be so dependent upon the acceleration of the mortgage loan is not clear, but until this ruling is overturned, that would appear to be the result, at least in New York.

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