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Maybe We Don't Have To Worry About Clogging The Equity Of Redemption

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In New York, commercial mortgage foreclosures can take years. Mortgage lenders find themselves tempted --->

Equity pledges can give a mortgage lender extra security, but they also create their own issues. (Photo by Ethan Miller/Getty Images) [-] GETTY IMAGES

to short-circuit the process by taking, as additional collateral for their mortgage loans, pledges of equity interests in the borrower entities. Here, the members of the limited liability company borrower pledge their membership interests to the lenders to give the lenders additional security.

This type of pledge might sound like a mortgage. It is, however, a security interest established under the Uniform Commercial Code, a different body of law. Governed by the UCC, foreclosures of these security interests move much faster than New York mortgage foreclosures, because they don't involve a court. If a lender seeks to foreclose on the equity interests in the borrower, the lender will in most cases end up owning the borrower rather quickly. Once that happens, the mortgage foreclosure no longer matters.

New York real estate lawyers have historically counseled their lender clients not to take equity pledges as additional collateral. They worry that old court decisions suggest that a "dual collateral" pledge somehow "clogs" the borrower's "equity of redemption" – i.e., the borrower's right to pay off the mortgage loan and get rid of the lender. In other words, without the dual collateral pledge, the mortgage borrower can pay off the loan, no problem; but introducing the equity pledge opens the door to a UCC foreclosure sale, which moves with such blinding speed that it doesn't give the borrower enough time to repay its mortgage.

Lawyers have agonized for years over whether the dual collateral structure "clogs" the mortgage borrower's equity in its property, potentially making the dual collateral structure unenforceable. Some find the whole concern to be quite silly. They reason that the law allows both real estate mortgages and pledges of equity interests, so combining the two shouldn't invalidate either. Other lawyers take "clogging the equity" very seriously, urging their lender clients to avoid taking dual collateral at all costs. Both sides approach the issue with religious fervor. Debates

about it often become personal. To the author's knowledge, though, they have not yet devolved into fistfights.

One might think the courts would resolve the debate over whether a dual collateral structure "clogs" the borrower's equity. But very few recent cases have considered the issue. In 2018, one New York court expressed some skepticism about the theory. A 2020 decision in essentially the same litigation left the issue entirely open.

In late 2021, a New York trial court squarely considered the validity of a dual collateral structure. In *Atlas Brookview Mezzanine LLC v. DB Brookview, LLC* (New York State Supreme Court, Index No. 653986/2020), a borrower challenged a UCC foreclosure sale of equity interests in the mortgage borrower, on the basis that the equity pledge clogged the mortgage borrower's equity of redemption – i.e., the theory described above.

The judge found the parties to the financing to be "commercially sophisticated people represented by able counsel," who had chosen to negotiate a loan structure with dual collateral, i.e., an equity pledge. The judge refused to declare the structure void from inception. The whole thing, he said, was a "business deal that [the borrower] entered into." And, at all times, according to the judge, the borrower remained free to pay off the financing and prevent any foreclosure sale, whether under the mortgage or under the UCC. So nothing was clogged.

The judge dismissed the borrower’s litigation. The borrower has appealed the dismissal, so it’s not necessarily the end of the story. At time of writing, nothing has happened to the appeal.

At least until this appeal is resolved, many New York real estate lawyers – those who don’t roll their eyes at the whole “clogging” issue – will still hesitate to rely on the trial court’s decision. But the decision might spell the beginning of the end for the “clogging” doctrine in New York courts.

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I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don’t. It’s important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

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