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Understanding UCC Article 9 Foreclosures

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AGENDA

Introduction to UCC Article 9 Foreclosure (3 minutes)

- What Is It?
- When Is It Used?
  - Type of Collateral
  - Pros
  - Limitations
- Steps Taken

Methods of Foreclosure — Section 9-610(c) (7 minutes)

- Private Sale
- Public Sale
- Strict Foreclosure
  - Requirements/Steps
  - Satisfaction of Debt

Requirements (30 minutes)

- Notice
  - When Must Notice Be Given?
  - To Whom Must Notice Be Given?
  - What Information Must Be Included in the Notice?
- Commercially Reasonableness
  - Definition — Section 9-610
  - Tests Employed by Courts
  - Requirements
  - When Not Applicable
- Price Determination
  - Public — Meaningful Opportunity

Post-Sale Procedures (5 minutes)

- Application of Proceeds
- Liability for Deficiency
- Right to Surplus

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- Successor Liability
  - De Facto Merger/Consolidation
  - Mere Continuation
  - How to Avoid?
- Language in Purchase Agreements
- Failure to Comply With Article 9 Enforcement Rules

Questions and Answers (10 minutes)

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Understanding UCC
Article 9 Foreclosures
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A. What Is It?

- UCC foreclosure is a non-judicial proceeding that is commenced by the secured creditor when there is no dispute as to the underlying obligation.
- Governed by Article 9 and permits a secured creditor to proceed against the debtor and foreclose on its collateral efficiently by either selling or taking possession of the collateral, similar in some respects to a section 363 sale in bankruptcy.
- Adopted by virtually every state (with possible minor modifications).

A. What Is It?

Basic statutory provision that governs UCC foreclosures is Article 9, section 610(a), which provides:

"[A]fter default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition following any commercially reasonable preparation or processing." UCC § 9-610(a).

B. When Is It Used?

- **Type of collateral**
  - Only available for personal property, including equity of an operating business
  - Not available for real estate
- **Pros**
  - Faster alternative to bankruptcy proceeding
  - Generally, more cost-effective

B. When Is It Used?

- **Limitations**
  - Susceptible to being stayed at any time due to the filing of a bankruptcy petition;
  - Usually no court order approving sale or addressing deficiency claims;
  - Does not address unsecured claims;
  - Sale may not yield highest price;
  - Potentially susceptible to successor liability claims.

C. Steps Taken

- Commencing a UCC foreclosure requires adhering to the requirements of Article 9.
- Usually, a secured creditor seeking to foreclose on its collateral must complete the following steps:
  - Determine what type of foreclosure sale it wants to proceed with
  - Provide adequate notice (which defers depending on type of sale)
  - Conduct the sale in a commercially reasonable manner, which includes determining price of collateral
  - Properly apply the proceeds and any surplus



II. Methods of Foreclosure — Section 9-610(c)

- Private Sale
- Public Sale
- Strict Foreclosure



A. Private Sale

- Pursuant to section 9-610(b), a creditor may foreclose on collateral by selling the collateral at a private sale.
- Private sales are generally encouraged under Article 9 due to it frequently resulting in higher realizations on collateral for all interested parties.
- Requires reasonable notice.
- Private sale eliminates the time and expense of advertising a public sale.

A. Private Sale

- Foreclosing secured creditors may not participate as a potential buyer in a private sale unless,
  - "the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations." UCC § 9-610(c).
  - Because these exceptions are narrow and generally only apply to certain assets, foreclosing secured party rarely is able to acquire assets in a private sale.

B. Public Sale

- Section 9-610(b) provides that a creditor can foreclose upon collateral by selling the collateral at a public sale.
- Reasonable notification of the foreclosure sale is required.
- Unlike disposition at a private sale, the sale price of the collateral is determined after the public has had a meaningful opportunity (defined below) for competitive bidding.

C. Strict Foreclosure

- Under section 9-620(a) creditors may accept “in full or partial satisfaction of the obligation” with respect to any type of collateral, whether tangible or intangible, and whether or not the collateral is in the secured party’s possession.
- In addition, the secured party may strictly foreclose upon equity interests taken as collateral in either partial or full satisfaction of a debt.

C. Strict Foreclosure

Before initiating a strict foreclosure, a secured party must take the following procedural steps:

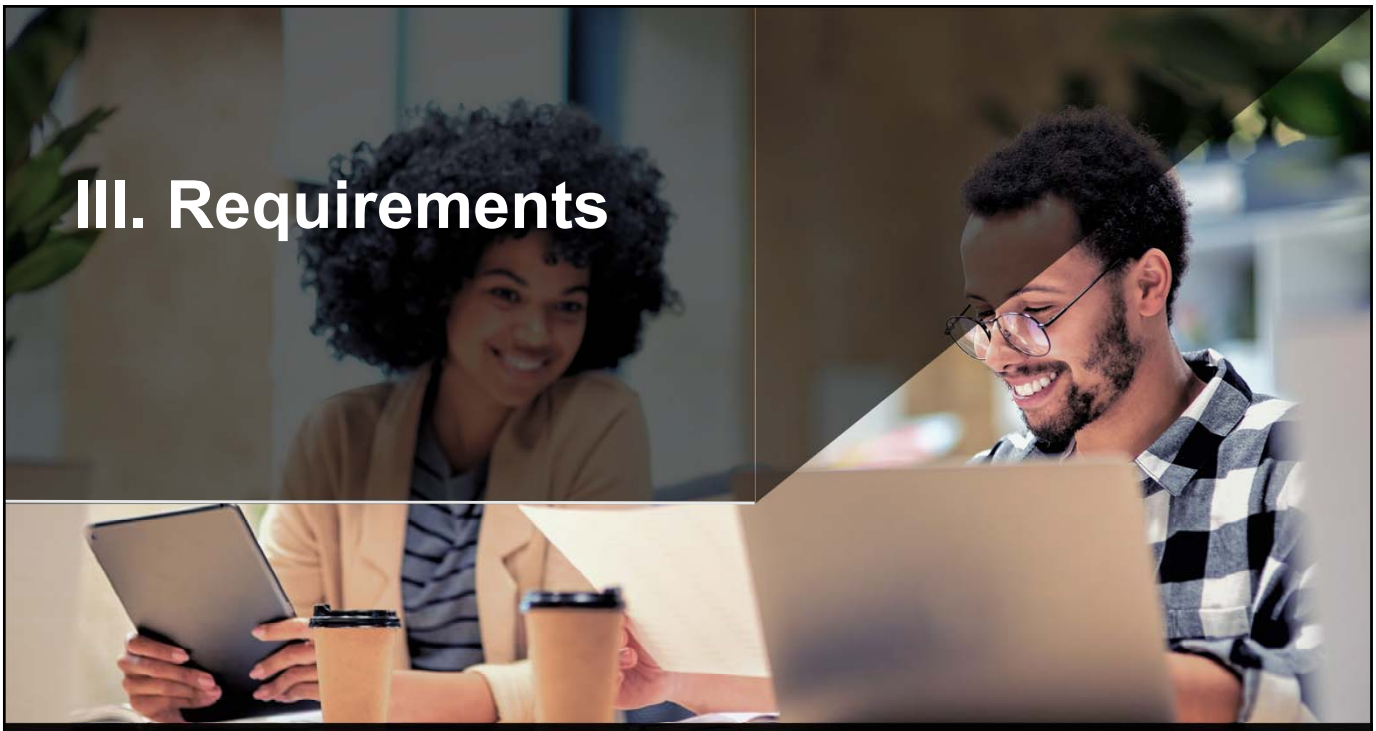
- Must provide notice of the proposed strict foreclosure and include whether the strict foreclosure will be in partial or full satisfaction of the debt.
- If the parties who received notice object to the foreclosure, for any reason, or no reason at all, within twenty (20) days after the proposal was sent, the secured party cannot proceed with the proposed strict foreclosure.
- If there are conditions or the collateral is being accepted in partial satisfaction, the debtor must consent.

UCC § 9-620(c)(1)

C. Strict Foreclosure

- Once a senior lender has strictly foreclosed upon the assets in which a junior lender had a subordinate interest, the junior lender's interests are extinguished.
- The foreclosure proposal is, therefore, binding on the junior lender.
- As such, best for subordinated creditor to object to a senior lender's strict foreclosure if the value of the assets is greater than the debt owed to the foreclosing secured lender. Before initiating a strict foreclosure, a secured party must take the following procedural steps:
  - Must provide notice of the proposed strict foreclosure and include whether the strict foreclosure will be in partial or full satisfaction of the debt.
  - If the parties who received notice object to the foreclosure, for any reason, or no reason at all, within twenty (20) days after the proposal was sent, the secured party cannot proceed with the proposed strict foreclosure.
  - If there are conditions or the collateral is being accepted in partial satisfaction, the debtor must consent.

UCC § 9-620(c)(1)



A. Notice

When must notice be given?

- Proper notice of a sale is dependent upon which type of sale is being utilized.
  - Private Sale requires:
    - Reasonable notice
    - Notice must contain time after which such sale is to occur
  - Public Sale requires:
    - Reasonable notice of the foreclosure sale date (at least 10 days)
    - Notice must contain time and place of public disposition to the debtor, secondary obligors, and other persons of which the security party is deemed to have notice of such person's interests
    - Recommended for secured party to order a lien search twenty to thirty days prior to proposed sale
  - Strict Foreclosure requires:
    - Reasonable notice to the same parties required to receive notice in a public sale
    - Notice must include whether the strict foreclosure will be partial or full satisfaction of the debt

A. Notice

What information must be included in the notice?

- In addition to information regarding the time and location of the sale, proper notice may require the inclusion of all information reasonably required for a potential purchaser to make an informed decision.

- For example:
  - The sale of a car may require the notice to include the year, make, model, condition, and mileage.
  - The sale of equipment may require the opportunity for pre-inspection and the dates/times for pre-inspection. Westgate State Bank v. Clark, 231 Kan. 81, 642 P.2s 961 (1982).

B. Commercially Reasonableness

- Section 9 -610(b) provides that
  - "[E]very aspect of a disposition of a collateral, including method, manner, time, place, and other terms, must be commercially reasonable." UCC § 9-610(b).
- A commercially reasonable disposition of collateral occurs when:
  - It is done in the usual manner on any recognized market;
  - It is sold at the current price in any recognized market at the time of disposition; or
  - It is disposed in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

UCC § 9-627(b).

B. Commercially Reasonableness

Also, commercially reasonable if the disposition has been approved by:

- A judicial proceeding;
- A bona fide creditors' committee;
- A creditors' representative; or
- By an assignee for the benefit of the creditors.

UCC § 9-627(d).

B. Commercially Reasonableness

- Whether collateral has been disposed of in a commercially reasonable manner is determined on a case-by-case basis.
- Notwithstanding, courts often look to the following factors:
  - Whether an investment bank was hired;
  - Whether an offering memo was prepared;
  - Whether potentially interested parties were contacted;
  - Whether notices of the sale were published in local or national newspapers or trade publications.

B. Commercially Reasonableness

Courts often employ the following tests when determining commercially reasonableness:

- **Proceeds Test**
- **Totality of the Circumstances Test**
- **Procedures Test**

B. Commercially Reasonableness

Proceeds Test

- Under the proceeds test, courts generally focus on the disparity between the sale price and the value of the collateral.
- Generally, courts will not reject a sale based solely on disparity, unless the disparity shocks the conscience. In re Adobe Trucking, Inc., 2011 WL 6258233 (Bankr. W.D. Tex. Dec. 15, 2011).

B. Commercially Reasonableness

Totality of the Circumstances Test

- Under the totality of the circumstances test, courts look at all circumstances with the price disparity being only one important factor.
- If the price disparity is large, the courts will look with close scrutiny. *Id.*
- Most cited case for this test is *In re Zsa Zsa, Ltd*., 352 F. Supp. 665 (S.D.N.Y. 1972).

B. Commercially Reasonableness

- *In re Zsa Zsa, Ltd*., 352 F. Supp. 665 (S.D.N.Y. 1972)
- Bankruptcy trustee challenged $300,000 sale price of collateral, which had an estimated retail value of $3.5 million, and a wholesale value of $1.5 million.
- Trustee also objected to terms and timing of advertisements ran by the creditor.
- Ultimately, the court determined that:
  - "It is the aggregate of circumstances in each case — rather than specific details of the sale taken in isolation — that should be emphasized in a review of the sale."
  - Focusing on the procedural aspects of the sale rather than the proceeds, the court ruled that the sale, despite the large disparity, was commercially reasonable.

B. Commercially Reasonableness

Procedures Test

- Under the procedures test, courts focus on how the sale was conducted and the efforts made by the creditor to achieve the best price.
- The price, however, is not determinative on the issue of whether the sale is commercially reasonable.
- As such, courts will uphold the sale if the secured party conducted the sale procedurally proper, even if the sale yielded a very low price.
- *Adobe Trucking, Inc*., 2011 WL 6258233, at *19.

B. Commercially Reasonableness

Examples of Commercially Reasonable Transactions

- *Adobe Trucking, Inc. v. PNC Bank (In re Adobe Trucking, Inc.)*, 551 F. App'x 167 (5th Cir. 2014) — sale deemed commercially reasonable despite a below-market bid because the sale was conducted according to the parties' credit agreement as authorized under N.Y. U.C.C. § 9-603.
- *SNCB Corp. Fin. v. Schuster*, 877 F. Supp. 820 (S.D.N.Y. 1994), *aff'd*, 71 F.3d 406 (2d Cir. 1995) — sale deemed commercially reasonable finding that the creditor was not obligated to delay the sale of the collateral in the hope of obtaining a higher price where price disparity alone is insufficient to determine a disposition commercially unreasonable.

B. Commercially Reasonableness

When not applicable

- Safe Harbors
  - If the collateral cannot be sold in a "recognizable market" such as a stock market.
  - If the collateral is sold pursuant to a court order (i.e., section 363 sale order in bankruptcy) UCC § 9-627(c)(1).
  - If the collateral is disposed of in a manner consistent with practices of dealers of similar collateral.

B. Commercially Reasonableness

When not applicable

- Terms by Agreement with Secondary Obligors
  - While parties cannot waive the commercially reasonable requirement, they can "determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor or the duties of the secured party if the standards are not manifestly unreasonable. UCC § 9-602.
  - Defining commercial reasonableness is highly recommended as it spells out what is required and, so long as the terms are not manifestly unreasonable, should be upheld on a motion for summary judgment, eliminating the need for costly trial. *See Adobe Trucking, Inc*., 2011 WL 6258233, at *24.

B. Commercially Reasonableness

When not applicable

- Non-consumer cases
  - The secured party need not prove commercial reasonableness unless an obligor or secondary obligor raises the issue. See UCC § 9-626(a)(1).
  - If raised, and the collateral was not sold in a commercially reasonable manner, the secured party may have jeopardized its ability to recover any deficiency, and in addition may be liable for damages. See § 9-626(c).

B. Commercially Reasonableness

Rebuttable Presumption — Non-consumer cases Section 9-626(a)(4)

- If secured party fails to conduct a commercially reasonable sale in non-consumer transactions, there arises a rebuttable presumption that the collateral had a value equal to the balance of the debt. UCC § 9-626(a)(4).
- Thus, the burden shifts to the secured party to prove that the value receives was, indeed, commercially reasonable, or to show what amount should be found to be commercially reasonable value and credited to the obligor.

B. Commercially Reasonableness

- In consumer cases, Article 9 does not impose or preclude a rebuttable presumption.
- Courts at their discretion, may impose a rebuttable presumption or irrebuttable presumption in consumer cases.
- Even if the sale is defective, due to being commercially unreasonable, the foreclosure sale will discharge all junior liens, so long as the buyer acted in good faith. UCC § 9-617(b).

C. Price Determination

- In a public sale, price is determined after the public has had meaningful opportunity for competitive bidding
- Meaningful opportunity requires that some form of advertisement or public notice precedes the sale and that the public must have access to the sale. See Official Comment 7 to UCC § 9-610.
- Because advertising is the essential element in creating "meaningful opportunity for bidding," serious thought should be given to determine which type of publication to advertise in.

C. Price Determination

- Proper publication can depend on the type of assets being foreclosed upon.
- For example:
  - Publication in a widely-circulated newspaper may be appropriate for the sale of equity interests in an entity that owns a small or moderate amount of real estate.
  - However, national publication may be required in a newspaper such as the Wall Street Journal for entities that own large tracts or property or property in multiple states.
  - In addition, advertisement in trade journals may be required if there are journals applicable to the type of property or business operated by the entity.



A. Application of Proceeds

Pursuant to section 9-615 proceeds must be applied as follows:

- Reasonable expenses and, to the extent provided for by agreement and not prohibited by law, reasonable attorney's fees and legal expenses incurred by the secured party.
  - Satisfaction of obligations secured by the security interest.
  - Satisfaction of obligations secured by any subordinate security interest in or other subordinate lien on collateral if:
    - an authenticated demand for proceeds is received prior to the completion of distribution
    - in case in which a consignor has an interest in the collateral, the subordinate security interest or other lien is senior to the interest of the consignor; and
  - A secured party that is a consignor of the collateral if the secured party receives from such consignor an authenticated demand for proceeds before distribution is completed.

B. Liability for Deficiency or Right to Surplus

- If the sale of the collateral is insufficient to satisfy the debt in full, the foreclosure creditor may pursue the debtor for any deficiency, unless the parties have agreed to a strict foreclosure. UCC § 9-615(d)(2).

- Likewise, if after application of the proceeds and payment of the debt, there exists surplus funds, section 9-615(d) requires the secured party to pay such proceeds to the debtor. UCC § 9-615(d)(1).

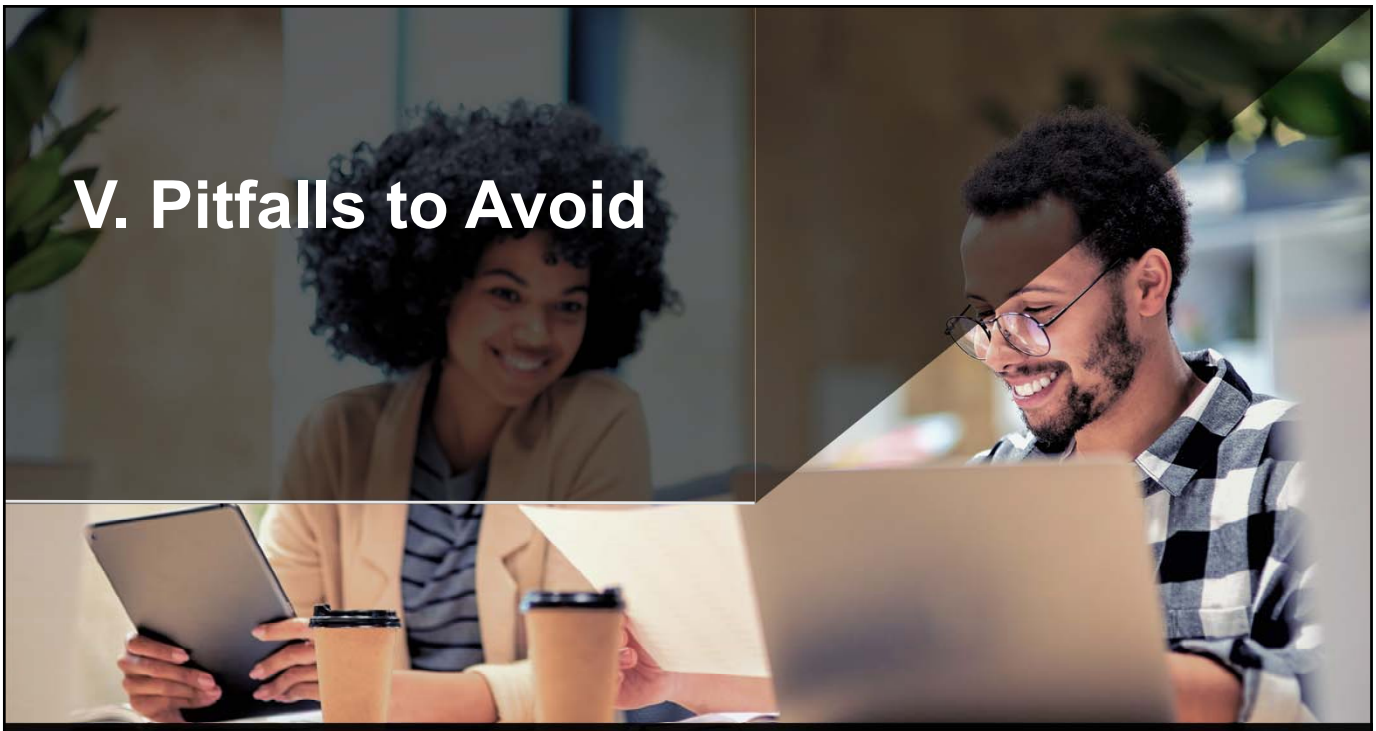
Unless…

B. Liability for Deficiency or Right to Surplus

The underlying transaction is a sale of accounts, chattel paper, payment intangibles, or promissory notes, the debtor is not entitled to surplus nor is liable for any deficiency. UCC § 9-615(e).

B. Liability for Deficiency or Right to Surplus

- When the foreclosing party purchases its own collateral at a foreclosure, section 9-615(f), governs the calculation of the deficiency.
- In this situation, because the foreclosing creditor may lack the incentive to maximize the proceeds of a disposition, section 9-615(f) requires that the deficiency be calculated as if the disposition was to an unrelated party.



A. Successor Liability

The general rule is that a corporation that buys the assets of another entity does not assume the liabilities of that entity (seller). However, successor liability may apply upon the existence of the following exceptions:

- Implied or express agreement to assume liabilities
- Fraudulent sale of assets
- *De facto merger*
- Where the purchaser is a mere continuation of the seller

A. Successor Liability

When a buyer acquires the assets of the seller through a UCC foreclosure sale, the buyer may become liable for the seller's debts under any of the above-referenced exceptions. Here, we will only discuss the last two exceptions and how to avoid such liability.

A. Successor Liability

- *De facto* merger occurs when the transaction between two companies is not structured as a merger, but the effect of the transaction yields the same results.
- Courts will find that a *de facto* merger has occurred when there is:
  - Continuity of ownership
  - Continuity of management, personnel, and physical operation;
  - Cessation of ordinary business and dissolution of the predecessor as soon as practically and legally possible; and
  - Assumption by the predecessor of the liabilities ordinarily necessary for the uninterrupted continuation of the business of the predecessor.

A. Successor Liability

- Courts do not agree whether all factors/elements must be shown prior to applying the de facto merger doctrine.
- Courts do agree that continuity of ownership is a threshold element, albeit not sufficient to warrant a finding on its own.
- *De Facto* merger is often applied sparingly.

A. Successor Liability

In *Miller v. Forge Mench P'ship*, 2005 U.S. Dist. LEXIS 1524 (S.D.N.Y. Jan. 31, 2005), the court determined that because the buyer continued the factoring relationship with the seller's creditors on identical terms and continued the same business, from the same location with the same employees, the de facto merger doctrine was applicable therein.

- There, a judgment debtor was in default of the lender's factoring agreement. The debt to the lender exceeded the value of the assets on the date of the sale by $2.5M. While the fraudulent transfer claims failed, the court determined that the buyer (new company) was formed solely to acquire the judgment debtor's assets and was owned by the same owners as the judgment debtor's corporate partners. Accordingly, enough factors existed for the de facto merger doctrine to apply.

A. Successor Liability

- Mere continuation exception applies when there is a continuation of directors and management, shareholder interest, and, in some cases, inadequate consideration.

- The gravamen of the traditional "mere continuation" exception is the continuation of the corporate entity rather than the continuation of the business operation.

A. Successor Liability

Courts have considered the following factors when determining whether the mere continuation exception applies:

- Number of employees that continued working for the buyer (new company)
- Whether members of senior management worked for the new company
- Whether and to what extent the new company acquired assets and liabilities of the seller
- Whether new company conducted the same business and provided the same services
- The purpose of the acquisition — was it merely to continue the seller's business by acquiring its assets while failing to contribute any assets, employees, or operations to the business' continuation. Call Ctr. Techs., Inc. v. Grand Adventures Tour, 635 F.3d 48 (2d Cir. 2011) (vacated summary judgment, trial needed to determine application of mere continuation exception)

A. Successor Liability

How to Avoid?

- Change of management
- Due diligence — examine tax and financial records
- Take certain steps to differentiate the new company from the old
  - New name
  - New tax identification numbers
  - New bank accounts/leases
  - New creditors
  - Change locations
  - Structure of purchase agreement as an asset purchase
  - Provisions in the purchase agreement to protect the buyer

B. Language to Include in Purchase Agreements

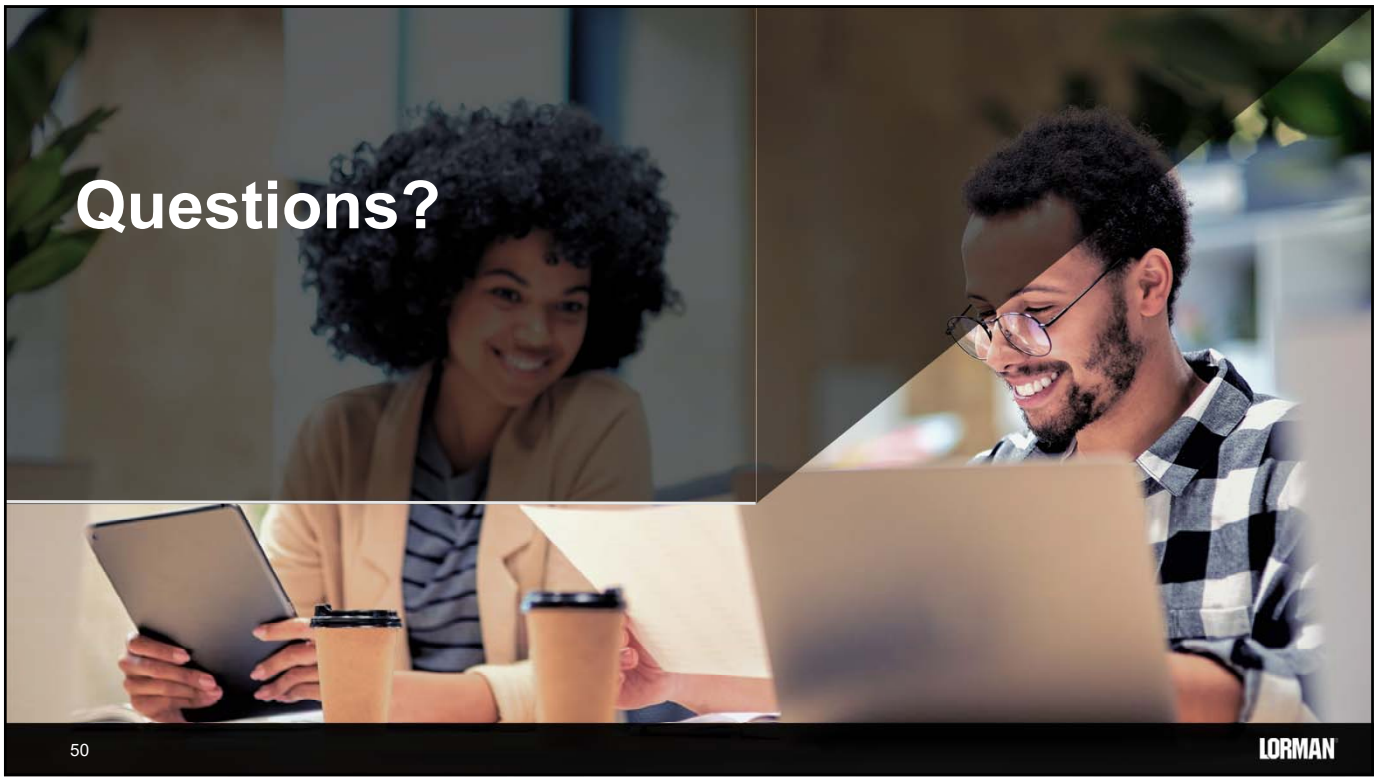
Purchase agreements may include

- Protective provisions and adequate remedies, such as strong representations and warranties
- Tailored indemnification language
- Avoid provisions providing for implied assumption of liability
- Holdback provisions

C. Failure to Comply With Article 9 Enforcement Rules

Section 9-625 discusses available remedies for when a secured party fails to comply with Article 9 Enforcement Rules, it provides:

- A court may order or restrain collection, enforcement, or disposition of collateral.
- A party may be liable for damages in the amount of any loss caused by the failure to comply.



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