NY CRE Lenders Need Clarity On Foreclosure Standing

By **Christopher Gorman and John Muldoon** (January 17, 2024)

Christopher Gorman

John Muldoon

In the current climate in the commercial real estate world, one frequently hears about owners and borrowers, faced with distress, handing back the keys to the lender or loan servicer.

Undoubtedly, there are situations where this may be the best strategy available to the borrower. For instance, in some circumstances, the lender will agree to take back the property in exchange for releasing personal guaranties of the principals of the owner, which may be a wise decision in some circumstances.

One size, however, does not fit all. With some degree of frequency, commercial borrowers, faced with a loan default or other distress related to their property for which they cannot devise an out-of-court resolution — e.g., refinancing the loan, selling the property, etc. — will rely upon the litigation process to try to retain the property or otherwise extract better settlement terms from a foreclosing lender.

The litigation process, of course, could be lengthy and cause all sides in the end to come to a resolution that does not involve handing back the keys.

The standing of a foreclosing lender is an issue that has garnered much attention in the 16 years since the 2008 financial crisis. That attention, however, was largely focused on the residential mortgage foreclosure context, with few considering how potential standing issues could arise in the context of commercial mortgage foreclosure actions.

While a standing defense is often not as readily available in the commercial context, there are certainly situations where such a defense may be available to a commercial borrower.

This is particularly so when dealing with commercial loans that, following origination, have been pooled and securitized into a trust with other commercial loans.

Commercial mortgage-backed securities are backed by underlying collateral consisting of commercial mortgage loans on many of the very properties that are quintessentially New York, including, among others, retail properties, office properties, industrial properties, multifamily residential properties and hotels.

By all measures, delinquencies on commercial mortgage-backed securities loans are on the rise nationwide, bringing an expectation of a large number of foreclosure actions that will be commenced in the very near future.

Many of the foreclosing lenders in these cases, i.e., the plaintiff in the foreclosure action, though, will not be the same entity that originated the underlying loan. Commercial mortgage loans, rather than being retained by the original mortgagee, are often pooled and sold into trusts created to receive the stream of interest and principal payments from the mortgage borrowers.[1]

The right to receive trust income is parceled into certificates and sold to investors, called certificate holders. The trustee hires a mortgage servicer to administer the mortgages by enforcing the mortgage terms and administering the payments.

The terms of the securitization trusts into which the commercial mortgages are pooled, as well as the rights, duties and obligations of the trustee, seller and servicer, among others, are set forth in a pooling and servicing agreement, or PSA.

In commercial mortgage foreclosure actions initiated by lenders and trusts based upon securitized debt obligations, borrowers often challenge or call into question whether the proceeding has been properly commenced due to the plaintiff's lack of standing and, in many cases, the ambiguity regarding who, or what entity, actually owns the mortgage or debt.

The Supreme Court of the State of New York, Appellate Division, Second Judicial Department's decision in HSBC Bank USA NA v. Sene[2] in September last year may help shed some light on what has otherwise been choppy waters for litigants navigating standing issues in the commercial mortgage foreclosure context.

Sene involved a foreclosure action where the defendant borrower challenged, among other things, the foreclosing lender's standing, as the lender had allegedly been assigned the underlying loan documents as part of a PSA prior to the commencement of the action.

On its motion for summary judgment, the plaintiff failed to submit the mortgage loan schedule to the PSA, which would have shown whether the note was assigned to the subject trust as part of a securitization transaction.

Accordingly, the Second Department held that the plaintiff failed to demonstrate that, as trustee under the PSA, it had standing as an assignee of the note under the PSA.

In its holding, the Second Department in Sene cited Deutsche Bank National Trust Co. v. Crosby, a case it decided a year prior to Sene.

Crosby similarly held that where a plaintiff fails to submit the mortgage loan schedule to a PSA, which would have shown whether the note was assigned to the subject trust as part of a securitization transaction, a plaintiff fails to demonstrate that, as trustee under the PSA, it has standing as an assignee of the promissory note under the PSA.[3]

What these recent Second Department decisions in Sene and Crosby suggest is that a defendant-borrower has the ability to challenge whether an underlying loan was actually assigned to the plaintiff in the relevant PSA and that, once a defendant borrower raises an issue with respect to the plaintiff's standing, it is incumbent upon the plaintiff to produce the underlying PSA to establish its standing.

In other words, where the borrower in a commercial mortgage foreclosure case challenges the plaintiff's standing, it is incumbent upon the plaintiff, in satisfying its burden of proving its standing, to come forward with the relevant documentation from the securitization transaction, i.e, the PSA and any supporting documents, to show that the underlying securitization documents establish the plaintiff's authority to foreclose.

Sene and Crosby, however, would seem difficult to square with other Appellate Division authority conversely holding that a borrower cannot challenge whether a plaintiff complied with the terms of the PSA itself.

Indeed, there is contrary authority predating Sene and Crosby stating that a borrower whose loan is owned by a trust does not have standing to challenge the plaintiff's possession or status as assignee of the note and mortgage based on purported noncompliance with certain provisions of the PSA.[4]

So, for instance, in Bank of America NA v. Patino, where the PSA at issue required the borrower's loan to be delivered to the foreclosing plaintiff by 2007, but the plaintiff admitted that it did not receive the note until 2014, the Second Department held that the defendant borrower did not have standing to raise this argument at all.

Cases like Patino emanate from the long-standing New York law that the terms of a contract may be enforced only by contracting parties or intended third-party beneficiaries of the contract, and that a nonparty to the contract, such as a borrower in the case of a PSA, does not have the ability to raise issues of noncompliance between the contracting parties.[5]

These cases posit that the borrower does not have standing to challenge noncompliance with the PSA, or any other assignment agreement itself, because the borrower is not a party to the PSA and the assignment of the underlying loan does not affect the borrower's underlying debt obligations or the terms of the mortgage.

It would seem difficult, if not impossible, to synthesize these two competing lines of case law.

Attempting to read these two lines of cases together, when a challenge to a plaintiff's standing is raised, the Appellate Division requires the plaintiff to show compliance with the PSA, as seen in Sene and Crosby, while simultaneously not allowing a borrower to raise many issues emanating from the PSA itself as a defense, as seen in Patino, as well as other Second Department cases like Wells Fargo Bank NA v. Tricario in 2020 and Rajamin v. Deutsche Bank National Trust Co. in 2014.

Thus, and again reading these two lines of cases together, even if a borrower cannot raise noncompliance with the terms of a PSA as a defense, the law allows for the equivalent because a borrower can point out the deficiencies in a plaintiff's proof precluding the plaintiff from meeting its burden on the issue of standing.

These diametrically opposed positions obviously create confusion for borrowers and litigants alike, and in anticipation of what will likely be an onslaught of commercial mortgage-backed securities foreclosures in the near future, clarity from the Appellate Division will become all the more necessary.

Indeed, based upon a review of the dockets for mortgage foreclosure cases currently pending before New York state court, it does not appear that many borrowers, if any, are raising these issues or making these arguments in their briefs yet.

These arguments, however, certainly will be forthcoming from borrowers in the months ahead based upon the current distress in the real estate markets and recent precedent from the Appellate Division, such as in cases like Sene.

The anticipation of more and more borrowers raising these issues, and lenders forced to confront the issues raised by the borrowers, of course, provides all the more reason why clarity in the near term from the Appellate Division on these issues is critical to lenders and borrowers alike.

Christopher A. Gorman is a member and John P. Muldoon is an associate at Rosenberg & Estis PC.

Rosenberg & Estis law clerk Michael Fortugno contributed to this article.

[1] See Rajamin v. Deutsche Bank Nat'l Trust Co., 757 F.3d 79, 81-82 (2d Cir. 2014), quoting BlackRock Financial Management Inc. v. Segregated Account of Ambac Assurance Corp., 673 F.3d 169, 173 (2d Cir. 2012).

[2] 219 A.D.3d 1499, 197 N.Y.S.3d 525 (2d Dep't 2023).

[3] 201 A.D.3d 878, 161 N.Y.S.3d 316 (2d Dep't 2022).

[4] See e.g., Wells Fargo Bank, N.A. v. Tricario, 180 A.D.3d 848, 119 N.Y.S.3d 139 (2d Dep't 2020); Bank of Am. N.A. v. Patino, 128 A.D.3d 994, 9 N.Y.S.3d 656 (2d Dep't 2015).

[5] See Rajamin, 757 F.3d at 85.