

Mortgage and Pledge of Equity — Clogging the Equity of Redemption?

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A recent decision by the Supreme Court of New York, New York County, addressed the issue of whether the borrower's equity of redemption was being impermissibly "clogged" by a foreclosing lender. The case, *HH Cincinnati Textile L.P., et al. v. Acres Capital Servicing LLC, et al.*, involved a loan in the amount of \$20,300,000 relating to two real estate projects in Kansas City, Missouri, and Cincinnati, Ohio. The lender's position was secured not only by mortgages recorded in the land records, but also by a pledge and security agreement granted by the equity owners of the underlying mortgage borrowers.

The loan went into default and the lender proceeded to enforce its rights under the pledge agreement by initiating a foreclosure proceeding against the pledged equity interests under the Uniform Commercial Code (UCC). The borrowers sought to restrain the lender from moving forward with the UCC sale, arguing, among other things, to the court that the loan documentation had created a "textbook example" of clogging the borrowers' equity of redemption, depriving them of their right to pay off the debt and retain the underlying properties. While the court initially granted the temporary restraining order, the court denied the borrower's motion for a preliminary injunction, noting that §9-623 of the UCC provides the borrowers with a right of redemption prior to the lender's realization on the equity collateral at the UCC sale. Further, the court noted that the defaulting borrowers would always be free to participate in the bidding process at the UCC sale to protect its ownership position.

This court's decision is important because it addresses a technical issue that practitioners and clients alike have considered when structuring and negotiating "dual collateral loans" and provides a level of comfort to lenders who, for various reasons, may wish to secure their positions with both a mortgage lien on the property and a pledge of equity from the sponsorship. A UCC foreclosure of pledged equity interests in the property owner can be accomplished fairly quickly (often between 30-60 days), but requires the lender (or the purchaser at the foreclosure sale) to acquire the equity interests subject to intervening liens and the debts of the property owner. A contested foreclosure of the mortgage, in contrast, may (depending on the jurisdiction) take two or more years to complete, but if successful will provide the lender (or the purchaser at the foreclosure sale) with clean title to the property.

Given this recent decision, we will wait to see whether the lending market moves toward requiring all borrowers to grant a pledge of equity as additional collateral, or whether borrowers will reject the requirement of an equity pledge as it affords a lender with an additional rapid foreclosure option. This issue was also decided by the New York Supreme Court, and could be overturned if this issue is heard by the New York State Court of Appeals.

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