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UCC Foreclosures: Overcoming Obstacles to the Sale and Evaluating Receivership and Bankruptcy Alternatives

Protecting Lender and Borrower Interests

WEDNESDAY, AUGUST 12, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Alternatives to UCC Sales

- Workouts
- Assignments for the Benefit of Creditors
- Receivership
- Bankruptcy Sales (Section 363)

Workouts

- Privately negotiated among loan parties
  - No court supervision
  - Least expensive
  - Fastest
- Lender will typically obtain
  - Additional collateral or other credit support
  - Tighter covenants
  - Release of liability
- Borrower gets
  - Time

Assignments for the Benefit of Creditors

- Proceeding under state law, which varies considerably state-to-state
- Generally, the borrower/debtor will assign all of its assets to an assignee who then liquidates and makes pro-rata distributions to unsecured creditors
- California has a robust regime governed by statute
- The advantages are that it is a cheaper, less expensive form of Chapter 7
- The disadvantages are an increased likelihood of suit by disgruntled creditors

Receiverships

- Like ABCs, it is a proceeding under state law, and the requirements vary state-to-state and federally
- Unlike ABCs, it is an in-court process in which a third party neutral is appointed by the court with certain rights and duties with respect to the collateral
- In most jurisdictions, the order appointing the receiver will determine all of the receiver's rights and duties
- Often used for real estate collateral, especially rents and profits, or where the borrower is a combination of uncooperative and engaged in fraudulent behavior

Bankruptcy Sales

BANKRUPTCY SALES ARE *BAD* BECAUSE:

- **They are expensive**
- **They take too long**
- **The lender is not in control**
- **Competitive bidding is more likely**
- **Terms of sale are public and scrutinized**
- **Carve-outs and surcharges may be necessary**
- **Credit bidding may be curtailed**

Bankruptcy Sales

BANKRUPTCY SALES ARE *GOOD* BECAUSE:

- **Assets may be sold "free and clear"**
- **No (not much) successor liability**
- **Marketable title is obtained**
- **Court approval insulates the parties from attack**
- **Contracts and leases can be assigned**

Bankruptcy Sales

Assets may be sold "free and clear"

11 U.S.C. § 363(f) The trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Bankruptcy Sales

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What is an "interest"? "In rem" interests v. "In personam" claims

- *In re Trans World Airlines, Inc.,* 322 F.3d 283 (3d Cir. 2003)
- *In re Old Carco LLC,* 538 B.R. 674 (Bankr. S.D.N.Y. 2015)
- *In re Catalina Sea Ranch,* LLC, 2020 WL 1900308, at *12 (Bankr. C.D. Cal. Apr. 13, 2020)
- Cf. *Matter of Motors Liquidation Co.,* 829 F.3d 135 (2d Cir. 2016)

Bankruptcy Sales

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(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Compare *In re Hassen Imports P'ship,* 502 B.R. 851, 861 (C.D. Cal. 2013); and Clear Channel Outdoor, Inc., v. Knupfer (In re PW, LLC), 391 B.R. 25 (9th Cir. BAP 2008); with

In re Jolan, Inc., 403 B.R. 866, 867 (Bankr. W.D. Wash. 2009)

Bankruptcy Sales

Marketable Title is Obtained

11 U.S.C. § 363(m)

The reversal or modification on appeal of an authorization . . . of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Trinity 83 Dev., LLC v. ColFin Midwest Funding, LLC, 917 F.3d 599, 602 (7th Cir. 2019)

Matter of Spanish Peaks Holdings II, LLC, 872 F.3d 892, 897 fn 4 (9th Cir. 2017)

Effectuating UCC Sale

- Steps to a UCC Sale
  - Assemble the collateral
  - Notice the Sale
  - Conduct the Sale
  - Apply the Proceeds

Assembly of Collateral

- UCC Section 9-609 provides that a secured creditor may take possession of collateral immediately upon a debtor's default.
- A secured creditor has the right to repossess collateral unless the parties have expressly agreed otherwise. A secured creditor has three options for repossessing collateral:
  - Exercise its right to self-help repossession under UCC Section 9-609(a) and (b)
  - Require its debtor to assemble and deliver the collateral under UCC Section 9-609(c)
  - Resort to a traditional judicial foreclosure under UCC 9-609(b)(1)

Self-Help Repossession

- A secured creditor may repossess a piece of collateral or render a piece of equipment unusable on the debtor's premises through self-help and without judicial process pursuant to UCC Section 9-609(b)(2).
- Self-help repossession is the easiest, quickest and most cost-effective means of repossessing collateral because it does not require the time and expense of a court order.
- However, self-help repossession poses risks because the creditor must ensure that there is no breach of the peace.
  - If the creditor causes a breach of the peace or wrongly repossesses the collateral, it may be liable for damages.
  - The prohibition cannot be waived by agreement and the parties may not determine by agreement what constitutes a "breach of the peace." Accordingly, what is deemed such a "breach of the peace" has been frequently litigated.
  - The phrase "breach of the peace" is not defined in the UCC.
  - Courts have generally defined "breach of the peace" to mean "a disturbance of public order by an act of violence, or by any act likely to produce violence, or which by causing consternation and alarm, disturbs the peace and quiet of the community." *People v. Most*, 171 N.Y. 423, 64 N.E. 175 (1902).

Breaches of the Peace

- Breaches of the peace have included:
  - Being accompanied by a uniformed police officer without a court order during a repossession
  - Being told to stop by a representative of the debtor
  - Involving a nearby police officer
  - Cutting a chain securing a gate and leaving the debtor's other property unprotected
  - Breaking a window; and breaking into a closed garage
- Acceptable means of peaceful repossession have included:
  - Tricking the debtor
  - Entering onto property that is not locked
  - Taking a vehicle from an open garage

Right to Make Debtor Assemble Collateral

- A secured creditor may require a debtor to assemble the collateral under UCC Section 9-609(c) if the security grants the secured creditor the right *or at any time after the debtor defaults*.
- If the debtor is willing to assemble equipment, this is the preferred method of repossession under Article 9. However, debtors will often not comply with this requirement and a secured creditor will have to resort to self-help or judicial intervention. One risk in demanding that a debtor assemble collateral is that it may give the debtor time to hide or transfer collateral.

Evaluating Defaults

- While Article 9 does not contain any explicit requirement that a default be material to afford a secured party the right to enforce against collateral, it obligates a secured party to act in good faith when exercising such rights
- Courts have frequently denied enforcement remedies where lenders relied on technical defaults or acted in bad faith
    - *In re ICPW Liquidation Corp.,* 600 B.R. 640 (9th Cir. 2019)
    - *Banc of America Leasing & Capital LLC v Walker Aircraft LLC,* 2009 US Dist. LEXIS 94657 (D. Minn. 2009)
    - *KMC Co. v Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985)
    - *Sahadi v. Continental Ill. Nat'l Bank & Trust Co.*, 706 F.2d (7th Cir. 1983)
    - *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367 (9th Cir. 1979)
- Before you send a default notice, ask what the default is, what evidence there is of the default, and how material it is
    - Materiality is generally a fact question

Adequate Lien Search

- A secured creditor must notice the debtor, any secondary obligor and any other party with an interest in the collateral. A secured creditor must generally be aware of three types of parties with interests in the collateral.
- First, a secured creditor must notice any party that sends an authenticated notice of its interest in the collateral.
- Second, a secured creditor must notice other secured creditors and lien holders. However, a secured creditor must only notice those secured creditors and lien holders who, as of 10 days before the sale, have a security interest perfected by a filing statement that identifies the collateral. This means that a secured creditor must only notice those parties that can be found in an official UCC search conducted by the office designated by the appropriate state (usually the Secretary of State's office).
- Third, a secured creditor must notify secured creditors perfected according to Section 9-311 of the Uniform Commercial Code in the same collateral as of the date that the secured creditor sends notification to the debtor. A secured creditor should look to the law of the debtor's home state and the state where the collateral is located to determine whether any other parties hold an interest perfected according to Section 9-311 of the Uniform Commercial Code.
- Although this burden seems substantial, under Section 9-611(e) of the Uniform Commercial Code, a secured creditor is deemed to have satisfied all notice requirements if it performs a financing statement search between 20 and 30 days before the sale of the collateral. As such, it is extremely important that a secured creditor both perform and memorialize a search of the records of the proper filing state before disposing of its collateral.
- As noted above, the search is usually conducted in office of the secretary of state where the entity is formed, or if an individual, where she is a resident. If the debtor is formed in one state but has its principal place of business in another, then it is prudent to search both.

Strict Foreclosure

UCC § 9-620(a) Except as otherwise provided in subsection (g), a secured party may accept collateral in full or partial satisfaction of the obligation it secures only if:

(1) the debtor consents to the acceptance under subsection (c);

(2) the secured party does not receive, within the time set forth in subsection (d), a notification of objection to the proposal authenticated by:

(A) a person to which the secured party was required to send a proposal under Section 9-621; or

(B) any other person, other than the debtor, holding an interest in the collateral subordinate to the security interest that is the subject of the proposal

Strict Foreclosure

The Benefits:

UCC § 9-622(a)

A secured party's acceptance of collateral in full or partial satisfaction of the obligation it secures:

(1) discharges the obligation to the extent consented to by the debtor;

(2) transfers to the secured party all of a debtor's rights in the collateral;

(3) discharges the security interest or agricultural lien that is the subject of the debtor's consent and any subordinate security interest or other subordinate lien; and

(4) terminates any other subordinate interest.

Strict Foreclosure

How does the secured party propose to retain collateral?

UCC § 9-621(a)

(a) A secured party that desires to accept collateral in full or partial satisfaction of the obligation it secures shall send its proposal to:

> (1) any person from which the secured party has received, before the debtor consented to the acceptance, an authenticated notification of a claim of an interest in the collateral;
>
> (2) any other secured party or lienholder that, 10 days before the debtor consented to the acceptance, held a security interest in or other lien on the collateral perfected by the filing of a financing statement . . . ; and
>
> (3) any other secured party that, 10 days before the debtor consented to the acceptance, held a security interest in the collateral perfected by compliance with a statute, regulation, or treaty described in Section 9-311(a).

(b) A secured party that desires to accept collateral in partial satisfaction of the obligation it secures shall send its proposal to any secondary obligor in addition to the persons described in subsection (a).

Strict Foreclosure

How does the secured party propose to retain collateral?

UCC § 9-620(b)

> A purported or apparent acceptance of collateral under this section is ineffective unless:
>
> > (1) the secured party consents to the acceptance in an authenticated record or sends a proposal to the debtor; and
> >
> > (2) the conditions of subsection (a) are met.

The proposal must be clear and explicit

> *Patrick v. Wix Auto Co.,* 288 Ill. App. 3d 846, 850, 681 N.E.2d 98, 101 (1997)

Strict Foreclosure

How does the debtor consent?

UCC § 9-620(c)

(1) a debtor consents to an acceptance of collateral in *partial satisfaction* of the obligation it secures *only if the debtor agrees* to the terms of the acceptance in a record authenticated after default; and

(2) a debtor consents to an acceptance of collateral in *full satisfaction* of the obligation it secures only *if the debtor agrees to the terms of the acceptance in a record authenticated after default or the secured party:*

(A) sends to the debtor after default a proposal that is unconditional or subject only to a condition that collateral not in the possession of the secured party be preserved or maintained;

(B) in the proposal, proposes to accept collateral in full satisfaction of the obligation it secures; and

(C) does not receive a notification of objection authenticated by the debtor within 20 days after the proposal is sent.

Pre-default consent is ineffective

In re CBGB Holdings, LLC, 439 B.R. 551, 555 (Bankr. S.D.N.Y. 2010)

Strict Foreclosure

When the lender does not comply

UCC § 9-622(b)

A subordinate interest is discharged or terminated under subsection (a), even if the secured party fails to comply with this article.

UCC §9-625

(a) If it is established that a secured party is not proceeding in accordance with this article, a court may order or restrain collection, enforcement, or disposition of collateral on appropriate terms and conditions.

(b) Subject to subsections (c), (d), and (f), a person is liable for damages in the amount of any loss caused by a failure to comply with this article. Loss caused by a failure to comply may include loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing.

(c) Except as otherwise provided in Section 9-628:

> (1) a person that, at the time of the failure, was a debtor, was an obligor, or held a security interest in or other lien on the collateral may recover damages under subsection (b) for its loss;

Strict Foreclosure

Special Rules Apply to Consumer Goods

UCC § 9-620 (a) Except as otherwise provided in subsection (g), a secured party may accept collateral in full or partial satisfaction of the obligation it secures only if: . . .

(3) if the collateral is consumer goods, the *collateral is not in the possession of the debtor* when the debtor consents to the acceptance; and

(4) subsection (e) does not require the secured party to dispose of the collateral or the debtor waives the requirement pursuant to Section 9-624.

(e) A secured party that has taken possession of collateral shall dispose of the collateral pursuant to Section 9-610 within the time specified in subsection (f) if:

(1) 60 percent of the cash price has been paid in the case of a purchase-money security interest in consumer goods; or

(2) 60 percent of the principal amount of the obligation secured has been paid in the case of a non-purchase-money security interest in consumer goods.

(f) To comply with subsection (e), the secured party shall dispose of the collateral:

(1) within 90 days after taking possession; or

(2) within any longer period to which the debtor and all secondary obligors have agreed in an agreement to that effect entered into and authenticated after default.

(g) In a consumer transaction, a *secured party may not accept collateral in partial satisfaction* of the obligation it secures.

Obstacles to UCC Foreclosures

- Notice
- Commercial Reasonableness
- Successor Liability
- Clear Title

Notice of Foreclosure

- Lender must give debtor notice if it intends to sell collateral or conduct strict foreclosure
- UCC says creditor must give reasonable notice of intended disposition of collateral
  - Loan documents often specify minimum notice
  - UCC creates 10-day “safe harbor” notice provision
- However, cases say notice period is a facts and circumstances test; depends on assets being sold and market for them
  - Adequacy of notice often challenged in litigation

Formalities Re Notice

- Who gets notice?
  - Debtor and any party with an interest in the collateral
  - Consider sending broader notice
- How does the lender know whom to notice
  - Prior to giving notice, conduct a UCC search to verify status of liens on collateral
- What does the notice say?
  - Whether debtor intends to sell collateral or retain it in strict foreclosure
  - Time, date and manner or proposed sale
- Check loan documents to see if any other notice(s) required

Commercial Reasonableness

- A secured creditor is required to make a "commercially reasonable" sale of the debtor's collateral. UCC Article 9 does not define what constitutes a "commercially reasonable" sale.
- Rather, Article 9 demands that a secured creditor's sale must be reasonable in every aspect, including ***time, manner, place and any other terms.***
- A secured creditor is required to provide reasonable notice of the sale to the debtor, secondary obligors, holders of interest in the collateral, and in the case of a public sale, the public at large.
- The parties to a security agreement cannot waive the requirement of a commercially reasonable disposition. A debtor or secondary obligor may, however, agree that a disposition was reasonable. Parties may agree on what standard constitutes a commercially reasonable sale prior to the sale.
- In structuring a sale of collateral:
  - A secured creditor may decide to sell the collateral in a public or private sale and in aggregate or in single units.
  - A secured creditor may also choose the time, place and manner of its disposition.
  - A secured creditor may choose to sell the collateral "as is" or may repair the collateral and apply the proceeds of the sale to the repairs before the sale.
  - A secured creditor should focus on maximizing sale proceeds.

Determining Whether Sale Was Commercially Reasonable

- Courts consider various factors in determining whether a sale was commercially reasonable, including:
  - Price: The price at which collateral is sold is not determinative of whether the sale was commercially reasonable. However, a very low sale price will cause the court to scrutinize the sale procedures more closely.
  - Manner of Disposition: A secured creditor may sells collateral in a public or private sale. Courts typically find a public sale commercially reasonable if the secured creditor gives sufficient notice to the public. A secured creditor can protect itself by holding a public sale, providing at least 30 days' notice, and advertising the sale in appropriate media.
  - A secured creditor's sale will be considered a public sale if "there is a meaningful opportunity for competitive bidding," the sale is advertised to the public, and the public may bid.
  - Courts scrutinize private sales more closely than public sales. Courts are generally concerned with how well a secured creditor marketed the collateral before a private sale. A secured creditor should be able to demonstrate that it solicited multiple offers before making a sale.
  - Time of Disposition: A secured creditor should ensure that the time that it holds the collateral before the sale and and the economic conditions at time of the sale are reasonable. A secured creditor's actions must also be reasonable with respect to the type of collateral that it is selling.
  - For example, it is not commercially reasonable for a secured creditor to let produce rot before disposing of it. Similarly, a secured creditor would act reasonably if it sold seasonal products shortly before those products would be used for the season.

Commercial Reasonableness of Sale: Courts Review All Relevant Circumstances

- Courts look at a foreclosure sale holistically and consider "the aggregate of circumstances. . . rather than specific details of the sale taken in isolation…The facets of manner, method, time, place and terms cited by the [UCC] are to be viewed as necessary and interrelated parts of the whole transaction." *DeRosa v. Chase Manhattan Mortgage Corp.*, 10 AD 3d 317 (1st Dept. 2004).
- "Unfortunately, the UCC does not specifically define the term 'commercially reasonable.' Because the statutory definition of a commercially reasonable sale is vague, the cases generally hold that a factual determination as to whether a sale was commercially reasonable must depend on the particular facts of each case." *Westgate State Bank v. Clark*, 642 P. 2d 961 (Kansas Sup. Ct 1982)

Deficiency Claims Can Be Lost Where UCC Sales Are Not Commercially Reasonable

- A secured creditor that does not follow the sale requirements of Article 9, including giving proper notice and making a commercially reasonable sale, may lose the ability to recover a deficiency claim.
- Section 9-626(a)(3) of the UCC provides that a secured creditor who fails to comply with the commercial reasonableness requirements faces a rebuttable presumption that the amount of proceeds that should have been produced by the sale is equal to the secured obligation plus costs.
- Where sales are not commercially reasonable, many courts do not allow the secured creditor to pursue a deficiency claim.

Successor Liability

UCC § 9-617(a)

A secured party's disposition of collateral after default:

(1) transfers to a transferee for value all of the debtor's rights in the collateral;

(2) discharges the security interest under which the disposition is made; and

(3) discharges any subordinate security interest or other subordinate lien [other than liens created under [cite acts or statutes providing for liens, if any, that are not to be discharged]].

Successor Liability

The common law rule:

An entity which purchases all the assets of another company "does not become liable for the debts and liabilities of its predecessor unless (1) the purchase agreement expressly or impliedly so provides; (2) there was a merger or consolidation of the two firms; (3) the purchaser is a "mere continuation" of the seller; or (4) the transaction was entered into fraudulently for the purpose of escaping liability."

Call Ctr. Techs., Inc. v. Grand Adventures Tour & Travel Pub. Corp., 635 F.3d 48, 52 (2d Cir. 2011)

Successor Liability

The "Friendly Foreclosure"

Often, management of a debtor will cooperate with a lender to transfer the debtor's business assets via to "Newco" via a "friendly foreclosure" via an arrangement under which insiders of the debtor can profit from the continuation of the business free of its existing debts.

"[E]xisting case law overwhelmingly confirms that an intervening foreclosure sale affords an acquiring corporation no automatic exemption from successor liability."

Ed Peters Jewelry Co. v. C & J Jewelry Co., 124 F.3d 252, 267 (1st Cir. 1997)

Successor Liability

When can the purchaser at foreclosure be liable as a "mere continuation" of the debtor?

"In determining whether successor liability exists under the mere continuation theory, the court looks at two factors: common identity of the officers, directors and stockholders in the two companies, and sufficiency of consideration running to the seller corporation in light of the assets sold."

Stoumbos v. Kilimnik, 988 F.2d 949, 962 (9th Cir. 1993)

Public or Private Sale

- A secured party may dispose of property through a public or a private sale. UCC Section 9-610(c).
  - In a public sale or auction, a public notice is given and any purchaser may bid, subject to eligibility criteria set by the secured party.
  - In a private sale, the secured party seeks out interested parties and agrees on sale terms without an auction. The decision whether to pursue a public or private sale must be made in a commercially reasonable manner. UCC Section 9-610, Comment 2.
- With the exception of certain types of collateral such as publicly traded securities, the secured party cannot purchase its own collateral in a private sale. UCC Section 9-610(c)(2).
  - Therefore, the secured party may buy in a private sale collateral of a kind that is customarily sold on a recognized market or is the subject of widely distributed standard price quotations, because there is an established market for such collateral. *See* UCC Section 9-610(c)(2).
  - In a public sale, the secured party may buy any collateral on which it bids. UCC Section 9-610(c)(1).
- Courts are more skeptical of the commercial reasonableness of a private sale. Absent unusual circumstances, a public sale is the safer alternative for a secured creditor.

Thank You

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