"CLOGGING" AND THE DUAL COLLATERAL LOAN: AN UPDATE

Date: 11 November 2019

U.S. Real Estate Alert

By: John M. Marmora

This article updates a similarly titled article published in the 21 October 2019 edition of the *New Jersey Law Journal* regarding the issue of “clogging” and dual collateral loans.

By way of quick recap, “clogging” is shorthand for a principle rooted in ancient English common law that a borrower who secures a loan with a mortgage on real estate holds an inviolable right to redeem the property from the lender by repaying the debt up until the point when that right is legally foreclosed through proper judicial procedures. Stratagems such as a lender obtaining a “deed in lieu of foreclosure” or an option to purchase the property from the borrower at the time of loan origination are generally considered void in the lender's hands as a “clog” on the borrower's equitable right of redemption.

The clogging doctrine is often invoked to re-characterize transactions that in substance are intended to be secured mortgage loans, though in form do not appear as such (often referred to as “equitable mortgages”). The example cited in the previous article is the landmark New Jersey case, *Humble Oil & Refining Company v. Doerr*, 123 N.J.Super. 530 (Ch. Div., 1973). The facts are rather complex and will not be re-explained herein. In brief, the form of the transaction was a “lease-leaseback” arrangement between an oil company and its customer who owned property on which it operated a gas station and which it mortgaged to a bank. The substance, however, was determined by the court to be a commercial mortgage loan on which the gas station owner was the primary obligor and the oil company, its guarantor. Just as the clogging doctrine precludes a mortgage lender from extracting a purchase option from the borrower in addition to the mortgage, the court held that a guarantor is similarly so precluded; therefore, the option contained in the lease from the gas station owner to the oil company was ruled void.

The focus of this and the preceding article is not on situations where the clogging doctrine is invoked to re-characterize the form of a transaction, but in the context of the election of remedies available to a lender utilizing a financing structure that has come more recently into vogue, the dual collateral loan. Such loans perhaps can be summarized as roughly analogous to a conventional mortgage loan combined with a mezzanine loan. In the former, the lender receives a security interest in the real estate via a mortgage which is then governed by the state's real property law, while in the latter it receives a security interest in the ownership of the borrower via an equity pledge which is then governed by Article 9 of the Uniform Commercial Code (as applicable in the subject jurisdiction). Thus, the dual collateral lender receives security interests in both realty and personalty for one and the same debt.

NEW YORK LAW: HH CINCINNATI TEXTILE L.P. AND HH MARK TWAIN LP

The clogging doctrine arose two years ago in a case venued in New York County, *HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC*, Index No. 652871/18 (Sup. Ct., N.Y.Co., 2018). There a lender financed the redevelopment of two historic sites in the Midwest by a borrower (a partnership), whose sole asset consisted of the properties. As security for the loan, the borrower granted the lender a mortgage on both properties, and the borrower's partners simultaneously pledged to the lender their equity interests in the entity. The two forms of collateral pertained to the same loan, however, which was not broken down into components as one would ordinarily see where a property owner finances a project by way of conventional mortgage loan and a separate mezzanine loan. Accordingly, upon declaring a default, the lender had the option of foreclosing on the real estate pursuant to the mortgage or executing on the partnership interests pursuant to the equity pledge. Substantively, the result of either would be the same in that the lender gains control of the real estate, directly in the former case and indirectly in the latter. Procedurally, however, there is a dramatic difference: Foreclosing a mortgage involves a judicial process that can easily consume several years, while a UCC Article 9 execution sale is a non-judicial procedure conducted by the lender that requires only "commercial reasonableness" and a minimum of ten days prior notice. [*Cf. N.J.S.A. 12A:9-610 and 611*.]

Upon H.H. Cincinnati Textile's default, the lender solicited bids for the partnership interests and published a notice of the pending execution sale which was to be conducted in the office of lender's counsel. Arguing that allowing a mortgagee to proceed in that fashion amounted to an impermissible "clog" on their equity of redemption under the mortgage, the borrowers succeeded in obtaining a temporary restraining order but failed in their effort to convert it to a preliminary injunction pending adjudication on the merits. The court not only held that the UCC afforded the borrowers with a sufficient right to "redeem" their partnership interests up until the time of the execution sale *[Cf. N.J.S.A. 12A:9-623*], but also that irreparable harm could not be demonstrated by the plaintiff as required for equitable relief because monetary damages would provide an adequate remedy at law. In separate but related litigation that followed, this latter point became critical.

Following the execution sale, the principals of the borrower (i.e., the equity pledgors) as well as the individual guarantors filed suit against the lender on various grounds. A separate count of the complaint was, once again, a claim that the UCC execution sale allowed the lender to circumvent the mortgage foreclosure process, thereby clogging the owner's equity of redemption. The lender responded by way of a motion to dismiss all counts, including the clogging claim on the theory that it had been rendered moot by reason of the court's prior ruling in *H.H. Cincinnati* and the subsequent execution sale of the borrower's ownership interests. Interestingly, the case was assigned to the same judge (Hon. Barry R. Ostrager), who rejected the lender's argument and ruled that his prior decision was not one on the merits of the clogging claim; rather, it was solely a rejection of the borrower's plea for equitable relief in the form of a preliminary injunction because the court determined that its claims could be remedied adequately by the legal remedy monetary damages. *HH Mark Twain v. Acres Capital Funding*, 2020 NY Slip Op 31737 - NY: Supreme Court June 3, 2020.

Accordingly, the question of whether New York law permits a single debt to be secured simultaneously by both a real property mortgage and an equity pledge remains unanswered. It will be interesting to see whether *HH Mark Twain* goes to a trial on the merits, particularly as one aspect of the relief plaintiffs seek on the clogging claim is a declaration that the underlying loan agreement itself is void, not just the availability of the UCC remedy in lieu of the mortgage foreclosure remedy.

Given the prevalence of New York choice of law stipulations in commercial transactions, the national importance of *HH Cincinnati* and *HH Mark Twain* is apparent. Where the previous article concluded with a caution that individual state courts might not follow *HH Cincinnati* on public policy grounds even in the face of a New York law stipulation, it is now unclear that it can be relied upon in any event. Therefore, until the matter is resolved, broader caution is perhaps warranted that dual collateral loans remain questionable not just with regard to the availability of a lender's option to pursue the UCC remedy, but also as to the possibility that the very validity of the loan itself could be called into question should the *HH Mark Twain* plaintiffs prevail on that aspect of their claim.

KEY CONTACTS

JOHN M. MARMORA
PARTNER

NEWARK
+1.973.848.4016
JOHN.MARMORA@KLGATES.COM

