Secured Party Sales Under U.C.C. Article 9: A Commonsense Solution to Maximize a Recovery

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The author explains why a secured party sale should be among the alternatives considered by a secured lender that is forced to resort to its collateral as the ultimate source of loan repayment.

The recession of 2008-2009 has toppled many businesses, with a significant additional number of companies likely to fall. In many instances, the companies' plight is so extreme that resuscitation is not possible; the obstacles faced by these businesses are insurmountable. The equity in these companies has been rendered worthless, as have the claims of unsecured creditors. The key consideration is how the company's secured lender, which likely has a blanket lien on the company's assets, can maximize its recovery.

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SECURED PARTY SALE

For many reasons, a secured party sale under the default provisions of Article 9 of the Uniform Commercial Code (the "U.C.C.") is the most sensible solution. It is an out-of-court, statutorily prescribed process by which the debtor's title in its assets is transferred to a purchaser for the agreed-upon consideration; typically, the process can be completed within 30 days. Negotiations occur primarily between the secured lender and the purchaser, as neither the debtor nor its principals are stakeholders in the transaction, based upon the assumption that none of the sale proceeds will be earmarked for equity. Cooperation from the debtor and its principals — on operational issues, customer retention, leasing of real estate from an affiliated entity or a myriad of other issues — is typically forthcoming, either as a result of the specter of a suit on a personal guaranty or the enticement of a short-term consulting agreement offered by the prospective purchaser of the company's assets.

Before examining the particulars of a secured party sale, it is instructive to analyze why it may be preferable to other exit strategies for a secured lender. An asset or stock sale by the debtor is usually not practical. Only in rare circumstances will a sophisticated purchaser incur the time and expense negotiating an asset or stock purchase agreement directly with the debtor, knowing that indemnification for breaches of representations, warranties or covenants will be provided by a shell entity or, equally unsatisfying, an individual who lacked the financial wherewithal or conviction to keep the business afloat. The secured lender, to whom most or all of the proceeds of sale will be paid, will resist any attempt to escrow a portion of the closing proceeds in order to protect the purchaser against future contingencies. Moreover, if there are junior liens encumbering the debtor's assets and the purchase price is insufficient to repay the senior lender in full, a purchaser must make the acquisition subject to those subordinate liens and, thereafter, negotiate directly with the junior lienholder. The likely consequences to the purchaser are added cost and distractions from running the business.

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BANKRUPTCY'S CHALLENGES

Bankruptcy presents its own challenges. Principals of the debtor are often opposed to bankruptcy for fear of calling attention to a business failure and thereby damaging their reputations; this is especially true for companies whose ownership structure includes private equity firms. Another concern with bankruptcy is that it is a costly process, saddling the estate with one or more layers of professional fees that can be avoided, or at least minimized, through a secured party sale. A sale of assets out of the ordinary course through the bankruptcy process often requires a court-sanctioned bidding process that is designed to encourage third parties to bid on the debtor's assets. Intended to maximize the price realized for those assets, competitive bidding may discourage a strategic purchaser from proceeding with the transaction, due to the risk that the purchaser may be outbid in a bankruptcy sale without any assurance of receiving a break-up fee sufficient to compensate it for the time and resources that it would have to devote pursuing an acquisition of the debtor.

Whether in the context of a direct purchase from the debtor or a Section 363 sale under the auspices of bankruptcy, the cost of delay cannot be overemphasized. Theoretically, the purchaser of a debtor's assets assumes no liabilities or only those liabilities specified in a purchase agreement; however, theory and reality frequently diverge. To avert disruption to a business, certain liabilities will have to be assumed. Those liabilities may include past due payroll and the attendant costs of accrued sick and vacation days; utilities, especially if following consummation of the transaction the business will be conducted from the same facility; trade payables to critical raw materials and other vendors; license or franchise-related obligations; and insurance premiums, as existing carriers (who understand the risks presented by the debtor company, its products and its work force) are often the most likely source of ongoing coverage after the closing has occurred. These liabilities grow on a daily basis, often without a corresponding increase in revenue, resulting in escalating costs to the purchaser or a diminishing recovery for the secured lender. Another concomitant of delay is customer defections, as a debtor's financial woes often disrupt production, distribution and customer service. The streamlined process of a secured party sale is an effective means of mitigating these risks.

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THE ESSENTIALS OF A SECURED PARTY SALE

How does a secured party sale work? The first step is for the secured party to disseminate a notice of disposition of collateral to those parties, including the debtor, any guarantors and certain lienholders of record, entitled to receive notice under Section 9-611 of the U.C.C.[1] The notice identifies the secured party and the debtor, the collateral being sold and the date of a public sale or the date after which a private sale will occur which, in all events, must be at least ten days after the notice of disposition of collateral has been sent.[2] A private sale is the preferred means if a purchaser of the assets has already been identified; the discussion of the secured party sale process that follows assumes that the disposition will be through a private sale.

Promptly after the notice of disposition of collateral is sent, the secured party and the purchaser negotiate the definitive purchase agreement. At a minimum, the agreement sets forth the assets being conveyed — typically on a schedule that reiterates the description of the collateral contained in the security agreement — and the purchase price. A prudent purchaser will require in the agreement assurances from the secured party that it has not transferred, released or otherwise compromised the lien that is the basis for the secured party sale and will also require conditions precedent to closing, the satisfaction of which usually requires cooperation from the debtor.

By way of example, if there is goodwill associated with the debtor's corporate name or an alternate or fictitious name under which the debtor conducts business, the purchaser may want to utilize that name which, in turn, will require the debtor to amend its organic documents to effect a name change or to abandon the alternate or fictitious name; neither the rights and remedies afforded by the U.C.C. nor those provided in most security documents enable the secured lender to accomplish that end. For the reasons noted above, the debtor and its principals who have guaranteed the debt will typically pledge their cooperation, signing the definitive purchase agreement for that purpose and to waive certain rights they would otherwise have under the U.C.C. Among the rights waived by the debtor and guarantors are the right to redeem the collateral, one of several rights

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that can only be waived pursuant to an agreement entered into after the occurrence of an event of default.[3] In negotiating the definitive agreement, the lender will refuse to provide warranties regarding the assets being transferred and insist upon obtaining a general release from the debtor and the guarantors; the loss associated with writing off a portion of the loan should never be exacerbated by a subsequent suit alleging lender liability or other wrongdoing on the part of the lender.

EFFECT

The consummation of a secured party sale results in the secured party conveying to the purchaser whatever rights the debtor had in the assets covered by the secured party's lien under Article 9 of the U.C.C.[4] The operative conveyance document is a secured party bill of sale, which identifies the assets being conveyed, notes that the conveyance is being made pursuant to a secured party sale under Article 9 of the U.C.C. and, accordingly, disclaims all warranties, including warranties of title, merchantability and fitness for a particular purpose. The secured party sale effects a discharge of the secured party's lien, as well as all subordinate liens, without the need to file U.C.C.-3 termination statements.[5] A critical element of a purchaser's due diligence is, accordingly, verifying that the secured party's lien is a first, perfected security interest and covers all essential assets owned by the debtor. In that regard, the purchaser and its counsel must be mindful of those categories of assets that cannot be perfected by filing a U.C.C. financing statement.[6] If the assets in question include registered patents, copyrights or trademarks, assignments to be filed in the U.S. Copyright Office or the U.S. Patent and Trademark Office are advisable, so long as the debtor's cooperation is forthcoming. It should be noted, however, if the assets being conveyed are evidenced by a certificate of title (e.g., a motor vehicle) or are otherwise registered (e.g., a copyright), in conjunction with a secured party sale, Section 619 of the U.C.C. provides for the issuance by the secured party of a "transfer statement" and directs the public official that maintains the applicable registry to record the change in title, subject to the payment of any applicable fee.[7]

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CONCLUSION

A secured party sale under Article 9 of the U.C.C. is a means by which a secured lender can realize on the debtor's collateral, without the need to institute litigation or bankruptcy proceedings. It is expeditious, cost-effective and free of the adverse publicity that frequently accompanies a bankruptcy filing. The cooperative nature of a secured party sale often results in the release of a debtor's principals from personal guaranties and a fresh start. While not appropriate in all circumstances, a secured party sale should be among the alternatives considered by a secured lender that is forced to resort to its collateral as the ultimate source of loan repayment.

NOTES

[1] U.C.C. § 9-611(c) (2000).
[2] U.C.C. §§ 9-612 to -613.
[3] U.C.C. § 9-624.
[4] U.C.C. § 9-617(a)(1).
[5] U.C.C. § 9-617(a)(2)–(3).
[6] *See, e.g*. U.C.C. §§ 9-104, -105, -106, -107, -109.
[7] U.C.C. § 9-619.

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