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Strict Foreclosure Offers Out-of-Court Alternative to 363 Sales

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The economic upheaval of recent years has focused renewed attention on various alternative remedies secured lenders may exercise to restructure distressed assets.

During the early part of the 21st century, the use of the court-supervised U.S. Bankruptcy Code Section 363 sales process became quite prevalent. Secured lenders were willing to fund the court-sanctioned process, and purchasers favored the benefits of a 363 sale. In particular, purchasers not only could take such assets (which in many circumstances included the stock of subsidiaries) free and clear of liens and encumbrances, but they also could choose which executory contracts of the distressed company they wanted to assume and, without regard to contractual restrictions on successors or assignment, compel the continued performance of the counterparty post-closing.

Boards of directors took comfort in the court-supervised process as a way to mitigate potential liability. In addition, investment bankers often found stalking horse bidders to provide a floor for the consideration to be received by a distressed company. The

auction process often attracted additional interested bidders, resulting in higher purchase price offers for assets. This potential increase in purchase prices often outweighed the expense of a bankruptcy filing and the length of the proceeding.

However, when the economy took a turn for the worse and the capital markets dried up, secured lenders were no longer willing to fund the process, and bidders vanished. As a result, secured lenders began to pursue out-of-court restructuring alternatives, particularly when incurring the expense and burden of bankruptcy was not advisable or feasible.

This article focuses on one such approach, out-of-court restructuring under Section 9-620 of the Uniform Commercial Code (UCC). The process often is referred to as strict foreclosure, an Article 9 sale, or a friendly foreclosure, depending on the manner of execution. The article identifies when a distressed situation is ripe for the use of Section 9-620 and highlights practical high-level issues to consider in determining whether Section 9-620 is appropriate for a particular situation.

Section 9-620 provides the framework under which a secured lender is authorized, following a default on the obligation of a borrower, to accept and retain pledged collateral in exchange for the full or partial discharge of all obligations of the borrower to the secured lender without the time-intensive requirements of a public or private foreclosure sale. The secured lender is then free to hold the foreclosed collateral and operate the business of the borrower. Alternatively, strict foreclosure could be structured as a foreclosure on the collateral by the secured lender, with the borrower transferring title to a third-party purchaser.

Regardless of the structure, pursuant to the UCC the secured lender or third-party purchaser acquires the collateral free and clear of subordinated liens. In the context of a third-party purchaser, the secured lender would release its liens in connection with the closing.

On its face, strict foreclosure sounds like a process that is highly creditor friendly,

without material ongoing upside to the borrower. This process, however, can also be a tool used to promote a mutually beneficial workout in which a secured lender sees the potential of a successful business post-restructuring and the board of directors can ensure that the company's employees, vendors, and customers will continue to be involved in the business.

Prospects for Success

The prospects for success of a strict foreclosure depend on the value of the collateral relative to the value of the debt exchanged in the strict foreclosure. If the relative values are such that the secured debt is the fulcrum security and only the secured lender will obtain a recovery from the sale of the collateral, a strict foreclosure is likely to be successful, assuming the other constituents generally agree on the value of the collateral. In this circumstance, neither the board of directors nor any other creditor has any financial incentive to object to a strict foreclosure by a secured lender because a sale of the collateral would provide no additional recovery for the borrower's other constituents.

If a secured lender proposes a strict foreclosure when the value of the collateral either exceeds or is relatively close to the amount of the secured debt, however, strict foreclosure will likely not be successful. In such a case, the board of directors, which owes fiduciary duties to its constituents, should object to the strict foreclosure and consider filing for bankruptcy protection.

One example of a capital structure for which a strict foreclosure is likely to succeed is one in which all borrowed indebtedness, other than the secured debt, is at a holding company and the operating assets are at the holding company's wholly owned subsidiary. The secured debt is at the wholly owned operating subsidiary, with a guarantee from the holding company. Under these circumstances—and provided that the trade payables are relatively small or associated with critical vendors and there are no material assets at the holding company—the secured lender could strictly foreclose

on the equity interest of the operating company owned by the holding company and acquire the entire business.

The UCC broadly applies to personal property, including equity interests and intangible assets such as intellectual property, but does not apply to real estate. Many states, however, have enacted foreclosure statutes, including deed in lieu of foreclosure procedures, which can be used to transfer real property as part of the strict foreclosure construct.

The following is an example of a simplified execution structure that may be appropriate in a strict foreclosure scenario. The parties enter into an agreement and plan of foreclosure, which can take a variety of forms but is likely to resemble a hybrid of a loan forbearance agreement and an asset purchase agreement, accompanied by UCC-specific legal provisions, such as notice requirements. Under this scenario, the borrower assigns and transfers to the secured lender (or a third-party purchaser) all personal property assets subject to the secured lender's lien in exchange for the full or partial satisfaction of indebtedness, the assumption of certain liabilities of the borrower, and an offering of employment to the borrower's employees.

Any additional assets held by the borrower that are outside the scope of the secured lender's lien or the UCC (such as real property) may be transferred to the secured lender or a third-party purchaser separately for other consideration. The parties may also agree on an equity incentive program to retain company management.

Offer Considerations

As with any acquisition, the secured lender must be able to propose a viable capital structure to the borrower's board of directors. Furthermore, a secured lender should closely evaluate the same hot-button liability areas reviewed in any acquisition context, such as environmental issues, taxes, employee benefits, and product liability.

Under generally settled corporate law, the board of directors of an insolvent borrower

must balance fiduciary obligations to both creditors and shareholders, ensuring that any restructuring plan maximizes the economic value of the borrower. Examples of these considerations include:

- Will the expense and ongoing administrative costs associated with a bankruptcy filing outweigh the comfort obtained by court oversight? Whether the board of directors believes the borrower can obtain debtor-in-possession (DIP) financing to fund operations during the period of a bankruptcy reorganization sale is often a critical factor.
- Does the borrower have institutional shareholders or an otherwise complex capital structure? If so, the company's board of directors should engage an outside valuation firm to provide an opinion on the fairness of the proposed transaction.
- What differing impact will a bankruptcy proceeding and an out-of-court restructuring, such as a strict foreclosure, have on critical vendors, customers, and employees?
- What size wind-down budget will the borrower require following strict foreclosure? The budget need not include all liabilities of the insolvent post-foreclosure corporation but should contemplate matters related to a successful transition of the business, including transition funding of employee wages and benefit plans; payment of certain insurance premiums, such as directors and officers (D&O) tail coverage; fees of advisors engaged by the borrower to assist with its restructuring; and other costs of the borrower's ultimate liquidation, such as final tax returns and state dissolution filings.

Structural Concerns

The most important structural issues in strict foreclosure typically arise in the areas of regulatory oversight, governmental permits, employees, and communication.

Regulatory Oversight, Permits. A borrower that is subject to the oversight of a regulatory authority or that holds material permits must determine the extent to which these assets may be assigned to the secured lender or third-party purchaser. A lengthy

and burdensome regulatory approval process can quickly eliminate a material benefit of a strict foreclosure transaction—speed.

In the case of non-transferable state or local permits, the parties can often get comfortable with transitioning the re-application process into the post-foreclosure period, depending on the materiality of any associated penalties. Any borrower operating in a regulated industry and requiring transactional approval, such as certain sectors of healthcare, telecommunications, or transportation, should give serious consideration to carrying out the restructuring process through a court-approved process to obtain benefits available under the Bankruptcy Code.

Employees. The perspective of the foreclosing secured lender often is analogous to that of a financial buyer in a typical acquisition. While the secured lender may have opinions or insight into the future direction of the new company, it is not likely to desire any real involvement in day-to-day operations of the business. In fact, a secured lender is most likely to pursue a strict foreclosure when it believes in the strength of existing management and its ability to successfully guide the borrower through the restructuring process, including managing the expectations of key customers and vendors, and obtaining their consent to the extent necessary.

Similarly, the borrower should consider the expectations of its key employees and their ongoing commitment to the organization. Employees may be hesitant to stay with the borrower through a lengthy and uncertain court restructuring process, but they may be incentivized to remain by the prospect of equity participation in the new company. Certainly an out-of-court restructuring is more likely to freely accommodate equity incentive grants than would a reorganization conducted under the scrutiny and requirements of the bankruptcy process.

Communication. Communication is perhaps the linchpin of successfully negotiating and implementing a strict foreclosure. The three principal lines of communication are between the (1) borrower and the secured lender, (2) borrower and critical vendors and customers, and (3) secured lender and third parties entitled to notification of the

proposed transaction.

Open and constant communication between the borrower and secured lender is vital and should closely parallel that of an arm's length acquisition in which the target is wooing a financial buyer. In consultations on strategy with the secured lender or third-party purchaser, management of the borrower may feel it needs to approach key customers and vendors to discuss the proposed restructuring. Similar to strategies employed in any transaction leading to a change in ownership, the secured lender may decide to make advance disclosures to certain critical customers or vendors, but not to other customers or vendors whose receivables from the company are not being assumed in the transaction.

Finally, pursuant to notification requirements under the UCC, the secured lender also must communicate the terms of the proposed foreclosure to other secured parties or lienholders claiming an interest in the collateral. Parties entitled to notification may include sophisticated mezzanine lenders with a junior lien on the assets of the borrower or, in an ideal construct, only suppliers holding purchase money security interests. If a party entitled to notification objects to the proposed transaction, the secured lender is prohibited from proceeding with the foreclosure as planned until the objection is resolved.

Several practical points should be considered in connection with the notification process:

- If the secured lender and a subordinated lender have entered into an intercreditor agreement, it may contain provisions granting the advance consent of the subordinated lender or other additional rights beyond the scope of the UCC and should be examined accordingly.
- Although case law provides little clarity on this point, the UCC makes clear that the failure of a secured lender to give proper notice to third parties does not void the transaction or the discharge of most common types of subordinate interests in the collateral. However, the party that did not receive proper notice may bring suit for

losses caused by the failure of the secured lender to do so. When a secured lender forecloses on collateral securing obligations that significantly exceed the value of the collateral, it may prove difficult for a subordinated creditor to demonstrate damages. However, the potential expense of defending against such a suit, even if it ultimately is determined not to have merit, may be enough to motivate a foreclosing secured lender's strict compliance with UCC notification requirements.

- The cooperation of ordinary trade creditors holding a purchase money security interest often can be secured merely by explaining the enhanced viability of the restructured enterprise. Given a choice between repossessing its collateral and consenting to the transaction, a supplier usually has a greater incentive to consent.

Effective Alternative

Strict foreclosure is not appropriate in all situations. It can, however, be an effective alternative to a lengthy and expensive bankruptcy proceeding. Under many scenarios, a secured lender can efficiently exercise its remedies to foreclose on pledged collateral with the purpose of selling such collateral to a third party or acquiring certain assets, along with the assumption of certain liabilities, to create a viable going concern out of a formerly distressed company.



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