

Dealing With Defaults Under Article 9 of UCC: A Player's Guide for the 21st Century

*Etahn Cohen and Jonathan P. Friedland**

Dealing With Defaults Under Article 9 of UCC: A Player's Guide for the 21st Century, by *Etahn Cohen and Jonathan P. Friedland*, begins with a summary of the legal remedies available under Article 9 of the UCC to a lender whose loan is secured by the personal property of a borrower who is in default. The article then discusses how these legal remedies can be implemented in practice. Also reviewed are a borrower's possible responses to lender actions. Part II of the article explores the dynamics of the application of these legal provisions through concrete examples in various situations.

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*Etahn Cohen and Jonathan P. Friedland are partners with the law firm of Sugar Felsenthal Grais & Helsinger LLP. This article is a preview of a chapter that will be included in the forthcoming 2022–2023 edition of *Strategic Alternatives For and Against Distressed Businesses*, published by Thomson Reuters. The authors thank their colleague, Clare T. McKeown, for her substantial and excellent assistance with this article.

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Part I. Article 9 Explained

A. Introduction & Intended Audience

This article aims to arm business borrowers and lenders with options and strategies when the borrower defaults on a loan secured by personal property. Readers (whether a borrower or a lender be,¹ whom we assume include both attorneys who do not specialize in secured lending and, indeed, businesspeople who are not attorneys at all, will be exposed to applicable laws and strategic considerations involved in navigating through a borrower's default under Article 9 of the Uniform Commercial Code (UCC).

B. Background

Most banks (and bank-like lenders) make loans to businesses on a *secured* basis, with their loans being secured by substantially *all* the borrower's property. In legal terms, the bank has a lien (*a.k.a.*, security interest) on substantially all the borrower's property (*a.k.a.*, collateral). A lender who

¹William Shakespeare, *Hamlet*, act 1, sc. 3. While a misquote of Polonius (who advises *against* being a borrower or a lender to friends), the theatrical reference prepares you for Part II.

underwrites its loan primarily in reliance on being able to foreclose on their security interest is commonly called an *asset-based lender*. Even a *cash-flow lender* (*i.e.*, one who lends primarily on the strength of a borrower's ability to pay the lender back from current cash flow), however, typically requires a security interest in substantially all the borrower's property.

The borrower, in either case, may own both real estate and other assets on which the lender may have a lien. This article focuses on *personal property*, which is simply *non-real estate* assets. Some borrowers may give certain lenders a lien on (or, to use another legal term, a *pledge of*) less than all the borrower's personal property (*e.g.*, a lender may have a lien on only one or more specifically identified pieces of equipment, only on accounts receivable, or only on inventory contained in a specific location). However, borrowers commonly have *at least one* lender that has a lien on substantially all of their personal property.

The law governing liens on most personal property in all 50 states is derived from Article 9.

C. What is the UCC?

The best way to answer the question “what is the UCC?” is to start by explaining what it is not. The UCC itself is *not* the law in any state.

The UCC is a compilation of “suggestions” written for, and directed to, state legislatures to adopt as law. These suggestions have been immensely successful. Nearly every state has adopted the majority of the UCC. Though states made some changes, those changes are generally minor.²

The UCC was originally a joint project of the Uniform Law Commission (formed in 1892 to create uniform commercial laws) and the American Law Institute. The UCC is maintained and updated periodically by the Permanent Editorial Board (PEB) of the Uniform Commercial Code. The PEB does this by (a) making amendments that continue to be adopted into law substantially as written by almost all the states, and (b) issuing interpretative releases which are

²Here is a state-by-state guide to all 50 states' actual codification of its version of the UCC. See https://www.law.cornell.edu/wex/table_ucc.

persuasive evidence of the meaning of UCC provisions but do not have the force of law.

Courts also look to the official commentary in the UCC for guidance. Because of the uniform nature of the UCC, courts in one state look to cases decided by courts in other states far more frequently than occurs in many other areas of the law.³

The UCC is divided into 11 Articles. Each Article addresses a different area of commercial law. UCC Article 9 governs security interests in personal property and contains detailed rules regarding:

- (a) the *creation, attachment, and perfection* of security interests in personal property (*i.e.*, most property that is not real estate);
- (b) the relative *priorities* of competing security interests; and
- (c) *remedies* available to a creditor upon a borrower's default.

D. A Relationship is Born!

The relationship of borrower and lender is governed by Article 9 when the following conditions are met:

- The lender loans money to a borrower, and the borrower agrees to grant a security interest in *collateral* consisting of personal property;
- The borrower signs an agreement (*a.k.a.*, a *security agreement*) agreeing to the security interest and describing the collateral with reasonable specificity;⁴ and
- The lender, with certain exceptions, files a UCC-1

³UCC Article 9 is enacted by all 50 states and, as a uniform law, decisions from all states and federal courts interpreting the UCC may be considered. *Durham Commercial Capital Corp. v. Select Portfolio Servicing, Inc.*, 90 U.C.C. Rep. Serv. 2d 1248, n.19 (M.D. Fla. 2016); *In re Ajax Integrated, LLC*, 554 B.R. 568, n.12, 90 U.C.C. Rep. Serv. 2d 464 (Bankr. N.D. N.Y. 2016).

⁴*In re Hintze*, 525 B.R. 780, 85 U.C.C. Rep. Serv. 2d 767 (Bankr. N.D. Fla. 2015) where the judge held that a description in a security agreement of "all of Maker's assets" failed to meet the specificity standards required of a security agreement under UCC Article 9.

Taking a step back, under UCC Article 9, a security interest must first attach to the collateral and become enforceable against the debtor and third parties before perfection can occur. In the words of Section

financing statement (Financing Statement) with the secretary of state office of the state where the business is formed. The Financing Statement states that the lender has a lien on the borrower's assets, which may be specifically described or be listed simply as "all assets."

While the above represents the standard arrangement between borrower and lender, depending on the assets, different steps may be required with respect to certain classes of personal property governed by laws other than Article 9 to ensure that the security interest is a valid lien with respect

9-203(b), a security interest in collateral is generally enforceable against the debtor and third-parties with respect to the collateral only if the following three conditions have been satisfied: "(1) value has been given; (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and . . ." (3) one of a variety of third conditions have been met, the most commonly used of which is that "the debtor has authenticated a security agreement that provides a description of the collateral . . ."; or the secured party has possession or control of the collateral.

While a full discussion of the concept of attachment is outside of the scope of this chapter, a failure of the security agreement to identify the collateral with sufficient specificity as required by Section 9-108(a) will cause a security interest to fail for lack of attachment. Under Section 9-108(a) the requirement is that the security agreement reasonably identify the collateral, and in most cases, merely describing the types of collateral, using the categories specified in the UCC, is sufficient. Consequently, whether a UCC financing statement was properly filed may be irrelevant if the underlying security agreement is inadequate with the result that the purported lien of the purportedly secured creditor loses to the trustee in bankruptcy or a secured creditor that has perfected its security interest in the collateral.

The prior two paragraphs are borrowed from *Commercial Bankruptcy Litigation* § 16A:5, published by Thomson Reuters. Jonathan Friedland is the principal author and editor-in-chief of *Commercial Bankruptcy Litigation* and its sister treatise, *Strategic Alternatives For and Against Distressed Businesses*, also published by Thomson Reuters. Etahn Cohen is co-author (with Louis S. Chiappetta of the Mayer Brown law firm) of the 2021 edition of *Commercial Bankruptcy Litigation* ch. 16A, titled "Intersection of UCC Article 9 and Other Statutes for Perfecting Security Interests and Bankruptcy Law." Cohen and Friedland are partners with the Sugar Felsenthal law firm.

to a such personal property that is enforceable against the borrower and third parties.⁵

Stated another way, a lender cannot perfect (obtain) a first-priority lien (and in some cases, any lien at all) in such property by causing a borrower to sign a security agreement and then filing a Financing Statement. Examples of such property are:

- Property subject to federal law with its own procedures for perfecting a security interest preempting state law (*e.g.*, ships, rolling stock, aircraft, aircraft engines, propellers, and federally registered copyrights);⁶
- Property for which ownership is evidenced by state-issued certificates of title (*e.g.*, cars and trucks). A lien on this type of property must be notated on the certificate of title through the secretary of state's office;
- Deposit accounts, in which only a lender with control (as defined in the UCC) has a perfected security interest;
- Actual cash money can only be secured by physically possessing the cash;
- Items that are outside of federal and state statutory law, including the UCC, such as life insurance policies, in which a security interest can only be perfected under

⁵While the above represents the standard form of a secured transaction, many other arrangements that look very different have been held to be a sale with a deferred purchase price and a security interest that fall under Article 9 and held to fail to create a perfected security interest because they do not follow the rules set forth in Article 9. *See* for example, in *In re Hawaii Motorsports, LLC*, 623 B.R. 786, 103 U.C.C. Rep. Serv. 2d 601 (Bankr. D. Mont. 2020) an elaborate arrangement where the financier owned the inventory and the sale proceeds through a trust arrangement was held to be a disguised secured loan where the lender did not have a perfected lien because it had not filed a financing statement in the property place.

⁶*See, e.g.*, *Matter of Imagine Air Jet Services, LLC*, 2020 WL 5499097 (Bankr. N.D. Ga. 2020) (secured creditor's security interest in aircraft deemed avoidable in bankruptcy where the creditor failed to perfect its interest by filing the security agreement with the FAA).

the state's common law (the law created by state courts over time);⁷ and

- Property subject to state statutes giving certain parties possessory liens (which often trump a UCC lien) or liens perfected by other means, primarily in the agricultural area.

Our hypotheticals in Part II assume, unless otherwise stated, that the borrower has pledged substantially all of its personal property to a lender, and the lender has perfected a first priority security interest in such property.⁸

⁷In *In re Montreal, Maine & Atlantic Ry., Ltd.*, 799 F.3d 1, 61 Bankr. Ct. Dec. (CRR) 113, 87 U.C.C. Rep. Serv. 2d 495 (1st Cir. 2015) the court held that the exclusion from the UCC of "transfer of an interest in or an assignment of a claim under a policy of insurance" applied in that case because the insurance proceeds at issue were not with respect to collateral and therefore not proceeds of collateral governed by U.C.C. Article 9.

⁸Priority is key. A secured creditor who has done everything necessary to create and perfect its security interest will nonetheless lose out to a creditor with a senior perfected security interest. *See In re Essex Construction, LLC*, 591 B.R. 630, 96 U.C.C. Rep. Serv. 2d 1060 (Bankr. D. Md. 2018). Because lien priorities in bankruptcy are fixed when the bankruptcy petition is filed, the secured lender with a first-priority security interest at the time of filing retained priority over a secured lender with a subsequently filed financing statement even though the senior secured party's financing statement lapsed during the bankruptcy proceeding.

The perfection and priority rules of Article 9 (*i.e.*, Part 3 of Article 9) generally are outside the scope of this article. However, because they are quite important, we do want to reinforce two concepts: (a) the general rule is that the first security interest that is properly perfected will give the perfecting lender a first-priority lien on the collateral that is subject to the security interest; and (b) the general rule is subject to some exceptions. *See also* Commercial Bankruptcy Litigation § 16A:5, *supra* n. 5:

Perfection under UCC Article 9 requires the creditor to give notice to others of the creditor's interest in collateral by the filing of a properly completed financing statement in the appropriate filing office or taking possession of the collateral. Subject to enumerated exceptions, UCC § 9-310(a) provides that a financing statement must be filed to perfect all security interests and agricultural liens. However, under UCC § 9-310(b) the filing of a financing statement is not required in the enumerated circumstances where other means of perfection are required or allowed. For example, in certain circumstances, a creditor may perfect a security interest by taking possession or delivery of the collateral, exerting control over it, or other means allowed by UCC Article 9. UCC § 9-312 to § 9-314 describe other means for a secured creditor to perfect its security interest without filing and which may result in a security interest senior to one perfected by filing. However, where filing of a financing statement under UCC Article 9 is being relied upon by the secured creditor to obtain the status

E. What, Me Worry?⁹

With the lender having rights in all the borrower's assets, what could go wrong? The lender should be fully protected in the event the borrower defaults on its obligations to the lender, assuming (a) the collateral was properly appraised, (b) the lender did a proper lien search to make sure the lender's lien will be a *first-priority* security interest, (c) the documents were properly drafted and the lien perfected, and (d) the loan does not represent more than a reasonable percentage of the value of the collateral.

The reality is that the value of assets fluctuates. Consequently, a security agreement in personal property collateral—and the rights it provides—is often not enough to allow the lender to realize the full amount of their loan.

For this reason, many lenders will insist on a personal guaranty from the human-being owner(s) of the borrower¹⁰ or affiliated entities of the borrower.

F. A Word About Loan Docs

We *could* loan you money without writing anything down. We *wouldn't* because we're not that stupid most of the time,

of a perfected secured creditor, any defect in such financing statement or its filing may be used by the trustee to avoid the purported secured party's lien for the benefit of the estate.

⁹Just an ode to Alfred E. Newman.

¹⁰When we represent companies in financial distress and their owners (who also are often in financial distress of their own), we commonly see personal guaranties that were not negotiated (or at least not negotiated well) at the time they were entered into. While beyond the scope of this article, we note that one basic concept any potential guarantor should understand is the difference between a *payment* guarantee and a *collection* guaranty.

If the language in the personal guaranty provides that the guarantor's liability vests immediately upon the primary obligor's default, then it is likely a payment guaranty. Guarantees in the commercial finance context are always (at least in our experience) payment guarantees.

On the other hand, it is likely a collection guaranty if it provides that liability vests only after: (a) the primary obligor's default; and (b) the beneficiary pursues and exhausts its collection efforts on the debt from the primary obligor. The distinction between the two can be hugely important, particularly when a guarantor hopes to file a chapter 11 bankruptcy and elect to proceed under Subchapter V.

but we *could*. The law doesn't prohibit it. Being able to *enforce* the repayment of such a loan, on the other hand, is a different question. In other words, when it comes to loaning money, get it in writing. You should live your life in business on the assumption that everything should be in writing.

What writing? First, you need a loan agreement and/or a promissory note.¹¹ If you want to make a secured loan to a company, then you also need a security agreement. Commonly, the loan agreement and security agreement are combined into a single document, creatively called a “*loan and security agreement*.”

There are other documents that may be appropriate, depending on the circumstances. If you want a personal guaranty from the owner(s) (or anyone), for example, then that's often another document. It is not uncommon for banks to demand a lot of other paper too. For the sake of brevity (and you really do not need to know the names of all the paper), we'll just refer to all such documents as the “loan documents.”

G. Before the Storm

Unless, or until, the borrower gets into financial distress, the loan documents typically just sit in a file in someone's office or on a computer server. Likewise, the financing statement remains another dormant (*i.e.*, meaningless) state filing.

When the borrower veers towards financial distress, the borrower (if well-advised) and the lender (unless poorly-run) will pull the loan documents out of their respective files to ascertain, among other things:

1. What rights each party has with respect to the collateral under (a) the loan documents and (b) under Article 9, both before and after a default.
2. Whether the lender has taken all the steps necessary to

¹¹A promissory note is used when the loan terms are relatively simple. As the loan terms become more complex—with elaborate representations, warranties, covenants, and lending computations—the documentation increases both in number of pages and in number of documents. Complex loans are usually split out into several promissory notes, a separate loan agreement, and other ancillary documents, which each memorializes one aspect of the lending relationship.

have and maintain a first priority security interest in the borrower's personal property that is valid against other creditors of the debtor (*i.e.*, whether the lender is *perfected*).¹²

Lenders generally go into a distressed situation confidently believing they have done a reasonably good job of protecting their interests through the loan documents and filings, but actual results vary.

H. Cue Scene—Here Comes the Storm

Since this article is a sad tale, at least at the start, the borrower soon falls on hard times and defaults under the loan documents.¹³

Default allows the lender to exercise the remedies granted the lender under the loan documents and Article 9, Part 6.¹⁴

Sections 9-602 and 9-624 work in concert to ensure that most of the rights given to the borrower and most of the duties imposed on the lender (under Part 6 of Article 9) *may only be varied by a written waiver entered into after default*.

Loan documents may nonetheless *purport* to waive certain borrower rights upfront. When that happens, such attempts fail *unless the lender can obtain the borrower's buy-in after default*. In light of this restriction on lender behavior, *one of the most common mistakes borrowers make*: entering into a *forbearance agreement* without the benefit of knowledgeable counsel. This is one reason why upon default, it is critical for a borrower to involve their lawyers.

¹²Given the complexity of the priority rules of Article 9 and the different ways in which security interests in various types of collateral can be perfected, we will have to leave this topic to our next production, although we hope to bring back the same actors.

¹³We didn't specify what the default was. Defaults under loan documents can be broadly characterized as either being in the nature of a *payment* default or in the nature of a *covenant* default. You might ask, will *any* default permit the lender to exercise its rights? The short answer is that it depends on what the loan docs say. For example, *see* Kirkendoll v. Entertainment Acquisitions, LLC, 2020 WL 1471674 (E.D. La. 2020) (Borrower missed payments due under installment promissory note; Creditor sued prior to the maturity date, but no "default" had occurred as of the date of suit under terms of promissory note, which defined default as failure to pay amounts due "on the Maturity Date").

¹⁴Part 6 of Article 9, Sections 9-601 through 9-628, is entitled Default.

Section 9-603 does permit a lender and borrower to define ahead of time how to measure the fulfillment of the borrower's rights and the lender's duties under a rule stated in Section 9-602.

I. Forbearance Agreements

We're just going to touch on forbearance agreements for only a moment since we don't want to knock your reading off track.

In a typical forbearance agreement, the borrower acknowledges that they have defaulted on their obligations. At the same time, the lender agrees that they will refrain from exercising their remedies arising from such defaults as long as the borrower performs or observes the new conditions set out in the forbearance agreement, and, by a certain date, cures the defaults or takes some other action to improve the lender's situation.

Remember, as we wrote above, *most of the rights given to the borrower and most of the duties imposed on the lender under Part 6 may only be varied by a written waiver entered into after default.*

Well, a forbearance agreement most certainly is a written waiver entered into after default (to the extent that it includes such waivers). *Our point to borrowers is this:* don't sign a forbearance agreement without understanding what it means. A forbearance agreement may look like a mere reprieve from the lender exercising the default remedies of Article 9, but lenders usually do not give up rights without gaining some benefit.

And *our point to lenders?* Hope that your borrower hasn't read this article and get them to sign a forbearance agreement early (preferably before they become smart enough to lawyer up) that remedies any issues with your position as a secured creditor and improves your position with respect to future issues.

Borrowers and lenders alike need to consider how a forbearance agreement may further the overall strategies of both parties.¹⁵

J. A Step Sideways—The New Lender

When a loan goes into default, a new lender may come onto the scene and *takeout* the existing lender. A takeout lender often does this by buying the *paper* (that is, the loan) from the existing lender since this allows the takeout lender to have the lien priority of the existing lender. A takeout lender arrives on the scene in a few different scenarios:

1. The existing lender may sell the loan, usually at a discount, to a new lender more willing to work with a borrower in distress, which lender sees such distress as a means of extracting a significantly higher interest rate and related fees than can be obtained on loans to more well-capitalized borrowers.
2. The existing lender may sell the loan, also usually at a discount, to a new lender more willing to exercise Article 9 remedies against the borrower.
3. The borrower may find a takeout lender more willing to accept the risk of lending to the borrower, usually at a significantly higher interest rate, as well as having an interest in acquiring the borrower's business. Such a lender is commonly referred to as a loan-to-own player.¹⁶

An existing lender is sometimes willing to sell their paper at a discount to avoid the uncertainty, time, and trouble of holding onto the paper and working with or fighting with the borrower. Any of these scenarios may be preceded by a forbearance agreement while a search for a takeout lender takes place. Although a robust cottage industry of takeout

¹⁵Lockwood International, Inc. v. Wells Fargo Bank, N.A., 459 F. Supp. 3d 827 (S.D. Tex. 2020), *aff'd*, 2021 WL 3624748 (5th Cir. 2021) (guarantor waived defense that he was fraudulently induced to execute original guaranty pursuant to terms of two subsequent forbearance agreements he signed after he became aware of alleged fraud).

¹⁶Loan-to-own is a “strategy used by investors to take possession of a distressed company, often through bankruptcy proceedings.” *Loan-to-Own*, Practical Law Glossary, Item 8-386-2450 (2021). The loan-to-own player invests in the distressed company's debt (secured by the company's personal property) “to have an advantage in eventual bankruptcy proceedings” or Article 9 sales.

lenders exists, the reality is that a takeout of the incumbent lender is the exception, not the rule upon a borrower default.

K. The Article 9 Sale that is not an Article 9 Sale

One alternative that is often attractive to a lender is to require the borrower to conduct a sale of their assets outside of Article 9 (or any other process).

Often a forbearance agreement facilitates this process. Since the sale is typically of an operating business, this process is attractive to the borrower because (a) it allows the borrower to keep its doors open for a period of time, (b) such a sale can be less of a public spectacle than a secured party foreclosure sale, and (c) it gives the borrower potentially more control of the process. From the lender's point of view, this approach is attractive because (a) it consumes only a limited amount of the lender's resources, and (b) it avoids a sale being measured against the commercially reasonable standard of Article 9 and possibly found wanting.

L. Other Less-Trodden Paths

Although the usual remedy for a lender is a sale of collateral under Section 9-610, Article 9 (as discussed below) offers two other paths to resolve a defaulted loan situation: (1) other state law remedies and (2) strict foreclosure.

State law remedies (other than those provided by Article 9, of course) are available under Section 9-601(a)(1). After default, the lender "may reduce a claim to judgment, foreclose, or otherwise enforce the claim, security interest, or agricultural lien by any available judicial procedure . . ."¹⁷ While these state law remedies may be attractive in some states, they are inconsistent across states since they are not the subject of a uniform statute such as Article 9. Consequently, they are less commonly used than the remedies of Article 9.

Strict foreclosure remedies are found under Section 9-620(c). Strict foreclosure occurs when after a borrower defaults the borrower and lender enter into an agreement

¹⁷Knight MPIC Ventures, LLC v. Higginson, 2020 WL 550654 (S.D. N.Y. 2020) (secured creditor may reduce its claim to judgment and then exercise whatever options are available, including foreclosure of collateral under Article 9 or other remedies available by law).

under which the borrower *turns over* some, or all, of the collateral to the lender in *full or partial satisfaction* of the debt. Turning over assets in full satisfaction of the debt may seem like an attractive route to any guarantor (since it avoids the uncertainty of how much the assets of the borrower will bring at an Article 9 sale), but it is not often used.

One obstacle to a turnover is that it requires the cooperation of interested parties other than the lender and the borrower. “Interested Parties” include parties with an interest in the collateral subordinate to the security interest of the lender and parties secondarily liable on the secured debt, such as guarantors.

Under Sections 9-620 and 9-621, the turnover of the collateral (in full or partial satisfaction of the obligations that the collateral secures) can only occur if all interested parties receive notice of the turnover of the collateral and do not timely object.

If a guarantor, for example, believes that the lender is valuing the collateral for too low an amount—leaving the guarantor with an unreasonably large liability for the remainder of the debt not satisfied by the turnover of the collateral—the guarantor may object, forcing the lender to sell the collateral in an Article 9 sale. Similarly, a junior creditor with a lien on the collateral may object if it believes that sufficient value exists in the collateral to provide some return to the junior creditor after the debt of the senior lender is satisfied.

Many lenders never want an ownership interest in the collateral and therefore prefer a sale where a third party will obtain the collateral directly from the borrower. While the strict foreclosure approach seems attractive to lenders because it does not need to satisfy the test of being a commercially reasonable sale, it is not often the first choice for lenders. If the lender goes down this road, they still have to figure out how to dispose of the collateral since, in most cases, the lender wants cash and not the collateral they would receive in a strict foreclosure. Consequently, the most common way that collateral is disposed of is a sale under Section 9-610(a), as discussed below.

M. Section 9-610 as a Touchstone

Section 9-610(a) provides the lender’s principal remedy af-

ter a default. The lender is granted broad powers to structure how they dispose of the collateral in which they have a security interest:

After 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.

Section 9-610(b) broadens this right concerning the disposal of collateral by stating:

If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.

With such broad rights with respect to the disposition of the borrower's collateral, what does the lender have to worry about? Keep reading . . .

N. Commercial Reasonableness

Section 9-610(b) grants the lender broad rights to dispose of collateral but also provides a significant legal restraint on the lender's manner of selling the collateral. The language we quote immediately above is preceded by this condition:

Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be *commercially reasonable*.

Guidance on whether a sale is commercially reasonable is provided in Section 9-627, though the analysis is backward-looking.¹⁸ Irrespective of its temporal attributes, Section 9-627 just doesn't say that much (meaning it really raises more questions than it answers). In large measure, the guidance provided only serves to beg the question it is meant to answer: What does *commercially reasonable* mean? To summarize, Section 9-627 says:

- The fact that more money could have been realized doesn't mean that the sale wasn't commercially reasonable.
- A disposition is commercially reasonable if was made (1) in the usual way on any recognized market, (2) at a

¹⁸The section title is "Determination of Whether Conduct Was Commercially Reasonable."

price current in any recognized market, *or* (3) in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

- A collection, enforcement, disposition, or acceptance is also commercially reasonable if it has been approved (1) in a judicial proceeding, (2) by a bona fide creditors' committee, (3) by a representative of creditors, *or* (4) by an assignee for the benefit of creditors.

In real life, any of the parties listed in the third bullet point will only approve of a proposed disposition if that party believes it to be commercially reasonable. So, the third bullet point is the epitome of “begging the question.”

The second bullet point is only useful for limited types of collateral (*e.g.*, stock traded on a stock exchange) because the concept of a “recognized market” is limited to markets where there are standardized price quotations, and the quotes are for property that is essentially fungible. Consequently, this provision must be used with extreme care. Even if the market itself is a recognized market,¹⁹ however, there are factual questions that still must be answered outside the four corners of Article 9:

- Whether a manner is *usual*;
- Whether an action is in *conformity*; *or*
- Whether commercial practices are *reasonable*.

Commercial reasonableness depends not only on the type of property being sold and its relevant marketplace, but also the state of the asset being sold.²⁰ Consequently, the commercial reasonableness of the sale is one of the most litigated

¹⁹*Compare* *Ross v. Rothstein*, 92 F. Supp. 3d 1041 (D. Kan. 2015) (finding OTCQB is a recognized market) with Carl S. Bjerre, *Investment Securities*, 71 *Bus. Law.* 1311 (2016) (criticizing the *Ross* decision as a misreading of the statutory requirements for a recognized market).

²⁰Joshua Nemser, *Now That's What I call Reasonable! Collateral Dispositions Under Article 9 of the UCC*, *Weil Restructuring: 363 Sales, Financing* (May 8, 2013) (discussing *Edgewater Growth Capital Partners LP v. H.I.G. Capital, Inc.*, 68 A.3d 197 (Del. Ch. 2013), where the business's distressed situation was a factor in scaring bidders away).

aspects of Subpart 6 of Article 9.²¹ It is important to keep in mind that the requirement of commercial reasonableness exists to protect not just the borrower but also Interested Parties as well as other interested parties (by which we mean to include every unsecured creditor and equity holder of the borrower).

Commercial reasonableness also depends in part on the larger world around us. Earlier in COVID times, some courts adjusted their definition of commercially reasonable, essentially requiring more of foreclosing lenders.²² This included the enjoining of some Article 9 sales by courts based on finding that sale procedures did not adequately consider the implications of COVID.²³

More recently, with COVID seemingly under more control, courts began to reverse course, demonstrating sympathy for lenders experiencing the difficulty of “shouldering the costs of a loan default.”²⁴ On the other hand, New York courts have also increased their scrutiny of some sale procedures, looking for lenders to provide virtual participation for bidders.²⁵ All of this is to say that the commercially reasonable standard is an ever-moving target with which courts continually wrestle.

O. How to Sell?

Section 9-610(a) grants broad rights to the lender to

²¹See *M&T Bank v. Guthrie*, 2020 WL 1987031 (Del. Super. Ct. 2020) (Court denied bank's motion for summary judgment on damages where the evidence on record was insufficient to establish whether the bank's sale of collateral was commercially reasonable.).

²²Marc Hamroff & Danielle Marlow, *The Courts' View of UCC Article 9 Sales in the Covid-19 Environment Is Clearly Changing*, JD Supra (Nov. 20, 2020).

²³Marc Hamroff & Danielle Marlow, *The Courts' View of UCC Article 9 Sales in the Covid-19 Environment Is Clearly Changing*, JD Supra (Nov. 20, 2020).

²⁴Marc Hamroff & Danielle Marlow, *The Courts' View of UCC Article 9 Sales in the Covid-19 Environment Is Clearly Changing*, JD Supra (Nov. 20, 2020).

²⁵Marc Hamroff & Danielle Marlow, *The Courts' View of UCC Article 9 Sales in the Covid-19 Environment Is Clearly Changing*, JD Supra (Nov. 20, 2020).

dispose of collateral,²⁶ and in the mind of most lenders, the decision comes down to how best to sell (and not how to lease, license, or otherwise dispose of) the collateral. Ideally, from the lender's perspective, collateral is sold "as is," where it is, and for cash at closing, notwithstanding the greater options granted by Article 9.

Once a borrower has entered default, many lenders just want to exit the situation and do not want to invest any more resources in what has turned out to be (in hindsight) a bad lending decision. Anything other than a cash sale without any representations or warranties potentially leaves the lender either (a) still involved with the assets or (b) with issues of collecting deferred payments; both options keep the lender involved in the situation when all it is looking for is a complete exit.

Therefore, the question becomes how best to sell the assets for cash. The lender may exit quickly through a sale of the loan or a refinancing (as discussed above). Still, in most cases, the lender is left to work out the sale of assets on their own (but with the support of an industry of turnaround and workout professionals that has grown up around the need for such support).

If the lender decides to hold a sale of the collateral, the first question is whether the sale is public or private—both are allowed under Article 9. One advantage of a private sale is that it allows for the assets to be shopped by a broker, investment banker, or other intermediary while avoiding the harm to the business of publicly advertising the borrower's assets are being sold by its lender.

One disadvantage of a private sale, from the lender's point of view, is that the intermediary is likely to require an

²⁶As a reminder, the lender has the right to "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." *Robb v. Bond Purchase, L.L.C.*, 580 S.W.3d 70, 83-4, 99 U.C.C. Rep. Serv. 2d 371 (Mo. Ct. App. W.D. 2019) provides an example of the many ways that the conduct of the secured party may cause a sale to be deemed to not have been conducted in a manner that was commercially reasonable. Contrast this case with *Atlas MF Mezzanine Borrower LLC v. Macquarie Texas Loan Holder LLC*, 199 A.D.3d 439, 158 N.Y.S.3d 19, 21 (2021) where the court reviewed the procedures undertaken by the secured party and found the sale was conducted in a commercially reasonable manner.

upfront fee to do a sophisticated marketing job with no guarantee of success. Often the Article 9 sale has been preceded by the borrower marketing their assets for a period of time (often a requirement under a forbearance agreement) without a positive result. Consequently, from the lender's point of view, it is unclear that further marketing by an intermediary will help sell the assets. Thus, many lenders are unwilling to invest in the private sale process when a public sale is generally considerably less expensive. Also, the lender cannot purchase the collateral at 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," a narrow exception.

Even if the borrower finds a potential buyer, the potential buyer may still insist on an Article 9 sale to extinguish junior liens on the collateral. Usually, this type of Article 9 sale is public, although it can also happen in a private sale. In the context of a public sale, the identified potential buyer may act as a *stalking horse* bidder. That means that the contract with the potential buyer may be the standard against which all other potential bidders are measured. Also, in exchange for being a *stalking horse* bidder, the potential buyer may be entitled to certain *bid protections*, including a *breakup fee* if another bidder ends up outbidding the *stalking horse* and winning the auction.

The ability to credit bid²⁷ in a public sale provides the lender with a safety net. The lender can credit bid in their own debt if they believe that the public sale would otherwise result in too low a price compared to the secured lender's view of the actual value of the assets if sold in some other manner.

P. What Happens if the Sale is Not Commercially Reasonable? No One is Perfect

Actions (or inactions) of the lender, the borrower, or third

²⁷A credit bid is when the lender bids on the collateral for their own loan. In doing this, the lender can "acquire the assets of the [borrower] . . . in exchange for a full or partial cancellation of the debt, allowing them to acquire the assets without paying any actual cash for them." *Credit Bid*, Practical Law Glossary, Item 2-500-6604 (2021).

parties such as a landlord²⁸ can cause a sale to fail to qualify as commercially reasonable. If the lender is not acting in a commercially reasonable manner, Article 9 provides rights for the borrower and other Interested Parties. Before a sale, however, the sole remedy of an aggrieved party under Article 9 who believes that the sale is seriously flawed is to obtain a court order to restrain the sale under Section 9-625(a).²⁹

If the lender did not conduct a commercially reasonable sale, the sale will nonetheless stand if the buyer acted in good faith (*i.e.*, was not colluding with the lender).³⁰ Without such legal protection, buyers would be less willing to bid at an Article 9 sale, further lowering the potential value regained on collateral assets. After a flawed sale, the aggrieved party can sue for damages under Section 9-625(b) or contest any deficiency alleged by the lender under Section 9-626,³¹ but the party is unable to unwind the sale absent a

²⁸See *Airpro Mobile Air, LLC v. Prosperity Bank*, 631 S.W.3d 346, 101 U.C.C. Rep. Serv. 2d 1403 (Tex. App. Dallas 2020), review denied, (Sept. 18, 2020) (secured creditor's sale of collateral in possession of landlord was commercially reasonable, despite landlord's interference and noncooperation with sale process).

²⁹During COVID, New York courts have significantly impeded a borrower's ability to halt or delay an Article 9 sale by establishing that "*under no circumstances* can the threatened loss of equity interests securing mezzanine or other financing constitute irreparable harm." Marc Hamroff & Danielle Marlow, *New York Appellate Court Puts Huge Road Block In Way Of Borrowers Seeking To Enjoin UCC Article 9 Sales*, JD Supra (Mar. 26, 2021). Irreparable harm is a prerequisite for an injunction. While seeking an injunction under Section 9-625(a) is the only remedy under Article 9, bankruptcy will also stop a sale.

³⁰Under Section 9-617(b), "[a] transferee that acts in good faith takes free of the rights and interests [of the borrower, the secured party and subordinate lien holders], even if the secured party fails to comply with this Article or the requirements of any judicial proceeding."

³¹Liability for conducting a sale that is not commercially reasonable is not unlimited. See *Forthill Construction Corp. v. Blue Acquisition, LLC*, 2020 WL 949256 (S.D. N.Y. 2020) (court found consequential damages, including lost profits and salary, unavailable under Section 9-625).

subsequent bankruptcy filing, which may enable an unwinding of the transaction.³²

If the borrower acts in a way that makes the sale not commercially reasonable, then the lender can conduct the best Article 9 sale that it can and use the borrower's misconduct as a defense against any later claim brought by the borrower that sale was not commercially reasonable. The lender may also, if it prefers, seek judicial intervention to order the borrower to comply with their obligations under the loan documents or Article 9.

Q. It Takes a Village

Most courts and commentators jump right into discussing the lender's duties concerning commercial reasonableness. We'll get to that. First, it's important to understand that, as averred in our prior paragraph, the borrower has some obligations, too, in terms of helping make sure a sale is commercially reasonable.³³

1. The Need for Information from the Borrower

First, the borrower needs to assemble information about the collateral that will enable the lender to accurately advertise what is being sold and enable buyers to value the collateral. Imagine we are talking about collateral that consist of a single machine. In that case, the information needed (or at least desired) may be limited to a user's manual, run time, and, perhaps, maintenance records. But in the case of the sale of an entire business, more is needed. And, since an operating business is often worth more than the pile of machines, inventory, and other stuff (not a technical term) that comprise a business, when a lender has a lien on all or substantially all of the assets of a business, it often makes sense to try to sell them all together, as a going concern.

³²In *In re Inofin, Inc.*, 455 B.R. 19, 75 U.C.C. Rep. Serv. 2d 269 (Bankr. D. Mass. 2011), the bankruptcy court found collateral sold at a commercially unreasonably foreclosure sale remained property of the estate.

³³The issue with commercial reasonableness is a dichotomy. It either is or it is not. The gradation occurs in what sort of damages the court assesses for a lack of commercial reasonableness. If the sale is commercially reasonable, you never get to damages. The *Adobe* case, *infra* n. 56, is a good example of what happens when the borrower interferes with the commercial reasonableness of the sale.

A lender usually needs information about the past operation of the business so that the lender has a chance of selling the business as an ongoing concern. The lender may have received audited annual financial statements and quarterly or monthly interim financial statements as required by the reporting requirements contained in its loan documents.³⁴ Rarely is this information sufficient for the needs of a buyer looking to operate the collateral as their own business.

This need for information that a potential buyer can review themselves is especially acute for two reasons. First, the lender will almost never make any representations or warranties with respect to the collateral because the lender usually does not have the necessary personal knowledge to make them prudently. Even when the lender has some personal knowledge, the benefits of making representations and warranties generally are outweighed by the risks (*i.e.*, the lender doesn't want to be sued later by a buyer for breach of a representation or warranty). The lender's objective in a sale is to finally resolve an unpleasant situation and not to have any potential liabilities linger on after the sale is closed.

Second, the borrower's financial distress that led to the sale in the first place makes any representation and warranty that the borrower is willing to make worthless, or nearly so, to most potential buyers. From a bidder's point of view, the risk discount they apply when they makes their bid is ideally to protect themselves from the things that they could not know, rather than risks and issues that are knowable with some diligence.

Consequently, the lender will usually (should) ask the borrower for extensive information prior to advertising the sale of the collateral, to have such information available to potential buyers. Often the borrower cooperates with these information requests in an attempt to minimize the liability of their guarantors (referred to as "the lender having a gun pointed at a debtor's head") or other co-debtors. The borrower may also cooperate for other reasons, such as with the hope that a buyer will keep their workers employed or—and call us crazy Rousseauians—because it's the right thing to do.

³⁴Reporting requirements are one of the items not governed by Article 9.

2. The Need to Obtain Access to the Collateral

Most loan documents (at least well-written ones) include a provision that, upon default, the lender may require the borrower to assemble the collateral and make it available to the lender. The need for this should be apparent: the lender needs to inspect the collateral, perhaps take possession of it and assemble it for sale, and in rare cases prepare the collateral for sale. Additionally, potential buyers also need to inspect the collateral since the sale documents almost certainly will not give them any contractual protections (other than any discount that they take on valuing the assets).

Section 9-609(c) codifies the borrower's basic duties with respect to collateral after default: "a secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties."

In real life, however, a borrower may nonetheless decline or otherwise fail to fulfill these duties. Under Section 9-609(a), the lender, after default, "(1) may take possession of the collateral; and (2) without removal, may render equipment unusable and dispose of collateral on a debtor's premises . . ."

Section 9-609(b) provides that a lender can only take the actions enumerated in Section 9-609(a) if they can do so without a breach of the peace.³⁵ If the lender cannot obtain and assemble the collateral without breach of the peace, the

³⁵"Breach of the peace" is another legal term of art. Article 9 does not define "breach of the peace." The official comments to Section 9-609 explain that courts should determine what qualifies as a breach of the peace. U.C.C § 9-609, cmt. 3 (Nat'l Conf. Comm'r Unif. St. Laws & Am. Law Inst. 2020). Courts have generally found a "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." Garry M. Graber, *Prac. L. Bankr. & Restructuring, UCC Article 9 Secured Party Sales*, 4 (2021) citing *People v. Most*, 171 N.Y. 423, 64 N.E. 175 (1902). *See also Westbrook v. NASA Federal Credit Union*, 799 Fed. Appx. 722 (11th Cir. 2020) (no breach of peace where reposessor did not use fraud, trickery, chicanery, force, threats, intimidation, or yelling, or attempt to prevent debtor from removing personal property from the collateral vehicle).

lender will need to use judicial process. That is, the lender will need a court order directing the sheriff to seize and assemble the collateral.

3. Landlords

The borrowers we speak of throughout this article are operating companies,³⁶ but they may own or use real estate in their operations. If the borrower owns it and the lender has a lien on it, the legal rights and obligations between them concerning the real estate are not governed by Article 9 (or any other Article of the UCC, for that matter). Rather, other state laws govern. And those other state laws (real estate law) are decidedly non-uniform, in stark contrast to the UCC.

Most operating companies, however, do *not* own the real estate from which they operate.³⁷ That means most borrowers are also tenants. And tenants have landlords. Lenders have to deal with their borrowers' landlords because, leaving the law aside, landlords control access to the physical space where some collateral is located, especially if the borrower has abandoned the premises. Once the borrower stops paying rent and possibly ceases operations, the lender risks losing access to collateral owned by the borrower in a landlord's building. Moreover, bringing the law back front and center, landlords often have contractual, statutory, and/or common law lien rights in the collateral.

This is where a *landlord's waiver* comes in.

A landlord's waiver (or warehouseman's waiver in the case of, you guessed it, a warehouse) is essentially a type of

³⁶As opposed to borrowers that merely hold assets—such as investments—or serve other functions than operating a business with active interactions with customers, employees, and suppliers. That's not to suggest that much of what we share with you isn't applicable to non-operating businesses. Some, however, isn't.

³⁷Even where the business enterprise owns real estate, it is commonly owned by a separate legal entity—with the same ownership structure as the borrower—that leases the real estate out to separate operating company. The separate ownership of real estate is often driven by tax considerations. Significant tax advantages arise from owning real estate in an entity with a pass-through tax structure such as a limited partnership or a limited liability company. Also, it is often easier to finance real estate in a company whose only purpose is to hold the real estate.

intercreditor agreement for the lender's benefit. A typical landlord's waiver (at least the first draft of one drafted by the lender) provides that the lender may enter the premises leased by the landlord to the borrower/tenant to retrieve or conduct a sale of the collateral. Such a landlord's waiver (again, meaning the first draft as drafted by a lender) also typically has the landlord stipulating that the lender's rights in the collateral are senior to the landlord's rights in the collateral. Smart landlords will think about whether subordinating their rights makes sense under the circumstances.

A landlord may enter into a landlord's waiver because they know that their tenant needs financing from a lender, who may not lend to the tenant without such a waiver. However, most landlords will not agree to simply waive their rights without receiving something in return.

Usually, landlords require that the lender pay rent for the term that the lender is using the premises, as well as agree to repair any damage that may occur when the lender (or the buyer of the collateral) removes the collateral from the landlord's premises. Smart landlords may also require that: (a) the tenant pay the fees of the landlord's attorneys in negotiating the waiver; and (b) time limits be placed on the lender's rights so that after a period of time, the landlord can repossess the space and find a new, rent-paying tenant.

R. Operating the Business between Default and Sale

So, what happens between the time a lender declares a default and the date of the sale?

The borrower can attempt to continue operating the business, assuming they have the cash needed to operate. If the borrower relies on a line of credit from its lender and their lender refuses to advance because of the default, then that will impede continuing operations. Likewise, if the lender takes other collection action that impedes the borrower's ability to operate, such as requiring all the borrower's account debtors to pay the lender rather than the borrower, then the borrower may not be able to operate.

This takes our attention momentarily back to the concept of the *forbearance agreement* (previously discussed in Section I, above). Many a lender in many a circumstance will

pressure their defaulting borrower to sign a forbearance agreement as a prerequisite to advancing funds under a line of credit (albeit under different terms than existed before the default). Whether the borrower should sign one depends on many factors, but, except to the extent discussed in Section I, those factors are beyond the scope of this article.

A lender may very well want the business of their defaulting borrower to continue—*whether or not it continues under the leadership of current management*. This will depend largely on whether the lender believes the juice is worth the squeeze. That is, the lender will (or at least should) do a cost/benefit analysis to determine if the additional money they would have to loan to the borrower is likely to increase the sale price to cover that cost, plus some margin.

This (“this” being that act of helping a lender decide if the juice is worth the squeeze and then, if it is, helping to do the squeezing) is where a *financial advisor* or *chief restructuring officer* (CRO) comes in. A cottage industry of restructuring/turnaround/insolvency financial professionals exists to provide these functions. From a lender’s point of view, the chief restructuring officer offers a number of essential functions:

- replacing or at least overseeing management;
- being able to act without the conflicts of interest that management may have, such as loyalty to long-term employees who are no longer productive or who are family members;³⁸
- having strong professional management credentials; and
- estimating the amount of new cash the lender may need to invest in keeping the doors open until the date of a sale.

Financial advisors and CROs find their way to the scene in several ways:

- a lender might hire a financial advisor to monitor the borrower and offer them some advice;

³⁸Long-term employees or family employees tend to have a vision of the company that does not fully consider its current economic reality, and goals that may put repaying the lender and other creditors at lower priority than other uses of cash.

- a borrower may hire a financial advisor to whom the lender may, if the lender is comfortable with the person selected, advance fees if necessary; and
- a borrower may hire a CRO to manage the borrower's operations and to whom the lender may advance fees if necessary (again, if the lender is comfortable with the person selected).

As a practical matter, the CRO must be acceptable to the lender, though the person is almost always selected by the borrower (among other reasons, the lender will not do so in order to avoid handing a borrower or other interested parties a lender liability claim).

S. The Sale Itself

The sale of the collateral by the lender under Article 9, as we discuss above, can be either public or private, provided that the chosen method satisfies the standard of commercial reasonableness.

1. Public Sales

Public sales are more common than private sales.³⁹ One reason is that it is more difficult for a third party (*i.e.*, a guarantor or other co-debtor, a junior secured creditor, or an unsecured creditor) to challenge a properly conducted public sale successfully.

If you didn't notice, our last sentence begs the question again; it told you that a sale is commercially reasonable if it is a properly conducted public sale. In other words, we told you nothing.

In all seriousness, the standards for properly conducting a public sale of collateral under Article 9, which we discuss at greater length in Section N above, are well-known, primarily because there has been so much litigation over the question in the past. *The key component of a commercially reasonable public sale* is advertising (a) in sufficient quantity, (b) in the proper forums, and (c) sufficiently before the sale to be reasonably designed to flesh out any interested buyers. In days of old, when most households purchased and read newspapers, accepted wisdom was that placing an advertisement of

³⁹Public sales must be truly public. Graber, *supra* n. 36. A sale that is open only to brokers or dealers does not qualify as a public sale.

a public sale in a newspaper of general circulation would inoculate the sale from attack on the grounds of inadequate public notice. This is no longer the case.⁴⁰

In advertising a public sale, the lender may set forth bidding requirements such as (a) minimum initial bid, (b) subsequent incremental bids, and (c) a good-faith deposit prior to bidding or possibly before being allowed to inspect the collateral. Bidding conditions can make a sale not commercially reasonable and therefore must be formulated with care.

Another compelling reason why many lenders go the public sale route is that under Section 9-610(c)(2), a lender may not credit bid for the collateral at a private sale unless it “is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.”⁴¹ But credit bidding is unrestricted at a public sale. If a lender credit bids their debt and is the successful bidder, they may then, if they choose, conduct a subsequent disposition without having to worry about meeting the commercially reasonable standard. In other words, the lender will own the assets outright without paying any cash (but will not have received any cash from the sale).

2. Private Sales

Most courts and commentators write that private sale can only meet the commercially reasonable standard if the lender engages in a vigorous campaign to market the collateral to parties likely to have an interest in the collateral. That commonly means engaging a reputable investment banker, broker, or other intermediary. Moreover, certain types of collateral require specialized marketing. In the case of *Regions Bank v. Hyman*, the court found the use of a commercial

⁴⁰Christopher M. Cahill and Jonathan Friedland, The Myth of the Newspaper Being a Commercially Reasonable Notice, *DailyDAC* (Jan. 29, 2019) (providing in depth analysis as to why newspaper notice alone no longer constitutes commercially reasonable notices in many circumstances).

⁴¹For example, publicly traded securities can be purchased by the lender at a private sale. *See* Graber, *supra* n. 36. *Bruce v. Cauthen*, 515 S.W.3d 495 (Tex. App. Houston 14th Dist. 2017) (Partner with security interest in other partner’s partnership interest wrongfully purchased it in private sale under Article 9.).

aircraft broker was a commercially reasonable way to sell aircraft.⁴²

In reality, however, many distressed businesses are marketed for sale prior to default or after default but before the lender seeks to exercise its Article 9 remedies. If this first round of marketing was unsuccessful, the expense of paying for a second round might not be something the lender is willing to bear. When this is the case, it drives in the direction of a public sale.

A private sale is also more likely, as we discuss in Section O, when (a) third parties involved in the matter (*i.e.*, guarantors, co-debtors, and junior secured creditors) agree that the lender is woefully undersecured, or (b) the lender does not want a public sale. Why might the lender not want a public sale? One reason may be that news of the borrower's financial distress could be bad for their business and, thus, for the sale price. A second reason may be that the lender doesn't want to be publicly outed as having made a bad loan.

T. The Result of a Sale

When the collateral is sold, the result is that all of the borrower's rights in the collateral are transferred to the buyer. The lender's security interest and every other subordinate security interest or lien are discharged.⁴³

The buyer's rights in the collateral are, under Section 9-617(a), limited to whatever rights the borrower had in the collateral. To change the owner of titled assets (such as cars and trucks), the lender can give the buyer a transfer statement under Section 9-619, which the buyer may use to change the record owner of assets with the office of the secretary of state.⁴⁴ The transfer caused by the transfer statement is not itself a disposition of an asset (that will have already occurred in the Article 9 sale) but merely a document to formalize the transfer of title.

After an Article 9 sale, a lender cannot simply pocket any

⁴²Regions Bank v. Hyman, 2012 WL 4479080 (M.D. Fla. 2012), *aff'd*, 597 Fed. Appx. 1012 (11th Cir. 2014).

⁴³Interests which have priority over the lender's interests are not discharged.

⁴⁴In most states, the office of the secretary of state is the record keeper for certificates of title on cars and trucks.

extra proceeds of the sale. Section 9-615(a) outlines how the lender must distribute proceeds:

1. The lender can pay reasonable costs and expenses related to “retaking, holding, preparing for disposition, processing, and disposing” the collateral. Attorney’s fees and legal expenses can only be reimbursed if they were first agreed upon in the loan documents;
2. The lender may satisfy the borrower’s obligation to the lender which was secured by the collateral; and
3. The lender must use any remaining proceeds to compensate junior interest or lien holders.

Under 9-615(a)(3), the lender is required to provide proceeds to junior interest holders only if, after receiving notice from the lender under Section 9-611, they make a demand for proceeds before the completion of the disposition of proceeds. If requested by the lender, the junior interest holder must provide proof of its interest or claim,⁴⁵ or else the lender need not distribute proceeds to the junior interest holder.

What if the proceeds of the sale are not enough to pay the junior interests? Even worse, what if the proceeds don’t pay the lender in full? Section 9-615(d) ensures the borrower is liable for any deficiency. On the upside, Section 9-615(d) also says any money left over from the sale goes to the borrower.

Part II. The Play

Now that the stage has been set, the players enter from stage right.

The Players

The hero of the story, depending on your perspective, is either **Lender** or **Borrower** (Borrower is also commonly referred to as “Debtor” or the “Company”). Borrower’s Owner, who we creatively call “Owner,” also plays a major supporting role.

All scenes assume the loan to Borrower consists of a five-year term loan of \$6 million and a \$4 million line of credit

⁴⁵The security agreement between the borrower and the junior interest holder, or some other evidentiary documentation of the loan, will prove the relationship. Graber, *supra* n. 36.

facility with a one-year term that has been renewed each year up to now.

Act I

Scene (Hypothetical) 1

Owner owns a business operating out of a factory building owned by Owner. Lender and Borrower entered into a loan and security agreement three years ago, at which time Lender asked Owner for a personal guaranty, but Owner refused. Owner also refused a personal guaranty secured solely by the building and did not entail any personal liability. At the time, Borrower was doing quite well. These loans were collateralized with all of Borrower's personal property. Borrower has run into trouble and has defaulted on multiple covenants. Lender is a small bank.

Deconstructing Scene 1

These limited facts paint a good picture for Borrower. That Lender doesn't have a personal guaranty from Owner is good for Owner, since Owner might otherwise feel like they have a gun to their head. Also, lenders (and courts) are generally more forgiving on covenant defaults than on payment defaults.⁴⁶

The Owner owning the building can cut in favor of or against Borrower, but is mostly good. If nothing else, whatever equity Owner has in the building should make Lender somewhat more comfortable. The building is a possible source of funds that Owner can use. Alternatively, having the building outside of the Lender's collateral package makes the Owner more comfortable since, if the business goes under, the Owner does not lose all their business assets.

The fact that Lender is a small bank tends to give us more hope for Borrower. Generally, small banks primarily want to be repaid by the Borrower and are more willing to work with borrowers to create a repayment plan. At this point, the Owner must decide whether they give the Lender a mortgage or second mortgage on the real estate to better secure the loan (assuming that there is sufficient equity) or risk losing their equity in Borrower and keep their real estate. Scene 1,

⁴⁶See *supra* n. 14 for a refresher on covenant defaults verses payment defaults.

in summary, presents facts that lend themselves to a cooperative workout, albeit with some difficult decisions.

Scene 2

Lender and Borrower entered into a loan and security agreement collateralized by all of Borrower's personal property three years ago when Borrower was doing reasonably well but was no superstar. *Lender asked Owner for, and received, a personal guaranty.* Borrower operates a factory located in a building owned by an affiliate of Owner. The affiliate's sole asset is this building. Lender also received a guaranty from this affiliate, which was secured by a mortgage on the building. Borrower has run into *significant* trouble and has defaulted on multiple covenants. *Owner has many interests (both business and personal) and would just like to walk away.* New Lender, who has purchased the loan from the original Lender, is a loan-to-own player (or at least is comfortable owning the collateral).⁴⁷

Deconstructing Scene 2

We changed and added some facts between Scene 1 and Scene 2 to paint a picture of a better-suited situation for "giving the lender the keys."

Recall from our discussion above,⁴⁸ even if Lender built in the right to "take back the keys" into the loan documents following a default, they could not do so. Well, Lender *could* draft the loan documents to so provide; however, those provisions would be per se unenforceable as a violation of Section 9-620(c) (which requires that Borrower can agree to Lender taking the collateral in satisfaction of the debt only *after* an event of default).

Assuming that New Lender is willing to accept the collateral as payment and Borrower is ready to give up the keys, then Scene 2 lends (pardon the pun) itself to New Lender *accepting* all Borrower's collateral (and perhaps the building)

⁴⁷See *supra* n.16 for a refresher on loan-to-own players.

⁴⁸See *supra* Section H.

in full or partial satisfaction of the loan. This is the stuff of strict foreclosure under Sections 9-620 and 9-621.⁴⁹

Borrower may be willing to agree to such an arrangement after an event of default, especially if the Owner (as guarantor) will be relieved of any deficiency for the underlying debt.

For New Lender, this approach is attractive because it avoids the issue of whether there was a commercially reasonable sale. As a loan-to-own player, the main benefit for New Lender is obtaining the assets in one fell swoop.

This, by the way, is the polar opposite of what traditional lenders want. The last thing traditional lenders want is any direct ownership interest in the collateral. Traditional lenders prefer a sale in which a third party purchases the collateral directly from the borrower for a cash payment to the lender.

Loan-to-own lenders are rare. They usually only come into the picture as a source of refinancing when a borrower defaults on a loan from a more traditional lender and that traditional lender sells off the loan quickly so they can walk away and put an end to their lender fatigue. Consequently, the most common way collateral is disposed of is by a sale as allowed under Section 9-610(a).

As we wrote above, Section 9-610(a) provides the lender's principal remedy after a default. The lender is granted broad powers to dispose of the collateral by sale, lease, license, or otherwise. Section 9-620, under which the lender may accept collateral in full or partial repayment of the loan, is the *less-used* remedy. Why? Because for this scenario to be both a viable and preferable remedy for lenders, the following factors, generally, must be in place:

- The lender must be willing to own the collateral;
- The borrower must be willing to surrender the collat-

⁴⁹Perhaps the best-known decision about strict foreclosure came out of the Bankruptcy Court for the Southern District of New York in 2010. The case was *In re CBGB Holdings, LLC* and the written opinion by Bankruptcy Judge Stuart Bernstein held that the pre-bankruptcy strict foreclosure of the debtor's assets was valid. The decision, by the way, probably owes its notoriety to the identity of the debtor in the case. CBGB was a legendary punk rock club that opened in 1973, where one of your co-authors spent many a night (and morning) in the late 1980s.

eral for the value that the lender is attributing to the collateral rather than have it sold at auction;

- Ten days before the borrower consents to the lender's acceptance of the collateral, the lender must give notice of the proposed action to every other secured party and lienholder who held a security interest in, or other lien on, the collateral;
- If the collateral only satisfies part of the debt, then the lender has to also give notice to any secondary obligor;⁵⁰ and
- No party entitled to receive notice objects within 20 days after the notice was given.

In summary, the strict foreclosure route only leads to an end to the final curtain call in a limited number of engagements.

Scene 3

Lender and Borrower entered into a loan and security agreement three years ago. The loans were *not* cross-collateralized against other assets that Owner owned outside of Borrower except the stock of the Borrower. Borrower is in default and is *not* willing to cooperate.

Deconstructing Scene 3

Owner did not give a personal guaranty, and Owner has protected their other assets. Perhaps Owner has another reason for risking personal attack for not cooperating; we do not know. We do know that no other entity owned by Owner gave collateral to support the loan. Regardless, Lender is faced with an uncooperative Borrower who will not give Lender possession of the collateral.

At this point, Lender may turn to the judicial foreclosure process of the relevant state's courts to become the owner of the assets or at least take possession of them. Lender certainly may not breach the peace to engage in self-help.

By turning to judicial process, Lender is necessarily stepping outside the strictures of Article 9. Yes, Section 9-601(a)(1) permits Lender, after default, to "reduce a claim to judgment, foreclose, or otherwise enforce the claim, secu-

⁵⁰Section 9-102(72).

rity interest, or agricultural lien by any available judicial procedure . . .” And Section 9-601(f) provides that “[a] sale pursuant to an execution is a foreclosure of the security interest or agricultural lien by judicial procedure A secured party may purchase at the sale and thereafter hold the collateral free of any other requirements of this article.”

Lender *can* conduct a public Article 9 sale of collateral even if they do not have it in their possession, though the price likely will be quite low. On the other hand, Lender may credit bid their debt at such sale and become the legal owner of the assets.

Lender as owner, either as a result of a judicial foreclosure or a UCC sale where they did not have possession of the assets but still purchased them for a credit bid, can then use legal process, usually involving the sheriff, to seize the assets and conduct a second sale of what at that point will be Lender's *own* property totally outside of Article 9.

Lender can try to assemble the collateral on their own for an Article 9 sale if Borrower is uncooperative, but cannot breach the peace to do so. Lenders use personal guaranties to try to force owners, and therefore the borrowers, to cooperate with assembling the collateral for sale and providing the information necessary for a productive sale.

The case of *In re Adobe Trucking, Inc.* is an instance when the lender chose to hold an Article 9 sale notwithstanding a non-cooperative borrower.⁵¹ In *Adobe*, at the Article 9 sale, the lender credit bid part of their debt.⁵² Lender's bid was based on an appraisal of the assets (to avoid an attack on the sale based on the inadequacy of the purchase price).⁵³ The court deemed the purchase price to be commercially reasonable.⁵⁴ After seizing the assets, they were held in a special subsidiary of the lender used solely for holding

⁵¹In re Adobe Trucking, Inc., 76 U.C.C. Rep. Serv. 2d 365 (Bankr. W.D. Tex. 2011), aff'd, 551 Fed. Appx. 167 (5th Cir. 2014).

⁵²In re Adobe Trucking, Inc., 76 U.C.C. Rep. Serv. 2d 365 (Bankr. W.D. Tex. 2011), aff'd, 551 Fed. Appx. 167 (5th Cir. 2014).

⁵³In re Adobe Trucking, Inc., 76 U.C.C. Rep. Serv. 2d 365 (Bankr. W.D. Tex. 2011), aff'd, 551 Fed. Appx. 167 (5th Cir. 2014).

⁵⁴In re Adobe Trucking, Inc., 76 U.C.C. Rep. Serv. 2d 365 (Bankr. W.D. Tex. 2011), aff'd, 551 Fed. Appx. 167 (5th Cir. 2014).

foreclosed assets to protect the lender from any liabilities associated with such assets.⁵⁵

When the borrower is unwilling to cooperate in the sale process, the sale is less likely to maximize the return on the assets. Ultimately, the borrower is the one to suffer from a flawed sale process because they cannot attack the commercial reasonableness of the sale when their own conduct caused the issue that presumably resulted in a lower price for the assets. As the *Adobe* court stated: “[h]aving denied [lender] access to the Collateral, the [borrower parties] cannot complain about inadequate preparation of the Collateral for sale.”⁵⁶ Similarly, “[w]here a debtor denies the secured party access to the collateral, it cannot complain about the commercial reasonableness of not making the collateral available for inspection.”⁵⁷

An additional feature of Scene 3 is that Lender took a pledge of the stock of Borrower from the Owner (if Borrower had been a limited liability company, Lender would have wanted to take a security interest in the membership interest in the limited liability company).

One advantage of taking a security interest in Borrower’s equity is that it gave Lender the option to sell the equity rather than the Borrower’s assets in the event of a default. Another benefit, if coupled with a right to vote the equity upon default, is that it can undercut Borrower’s ability to file a defensive bankruptcy.

If a lender takes a security interest in their borrower’s stock, they should do so by “control,” by taking the stock certificate for the stock of the borrower and an assignment separate from certificate in blank signed by the borrower’s owner(s) sufficient to transfer the stock in the case of an Article 9 sale. This security arrangement is usually documented in an additional loan document known as a pledge agreement. U.C.C. Article 8 has special provisions for uncertificated

⁵⁵In re *Adobe Trucking, Inc.*, 76 U.C.C. Rep. Serv. 2d 365 (Bankr. W.D. Tex. 2011), aff’d, 551 Fed. Appx. 167 (5th Cir. 2014).

⁵⁶In re *Adobe Trucking, Inc.*, 76 U.C.C. Rep. Serv. 2d 365 (Bankr. W.D. Tex. 2011), aff’d, 551 Fed. Appx. 167 (5th Cir. 2014).

⁵⁷In re *Adobe Trucking, Inc.*, 76 U.C.C. Rep. Serv. 2d 365 (Bankr. W.D. Tex. 2011), aff’d, 551 Fed. Appx. 167 (5th Cir. 2014).

shares, although lenders generally are less comfortable with uncertificated shares.

While a lender could also obtain a security interest in the stock of their borrower through a simple security agreement and filing a UCC-1 financing statement, a lender with control has priority over any party who has an interest in the security by mere filing (regardless of when the filing was made).

Most small businesses these days are limited liability companies and not corporations.⁵⁸ Unlike stock, which is classified under the UCC as “investment property,” limited liability company membership interests are classified as “general intangibles.” The rules governing general intangibles are different from those governing investment property. In the case of general intangibles, the party with the superior security interest is the first to file, as “control” is not a concept applicable to general intangibles.

There is a wrinkle, however. Under U.C.C. Article 8, Borrower can elect to have their membership interests treated as securities and investment property under Article 8 (and therefore not be general intangibles). Lenders often require that their borrowers elect this option and have their membership interests be evidenced by a membership interest certificate, the equivalent of a stock certificate. Following that, such a lender would take possession of the membership interest certificate and an assignment separate from certificate endorsed in blank. Such a lender thereby obtains “control,” and the same type of iron-clad security interest that they would have had with a corporate stock certificate.

Scene 4

Lender and Borrower entered into a loan and security agreement three years ago. Borrower is in default and is willing to cooperate.

⁵⁸For example, in Delaware, approximately three quarters of the entities formed in 2017, 2018, and 2019 were LLCs. In 2019, there were 165,910 LLCs formed of a total of 226,589 state authorized entities, and only 45,405 of those entities were formed as corporations. 2019 Del. Div. Corp., Ann. Rep. Stat. In Florida, the Department of State reports that, as of 2020, there were a total of 1,659,751 limited liability companies and only 797,965 domestic for-profit corporations registered in Florida. 2012–2020 Fla. Div. Corp., Yearly Stat. (Mar. 5, 2021) (updated quarterly).

Deconstructing Scene 4

We slimmed down the facts to provide a situation where, for whatever reason, Borrower is willing to cooperate. This could lead to the result in Scene 2, with Lender accepting the collateral in satisfaction (*i.e.*, Borrower giving Lender the keys). But, as we discuss above, it is more likely to lead to a cooperative sale process, sometimes referred to as a *friendly foreclosure* (though we use that term a bit more broadly to refer to any cooperative *disposition*).

It is important to understand that while an Article 9 sale needs to be commercially reasonable, the price it achieves will not necessarily be one that either Lender or Borrower will be happy about. The commercially reasonable requirement hinges on the sale being executed in a manner that is likely to achieve a reasonable price for the collateral. The price realized does not need to be the highest possible price possible regardless of the time and expense to achieve such a price, but it does need to be a price that results from a commercially reasonable sale process.⁵⁹

An Article 9 sale is a fire sale that does not require the sale price to be what a willing buyer and a willing seller would reach in an arms-length transaction. Buyers understand this. To quote the *Adobe* case: “New York courts have held that sales prices as low as 30% of market value are commercially reasonable, and have routinely upheld sales prices of 50% or more of market value.”⁶⁰ For this reason, a smart lender will try, if possible, to cause the sale to happen outside of Article 9.

Intermezzo

Think of our chosen literary device (*i.e.*, our references to

⁵⁹The *Adobe* case is useful for a full legal discussion of the tests that courts use to analyze the commercial reasonableness of a sale. The case discusses the “[t]hree tests [which] have been employed by courts to measure the commercial reasonableness of a sale of collateral: (i) the ‘procedures’ test, which examines the fairness and adequacy of the procedures used before and during the sale; (ii) the totality of circumstances test, which looks to the circumstances surrounding the sale and closely scrutinizes transactions where there exists a large gap between the sale price and fair market value; and (iii) the ‘proceeds’ test, which looks solely to the price received for the goods.” *See supra* n. 58, at *5.

⁶⁰*See supra* n. 58, at *11.

acts and scenes) as a “choose your own adventure” story. Act I laid out four common scenarios:

(1) borrower and lender cooperation leading to a workout or a new lender;

(2) borrower and lender cooperation leading to a surrender of collateral in full or partial satisfaction of borrower's debt;

(3) a non-cooperative borrower leading to foreclosure action by lender under non-uniform state law; the lender holding an Article 9 sale without having the assets and obtaining the assets through a credit bid, and/or the use of state judicial process to assemble the collateral for an Article 9 sale; and

(4) borrower and lender cooperation leading to a sale.

A key takeaway is that the sale of collateral through Borrower and Lender cooperation *is not the only scenario* that results from a default. The borrower and lender may enter into a forbearance agreement, in which the parties agree on a plan to resolve the default without an Article 9 sale. This is commonly referred to as a workout (the result of Scene 1). A workout may include the sale of some collateral or the raising of new equity. A workout may also fail and turn into the sale of collateral either by Borrower or Lender.

But wait, there's more!⁶¹ A plot twist, powered by the supremacy of federal law waits in the wings. If this play were a fairy tale rather than the high-minded and erudite drama that it is, a big bad wolf would be lurking to devour both Lender and Borrower.

But no, our plot twist is bankruptcy. A bankruptcy filing (voluntary or involuntary) has the power to halt a state law foreclosure proceeding and any other scenario discussed above. To mix metaphors, badly, a bankruptcy filing, like in an episode of Dr. Who, thrusts all the actors into a totally new dimension with new rules, new procedures, and (in the forms of the bankruptcy judge, the United States Trustee, and perhaps a creditors' committee), new characters added to the show.

⁶¹Due credit is given to that great, late inventor, Ron Popeil, inventor of the pocket fisherman and master pitchman. One of your co-authors had the privilege of representing RonCo for several years, though it was long after Mr. Popeil's tenure with the company.

Bankruptcy, however, is a different story.

Act II

Scene 5

Lender and Borrower entered into a loan and security agreement three years ago. Borrower is now in default. The Borrower's business provides repair services for oil rigs primarily using a collection of employees and independent contractors who do the actual repair work. They have a limited number of parts in inventory and a limited number of tools that they own. If an expensive part is required, the customer has to order and pay for it. Borrower's primary expense is wages, so they need cash from their invoices a lot sooner than they are paid. Unlike with Scene 4, the collateral is primarily accounts receivable (or in the lexicon of the UCC, *accounts*) and possibly other intangible assets of Borrower. Borrower may or may not be cooperative.

Deconstructing Scene 5

Here, we have moved away from the world of collateral that consists of physical things—such as physical inventory, oil rigs, trucks, and machinery—to types of collateral that are legal rights. Accounts are the legal right to receive payment in cash from a third party. Possession will not be an issue since there is nothing tangible to possess.

Descriptive information about the collateral may be necessary to execute a foreclosure, and Lender may need records of accounts or other intangible collateral in Borrower's possession. However, from Lender's point of view, accounts or accounts receivable are highly desirable types of collateral because their value is readily ascertainable. Accounts are an obligation by an account debtor to pay Lender's borrower a specified amount of money for goods or services provided.⁶²

Article 9 provides special rules for exercising lender reme-

⁶²Not all money owed to a borrower is necessarily an "account receivable." In *Louisiana Newpack Shrimp, Inc. v. Ocean Feast of China, Ltd.*, 2020 WL 5046489 (E.D. La. 2020), the secured party had a security interest in "accounts receivable." The court denied the secured party's request to hold tariff reimbursements, finding the term "accounts receivable" typically refers to money owed by customers for goods or services delivered or used.

dies on accounts. Section 9-607(a), titled "Collection and enforcement generally," provides: "If so agreed, and in any event after default, a secured party . . . may notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of the secured party . . ."

This Article 9 provision, which is likely provided for explicitly in the loan documents, allows Lender to collect the cash from the goods and services provided by Borrower directly from the account debtor (*i.e.*, Borrower's customer) after default without any need to have Borrower involved in the collection process.

Account debtors often pay into a lockbox⁶³ held with their supplier's lender, such that they do not make payments directly to their supplier (*i.e.*, the borrower). Loan documents commonly give a lender a power of attorney to endorse any checks received from account debtors. A lender, thus, usually can be paid some of their borrower's accounts receivable directly from their borrower's customers. As a practical matter, though, a lender commonly needs their borrower's cooperation to realize the full value of the accounts receivable (because when a supplier is going out of business, some of their customers usually try to take advantage of the situation by disputing amounts owed).

If a lender takes all the proceeds from their borrower's accounts, the borrower will be cut off from their primary source of working capital, and won't survive long. A CRO or financial advisor often enters the scene at this point to help preserve the borrower as a going concern or to help the lender make an informed decision about whether or not to keep the borrower operating. Often in this scenario, a lender is unwilling to lend new cash but is willing to let their borrower use cash from the collection of the accounts.

Scene 6

Lender and Borrower entered into a loan and security

⁶³A lockbox is not a literal lockbox. A lockbox arrangement entails the account debtor making "payments to a location only accessible by Lender," who first pays themselves and then passes the surplus onto Borrower. Graber, *supra* n. 36. However, in a distressed situation, there will be no surplus to pass to the Borrower.

agreement three years ago. Borrower is a retailer with well-recognized trademarks, brick-and-mortar stores from its historical origins, and a large internet presence with significant online sales with a large consumer base. As a result of a default, Borrower and Lender bring in a liquidator to liquidate the brick-and-mortar stores, but the results of the liquidation sales still leave Lender owed millions. A path for Lender to realize value from the trademarks, online operations, and large database of customer data is less clear.

Deconstructing Scene 6

A large cottage industry of liquidation firms has evolved to assist lenders in conducting going out of business sales at retail stores and warehouses. Whether such a liquidation firm is retained or not, it is almost always preferable to hold such sales where the collateral sits rather than incurring the cost to move it.

However, doing so, and even accessing the collateral, requires cooperation from landlords when locations are leased. This is because landlords may have liens that arise automatically under state law, as well as their contractual liens under Article 9.

This is why a smooth liquidation of inventory from retail stores and warehouses usually depends in considerable measure on whether Lender has gotten landlord waiver and warehouseman lien waivers.⁶⁴ In our experience, Lender has likely gotten at least some waivers, but it is also expected that they are not drafted as strongly in Lender's favor as Lender would like. So, there is expected to be some negotiation to be done in this regard.

The trademarks, while valuable assets, are not saleable without the accompanying business. Such a sale of the marks without the business assets would be deemed under trademark law as an "assignment-in-gross" under which the trademarks would lose their legal status as trademarks. Consequently, if the trademarks are being sold, they will need to be sold with the rest of the online business, i.e., the goodwill of the business, as a package.

Whether the sale of the online business will include the

⁶⁴See *supra* Section Q(3).

customer data is trickier. While customer data is a valuable asset, if the terms of use pursuant to which Borrower collected it did not allow for a transfer in a UCC sale, the data will need to be destroyed. In a number of cases where a debtor or even a bankruptcy court has tried to sell or transfer consumer data in ways that were not allowed under the governing customer agreement, state attorneys general and the Federal Trade Commission have moved in to protect consumer data from unauthorized use.⁶⁵

This means that Lender must have an in-depth understanding of Borrower's business and its collateral since the collateral may, such as is the case with trademarks and consumer data, be subject to other laws outside of Article 9 that impact the ability of Lender to sell the collateral.

Scene 7

Lender and Borrower entered into a loan and security agreement three years ago. The collateral consists of software that is licensed to third parties by Borrower. Most business software is not licensed in perpetuity, or if it is, the license fee is only a small portion of the expected revenue stream.

The users of business software commonly look to the vendor/borrower for continuous maintenance to ensure that the software continues to work smoothly in the licensee's technology environment, customization of the software to the licensee's business and technology needs, and access to periodic bug fixes, minor improvements, and new versions of the software.

The revenue from Borrower's performance of these services forms the basis of Borrower's revenue stream. Competition from rival software, changes in technology, or development errors with respect to the software has caused Borrower's revenue to decline and Borrower to go into default.

Deconstructing Scene 7

In this scenario Lender is faced with only two viable

⁶⁵Rich Suggests Conditions on Sale of Consumer Data on Radio Shack Bankruptcy Case, Privacy News, 2015 WL 3652926. Also, states are enacting state statutes to restrict the sale of consumer data. Texas Attorney General: Privacy is Not for Sale, ABI Journal, October 2000.

choices: (i) selling the business as a going concern, either under a forbearance agreement, in an Article 9 sale, or in bankruptcy, or (ii) shutting the enterprise down and walking away from the loan with minimal prospects for collection.

In this scenario the revenue from maintenance, updates, customization, and new versions all require the continuing efforts of the personnel that Borrower now employs. It is a rare piece of software that can be a source of continuing fee revenue or sold for significant value without having the personnel who maintain and support the software coming along as well. Moreover, if Borrower were to shut down, existing receivables would likely decline in value substantially since licensees may assert counterclaims for breach of contract to avoid paying their invoices. Consequently, the software may only be saleable and valuable if sold with the remainder of Borrower's business.

Moreover, through software escrows or other arrangements, some of the licensees may have an option upon a Borrower default under their license agreements to have a perpetual right to use and modify the source code.

While this would not necessarily make the software unsaleable, it makes it less attractive. While more twists and turns may be derived from this scenario depending on the nature of the software, the licensor, and the licensees, the key takeaway is that any collateral with software other than readily available commercially mass-market licensed software requires knowledge of Borrower's business and the role the software plays in it.

The Final Act

The final act of a play is sometimes called a "Catastrophe."⁶⁶ Hopefully, we have given you enough insight to act like a star in the case of a borrower default so that the

⁶⁶"In drama, particularly the tragedies of classical antiquity, the catastrophe is the final resolution in a poem or narrative plot, which unravels the intrigue and brings the piece to a close. In comedies, this may be a marriage between main characters; in tragedies, it may be the death of one or more main characters. It is the final part of a play, following the protasis, epitasis, and catastasis." Wikipedia entry, retrieved 9.27.2021.

DEFAULTS UNDER ARTICLE 9: A PLAYER'S GUIDE

term “resolution”⁶⁷ is a more apt description of your performance. As we have seen, no single path takes a borrower and lender from default to resolution. While all defaults, like all plays, do not have a happy ending, we hope we have given you some tools to make the best of a difficult situation and, like a seasoned trooper, play your part in any drama that may come.

⁶⁷“The final portion of the play, often called the RESOLUTION/DENOUEMENT, extends from the CRISIS to the end of the play. The CRISIS leads to the OBLIGATORY SCENE which answers the questions posed throughout the play.” Introduction to Theater, course material authored by Dr. Cheryl Frederic for her class, Introduction to the Theatre at Southern New Hampshire University, retrieved 9.27.2021. See <https://www2.southeastern.edu/Academics/Faculty/cfrederic/playanalysis.htm>.