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A LOOK AT THE FRIENDLY FORECLOSURE OPTION

Prepared in connection with the panel entitled *Who Will Be There to Shut Out the Lights?*

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Introduction

When a debtor defaults on a loan, a secured lender has several options for repayment. One option is a foreclosure sale under Article 9 of the Uniform Commercial Code ("UCC").[1] An Article 9 sale can maximize the secured lender's recovery without the cost and delay of a judicial foreclosure sale or a sale under Section 363 of the Bankruptcy Code and without certain hurdles presented by a direct sale between the debtor and a buyer. If a buyer or the secured lender determines the Article 9 sale is the preferred route, there are procedures to consider. This article discusses the procedures of an Article 9 sale as well as the advantages and pitfalls involved. Section I explains the sale remedy, section II describes the mechanics of the sale process, section III discusses the advantages, and section IV points out potential pitfalls.

I. Sale Remedy

A default triggers a secured lender's statutory remedies under Article 9.[2] The UCC, however, does not define the term "default".[3] Thus, the parties to a secured transaction generally delineate when a default has occurred in the loan or security agreement.

The secured lender's remedy under Article 9 after a default is disposition. UCC 9-610(a) provides that "[a]fter default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing."[4] Article 9 thus offers broad flexibility to the secured lender in the disposition of its collateral. The secured lender's guiding principle, however, is that "every aspect" of a sale, "including the method, manner, time, place, and other terms, must be

[1] *See* U.C.C. § 9-610(a) (2014).
[2] *Id.* § 9-601(a).
[3] *Id.* § 9-601 cmt. 3.
[4] *Id.* § 9-610(a).

commercially reasonable."[5] Whether a sale is commercially reasonable is a question of fact.[6] Therefore, the secured lender's adherence to the procedures delineated in Article 9 is of great importance in successfully conducting an Article 9 sale. These procedures are discussed generally in the next section.

II. Mechanics

a. Public vs. Private Sale

First, the secured lender must determine whether to dispose of the collateral in a public or private sale.[7] The determination depends on the circumstances. If the secured lender wants to purchase the collateral for itself, a public sale is generally required.[8] A secured lender cannot purchase collateral in a private sale unless the collateral is "of a kind customarily sold on a recognized market" or "the subject of widely distributed standard price quotations."[9] As such, only assets such as publicly traded securities may be purchased by the foreclosing lender in a private sale.[10] A public sale requires that the public have access to the sale and the sale be advertised.[11] Proper advertisement calls for commercially reasonable notice of the time, place, and terms of the sale as well as notice of the collateral to be sold.[12] Such notice should be placed in a generally circulated newspaper in the geographic area of the location of the sale or in a trade or industry publication in the field of the assets being sold. In many cases, a private sale is preferable. A private sale does not require any marketing because the public does not participate

[5] *Id.* § 9-610(b).
[6] *See, e.g.*, *Colonial Pacific Leasing Corp. v. N & N Partners*, 981 F.Supp.2d 1345, 1350 (N.D. Ga. 2013) (explaining that commercial reasonableness is "normally a question of fact").
[7] U.C.C. § 9-610(b).
[8] *See id.* § 9-610(c).
[9] *Id.*
[10] *See id.* § 9-610 cmt. 9.
[11] *Id.* § 9-610 cmt. 7.
[12] *Id.*; *see also id.* § 9-611 cmt. 2.

in the sale process. As such, a buyer in a private sale does not risk being outbid, and the financial condition of the company being sold is not publicized.

b. Notice

Regardless of the type of sale, the secured lender must give notice to certain interested parties of its intention to sell the collateral. Article 9 specifically requires "a reasonable authenticated notification of disposition."[13] Such notification must be reasonable with respect to timing, manner, and content.[14]

The interested parties are the debtor, any secondary obligor, and certain other secured parties described below.[15] For purposes of Article 9, the debtor is the party that holds a property interest in the collateral, the secondary obligor is the party that has a secondary obligation to pay the secured debt, and the secured parties are those that hold a security interest in the collateral.[16] As such, a surety is entitled to notice regardless of who created the security interest.[17] "If the surety created the security interest, it would be the debtor" not the secondary obligor.[18] In this situation, the primary obligor would not be entitled to notice.[19] If the surety did not create the security interest, the surety would be entitled to notice as a secondary obligor, and the primary obligor would be entitled to notice as the debtor.[20]

Other secured parties entitled to notice are those that have (i) requested in advance to be notified[21] or (ii) perfected a security interest or other lien on the collateral by filing in the appropriate office a financing statement that describes the collateral and is indexed under the

[13] *Id.* § 9-611(b).
[14] *Id.* § 9-611 cmt. 2.
[15] *Id.* § 9-611(c).
[16] *Id.* § 9-611 cmt. 3.
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.* § 9-611(c)(3)(A).

debtor's name.[22] While seemingly burdensome, the foreclosing lender can ensure compliance with the requirement to notify other secured parties by performing a UCC lien search in the appropriate filing office or offices[23] between twenty and thirty days prior to the date of notification of the sale.[24] Such a search satisfies a safe harbor provision of Article 9 intended to ease the foreclosing lender's burden of identifying all of the secured parties entitled to notice.

The notice requirement is further complicated by the qualification that notice be reasonable.[25] With respect to timeliness, whether notice is reasonable "is a question of fact."[26] In general, notice must be sent sufficiently in advance of the sale to allow any person who has been notified to take action on account of such notification. The foreclosing lender, however, is deemed compliant under a safe harbor provision if notice is given ten days or more prior to the date of the sale.[27]

Whether the contents of the notice are sufficiently reasonable is also "a question of fact."[28] Article 9 dictates that the notice include (i) a description of the debtor, (ii) a description of the secured party, (iii) a description of the collateral to be sold, (iv) a statement of the method of intended disposition, (v) a statement that the debtor is entitled to an accounting of the outstanding debt, and (vi) if a public sale, the time and place of the sale or, if a private sale, the date after which the collateral will be sold.[29] Contents are sufficient even if the notice includes "minor errors that are not seriously misleading" or information not required by Article 9.[30]

[22] *Id.* § 9-611(c)(3)(B).
[23] *Id.*
[24] *Id.* § 9-611(e).
[25] *See id.* § 611(b).
[26] *Id.* § 9-612(a).
[27] *Id.* § 9-612(b).
[28] *See id.* § 9-613(2).
[29] *Id.* § 9-613(1).
[30] *Id.* § 9-613(3).

Therefore, to comply with Article 9's notice requirement, a foreclosing lender should be sure to perform and memorialize an appropriate lien search and, at least ten days prior to the date of the sale, notify the debtor, any secondary obligor, and any secured parties identified by the search or from whom the foreclosing lender has received notice prior to the sale. UCC 9-613 provides a form of notice, which will satisfy the reasonable contents requirement if completed.[31]

c. Commercially Reasonable

In addition to the notice requirements, Article 9 imposes the standard of commercial reasonableness on "every aspect" of the sale "including the method, manner, time, place, and other terms."[32] UCC 9-627 attempts to shed light on what constitutes commercial reasonableness, but falls short of prescribing helpful parameters.[33] The section states that evidence that a higher price for the collateral "could have been obtained" does not "preclude" a finding of commercial reasonableness, but suggests in comments that "a court should scrutinize" aspects of a sale of collateral sold at a low price.[34] Article 9 further states that a sale is commercially reasonable if it is conducted "in the usual manner" or "at the current price" of "any recognized market" or "in conformity with the reasonable commercial practices among dealers in the type of property" sold.[35] In determining commercial reasonableness, courts consider factors such as whether the foreclosing lender sought to obtain the best price, whether the sale was private or public, the condition of the collateral and any efforts to enhance the condition, the marketing involved, the number of bids received, and the method of soliciting bids.[36] What can

[31] *Id.* § 9-613 Notification of Disposition of Collateral.
[32] *Id.* § 9-610(b).
[33] *See id.* §§ 9-627(a)-(d).
[34] *Id.* § 9-627(a); *id.* § 9-627 cmt. 2.
[35] *Id.* § 9-627(b).
[36] *See, e.g., Colonial Pacific Leasing Corp. v. N & N Partners, LLC*, 981 F.Supp.2d 1345, 1350 (N.D. Ga. 2013). See also, *What's "Commercially Reasonable" for Article 9 Foreclosure Sales*, BLANK ROME LLP (Jan. 16, 2014), http://www.blankrome.com/index.cfm?contentID=37&itemID=3243, for a discussion of a case decided under Delaware law holding that the public sale of a debtor's assets to a private equity firm was commercially reasonable.

be gleaned from Article 9 and the relevant case law is that even though the foreclosing lender is not required to procure the absolute best price for the collateral, taking steps to maximize recovery will help to ensure the sale is commercially reasonable and mitigate the risk of other potential setbacks discussed below.

d. Buyer Takes Free and Clear

Upon the completion of an Article 9 sale, the buyer takes whatever rights the debtor had in the collateral, and the foreclosing party's security interest is "discharge[d]" as well as any "subordinate security interests" and generally any "subordinate liens."[37] Security interests senior to the foreclosing party's interest remain.[38] The operative document is a bill of sale or a purchase and sale agreement. The bill of sale should identify the assets being sold and state that the sale is made pursuant to a secured party sale under Article 9. The foreclosing lender should disclaim all warranties.

e. Applying the Proceeds

Article 9 prescribes the order in which the proceeds of a sale should be applied.[39] First, proceeds must pay expenses in connection with the sale including, to the extent provided for in the security agreement, attorneys' fees and legal expenses.[40] Second, proceeds must be applied to satisfy the outstanding debt owed to the foreclosing lender.[41] Third, proceeds must be applied to satisfy any debts secured by security interests junior to the foreclosing lender's security interest.[42] Any surplus must be remitted to the debtor.[43] If the proceeds are insufficient to satisfy the foreclosing lender's debt after paying expenses, the secured lender may pursue a claim

[37] U.C.C. § 9-617(a).
[38] *See id.*
[39] *Id.* § 9-615(a).
[40] *Id.* § 9-615(a)(1).
[41] *Id.* § 9-615(a)(2).
[42] *Id.* § 9-615(a)(3).
[43] *Id.* § 9-615(d)(1).

against the debtor to collect the deficiency.[44] Note that deficiency judgment statutes must be followed to preserve a deficiency claim.

III. Advantages

A cooperative Article 9 sale, or a friendly foreclosure, is quick, cost-effective, and can in many instances mitigate claims of fraudulent transfer. Compared to a Section 363 sale under the Bankruptcy Code, an Article 9 sale can be accomplished on a shorter time line and thereby minimize administration costs and expenses as well as the need to fund a company for a protracted period. Additionally, the Article 9 sale is not public and thus avoids the damage to a company's reputation that can result from the publicity of a sale in bankruptcy. The foreclosing lender under Article 9 need not notify customers or vendors.[45] Only the interested parties discussed above are entitled to notice.[46] Furthermore, the buyer frequently can receive free and clear title more easily from a secured lender than it would from an insolvent debtor in a direct sale where the debtor needs consent from the junior lien holders. This is because the collateral is frequently sold at a price less than the amount needed to satisfy the debt owed to the foreclosing lender and the junior liens are extinguished by operation of law.[47] Junior creditors are unlikely to challenge the sale because they have little incentive to incur the cost of litigation when there is likely no chance of recovery. Similarly, a debtor may negotiate the release of personal guarantees in exchange for cooperation. For these reasons, a friendly foreclosure can be a preferable course of action.

IV. Pitfalls

a. Strict Adherence to the Provisions of Article 9

[44] *Id.* § 9-615(d)(2).
[45] *See id.* § 9-611(c).
[46] *See id.*
[47] *Id.* § 9-617(a)(3).

While the Article 9 sale provides certain advantages to alternative exit-strategies, the secured lender must be aware of the pitfalls. For example, failure to adhere to the statutory requirements or follow commercially reasonable standards may result in challenges to the sale. A court may order or restrain the sale.[48] Statutory damages may apply if the collateral is consumer goods.[49] Further, the foreclosing lender may be liable for any loss it has caused by failing to follow the rules.[50] In reality, however, establishing the value of the loss caused by the foreclosing lender's failure to comply is difficult. Sometimes it is unclear at what price the collateral would have sold had the foreclosing lender done something it was required to do under Article 9 but failed to do.

b. Rebuttable Presumption

The foreclosing lender's failure to comply with the statutory requirements of Article 9 may result in the elimination or reduction of its deficiency claim. Article 9 imposes a rebuttable presumption rule when the "debtor or secondary obligor places [the foreclosing lender's] compliance in issue."[51] The rule places the burden of proving compliance on the foreclosing lender once the issue is raised. If the foreclosing lender fails to meet its burden, its deficiency claim "is limited to an amount by which the sum of the secured obligations, expenses, and attorney's fees exceeds the greater of: (A) the proceeds of the collection, enforcement, disposition, or acceptance; or (B) the amount of proceeds that would have been realized had the non-complying secured party proceeded in accordance with the provisions of [Part 6] relating to collection, enforcement, disposition, or acceptance."[52] For purposes of subsection B, "the amount of proceeds that would have been realized is equal to the sum of the secured obligation,

[48] *Id.* § 9-625(a).
[49] *Id.* § 9-625(c).
[50] *Id.* § 9-625(b).
[51] *Id.* § 9-626 cmt. 3. The rebuttable presumption rule does not apply in consumer transactions. *Id.* § 9-626(a).
[52] *Id.* § 9-626(a)(3).

expenses, and attorney's fees unless the secured party proves that the amount is less than that sum."[53] Thus, application of the rule can effectively value the foreclosing lender's deficiency claim at zero.[54] Unless the foreclosing lender can prove that the collateral, at the time of the sale, was worth less than the amount of the outstanding debt, its recovery will be limited to the amount of the sale proceeds.[55] Since actual value is extremely difficult to establish, the rule places a heavy burden on the foreclosing lender and can therefore result in either the elimination or reduction of its deficiency claim.

c. Successor Liability

Successor liability may be a concern to some buyers especially if the foreclosing lender purchases the collateral for itself and expects to continue with the business. In most states, four exceptions to the general rule that a buyer is not liable for the debts of the seller apply: (1) whether the buyer agreed to assume the liabilities, (2) whether there was a de facto merger of the buyer and the seller, (3) whether the buyer is a mere continuation of the seller, and (4) whether the sale was intended to escape the seller's liabilities and thereby defraud its creditors.[56] The first exception may be avoided by expressly providing in the agreement that the buyer is not assuming the seller's liabilities. The other exceptions are less easily avoided. For example, the mere continuation exception can arise where the buyer has owners or managers in common with the seller or retains employees of the seller and continues the business. Additionally, an inadequate sale price might trigger the fraud exception. The facts of a particular sale will

[53] *Id.* § 9-626(a)(4).
[54] *Id.* § 9-626(a)(3)-(4).
[55] *Id.* § 9-626(a)(4).
[56] *Call Center Techs., Inc. v. Grand Adventures Tour and Travel Publ'g Corp.*, 635 F.3d 48, 52 (2d Cir. 2011) (holding that genuine issues of material fact existed regarding successor liability where, among other things, buyer's business retained some senior managers and thirty one of fifty one employees, operated in the same building, and provided many of the same services as seller's business).

determine whether successor liability is a risk that warrants an alternative strategy such as a Section 363 sale.

d. Real Property

An Article 9 sale is not ideal if the collateral to be sold includes real property. In such a case, the secured lender loses the ability to sell the assets as a single package because Article 9 is inapplicable to real estate transactions.

e. Unfriendly Foreclosure

A secured lender should consider the unfriendly foreclosure scenario when deciding whether to use Article 9. If the debtor is unwilling to cooperate, the secured lender may still foreclose under Article 9, but it may not be practical to do so. Issues arise with respect to gaining possession of the collateral and physically conveying or delivering the collateral to the buyer, which the buyer may require. Additionally, an uncooperative debtor is more likely to challenge the sale on the basis of lack of commercial reasonableness or another available defense under Article 9.

Conclusion

A sale under Article 9 may be an ideal exit strategy for a secured lender where the defaulting borrower is a small or mid-sized company that is willing to cooperate and where any sale value would be less than the secured debt owed to the lender. This type of friendly foreclosure scenario can maximize a secured lender's recovery because it avoids judicial intervention and is less costly and time consuming than a sale in bankruptcy. Further, a friendly foreclosure stays between the parties to the sale. To be sure, there are pitfalls to be aware of, but a secured lender should consider the economic sense of an Article 9 sale when it must look to its collateral to satisfy a debt.