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WHO CARES ABOUT CLOGGING?

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Commercial mortgage loans, especially in New York, take years to foreclose. In response, lenders sometimes ask for a pledge of the partnership, membership, or other equity interests in the entity that owns the collateral. A lender can foreclose on that pledge quickly, unlike a mortgage. The lender just needs to conduct a Uniform Commercial Code (UCC) foreclosure. That doesn't involve a court, so it should move faster. If the lender completes the UCC foreclosure, then the lender can acquire the entire borrowing entity—almost as good as acquiring its real property.

It sounds too good to be true. And it might be. Real estate finance lawyers worry that if a mortgage lender takes an equity pledge, this might run afoul of an ancient doctrine that prohibits "clogging the equity of redemption." That doctrine potentially invalidates any mechanism that prevents a borrower from paying off a mortgage, getting rid of its mortgage lender, and owning its real property free and clear. Rationale: a UCC foreclosure sale moves so fast the borrower can't exercise its right to redeem the real property from the mortgage. Hence it might be invalid.

Few reported cases actually apply the doctrine of "clogging the equity of redemption." Most are old. But the doctrine still strikes fear into the hearts of real estate finance lawyers. So they usually discourage their lender clients from taking equity pledges as additional security for mortgage loans. It's not worth the risk, they say.

Let's step back a bit. Real estate mortgages and foreclosures are perfectly legal, valid, and enforceable. UCC pledges of equity interests are perfectly legal, valid, and enforceable. But the "clogging" doctrine says that when a lender combines those two elements into a single transaction, the lender may create an unenforceable security structure because of some ancient case law. This makes no sense.

Even less sensibly, this issue can arise even with a highly sophisticated borrower that offers an equity pledge as additional security in exchange for better loan terms. It can arise even though the equity pledge has different collateral than the mortgage borrower's real property.

In a recent New York case, a court briefly considered how the "clogging" doctrine applies to a modern commercial mortgage loan with an equity pledge as additional collateral, the fact pattern that triggers "clogging" issues. Procedurally, the court's decision arose early in the life of the case, before the parties could fully argue all the issues.

The borrower argued that the lender could not hold a UCC foreclosure sale, because this would "clog" the borrower's equity of redemption. The court rejected that argument in a dismissive way, saying the potential UCC foreclosure sale did not in any way "clog" the borrower's equity of redemption. The borrower, the court said, "at this very moment, retain[s] a right of redemption" under the UCC, a right that continues until the UCC foreclosure sale. So the court rejected the borrower's argument and said the UCC foreclosure sale could proceed. The court noted that if the borrower were able to pay its obligations it could also bid at the UCC foreclosure sale and keep its equity. So the borrower had a clear opportunity to preserve its equity if that's what it wanted.

The decision was extremely abbreviated. It arose early in the case. But the case did give the court an opportunity to apply the "clogging" doctrine, if it exists, and to protect a borrower from whatever horrible and unfair injury that doctrine seeks to prevent. The court declined to do that.

The recent court decision hardly amounts to a resounding and reasoned rejection of the "clogging" doctrine. Under the facts of this case, the court chose not to use "clogging" as the basis to block a UCC foreclosure. Real estate finance lawyers will still worry about the doctrine and discourage use of equity pledges to backstop a real estate mortgage.

Should we ask the legislature to pass a law saying the "clogging" doctrine does not exist? To put it another way, should we expect the legislature to validate a security structure that allows commercial real estate lenders to do an "end run" around the mortgage foreclosure process? These are questions the answers to which lenders probably do not want to know. So they will continue to avoid equity pledges as additional security for mortgage loans—or will require personal guaranties to incentivize borrowers not to assert "clogging" to block foreclosures.

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To read the case, copy and paste this link: https://tinyurl.com/y7uefe83