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Keeping the Peace...
Ensuring A Successful Liquidation

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By Steven N. Kurtz

No matter how diligent you are with your portfolio or credit criteria, it is a statistical reality that eventually a default will occur and you will be required to liquidate your collateral. Given this eventual reality, it is important that the reader become familiar with certain basic concepts which can assist you in a successful liquidation.

The first step in any liquidation is to assess the nature of the default, i.e. whether there was fraud or other misconduct on the debtor's behalf. If there was fraud or other misconduct, in addition to the steps outlined below, you will likely need to take additional actions beyond the purview of this article. Your second step is to immediately take stock of your loss. Quantify it and begin to outline your exit strategy. Next, you will need to ensure that all of your transaction documents are in order. Review all of your transaction documents, check your UCC filings, make sure your liens are perfected, and access your guarantors. If there are any problems with any of your documents or if you are not perfected against any of your collateral, now is the time to fix these problems. Lack of perfection is not fatal between you and your debtor if you seek to enforce your transaction documents outside of a bankruptcy or other insolvency proceeding, such as an assignment for the benefit of creditors. However, lack of perfection will negatively impact your rights against competing creditors and will result in a loss of your collateral in a bankruptcy or assignment for the benefit of creditors. Therefore, before you begin to enforce your rights against your collateral, which will likely alert your debtor to hire counsel to look for problems, make sure all of your transaction documents are in order.

Your rights under Article 9 of the UCC are not exclusive. You may resort to any available remedy without losing your other rights. (UCC Sec. 9-601(c)). Thus, you may reduce your claim to judgment, proceed against your collateral or otherwise enforce your claim in any manner available under the law or in your transaction documents. Article 9 does not define what a default is, thus you will need to resort to your transaction documents to determine if there is a default, which generally will include non-payment of any obligation, failure to perform any obligation, breach of any warranty or covenant, or a cross-default provision in any of your transaction documents.

The basic remedy under Article 9 is taking possession of your collateral, which you may do so long as there is no breach of peace. (UCC Secs. 9-609(a) and 9-609(b)). Although there are lots of colorful cases which deal with breach of peace, the general rule of thumb is that if your debtor will not cooperate, you will need to resort to judicial measures to take possession of your collateral.

In addition to taking possession of your collateral, for those with security interest in accounts, Article 9 gives you the right to collect directly on obligations from account debtors and parties liable on instruments. (UCC Sec. 9-607). This is a simple procedure; you send an authenticated notice to the account debtor. Once the account debtor receives notification from the secured party to pay on the account or instrument, the account debtor's obligation on the account or instrument is not discharged unless payment is made to the secured party. (UCC Sec. 9-406(a)). Your notification should identify the secured party, the rights assigned (which is payment on an account or instrument owed to your debtor) and indicate that if the account debtor pays anyone other than you, it will not relieve the account debtor of the obligation to make the payment. This is typically known as a double jeopardy situation.

For those with perfected security interests in deposit accounts, either a bank with the debtor's deposit accounts at the bank or anyone else with a deposit control agreement (UCC Secs. 9-312(b)(1), 9-314), you may enforce your rights against the deposit accounts via an offset. For those with provisions in your transaction documents that allow for debits via the ACH, you may wish to initiate a debit against the debtor's bank accounts via the ACH.

Of course, it is always better to have the debtor's cooperation, and when this happens, the liquidation is generally more successful. However, debtors are often uncooperative. This does not prevent you from exercising your foreclosure rights, but it does mean that you will have to resort to judicial intervention, since to do otherwise could result in a breach of peace. The pre-judgment remedies most commonly associated with this are writs of possession, repleven actions, or court receivers. Although this process generally is more expensive and takes longer, the ray of sunshine is that a court supervised foreclosure sale will be deemed commercially reasonable. (UCC Secs. 9-314, 9-627(c)(1)). In order to better equip yourself for your debtor's possible non-cooperation, it is advisable to include a clause in your documents that allows for the appointment of a receiver in the event of default. The benefit of a receiver is that he or she functions as the eyes and ears of the court.

Assuming you have your debtor's cooperation and you are being given possession of the collateral, it is best to obtain a peaceful possession agreement from the debtor, signed by all guarantors. The peaceful possession agreement should contain an acknowledgement of the default, a surrender of the collateral, a release in the creditor's favor, a waiver of notice of the foreclosure sale, a waiver of the right to redeem the collateral, a waiver of any right to object to the creditor keeping the collateral in full satisfaction of the debt, and a statement that will let landlords know that the second party is authorized to enter into the debtor's premises. It is also advisable that you obtain, if possible, a landlord waiver when you initially document the transaction. For commercial transactions, after the debtor defaults, the UCC allows for debtors to waive notification of the foreclo-

sure sale, the right to object to retaining the collateral in full or partial satisfaction of the debt, and right of redemption. (UCC Sec. 9-624).

Once you have possession of the collateral and/or the debtor's cooperation, you will have various choices as to how to deal with your collateral. Your choices are public sale, private sale and retaining the collateral in full or partial satisfaction of the debt. If you are going to foreclose or take collateral in partial satisfaction of the debt and there is a possibility of a deficiency against the debtor and guarantors, it is important that every aspect of your collection and foreclosure be commercially reasonable. (UCC Secs. 9-610, 9-615). Before liquidating your collateral, you should have your collateral appraised by a reputable appraiser with sufficient expertise to value your specific collateral.

Once you have an understanding on the approximate value of the collateral, you will need to address the notice process. Unless the collateral is perishable or will rapidly decline in value, the UCC requires that you give notice to the debtor, all secondary obligators (which include guarantors), subordinate lien creditors, and those who have sent authenticated requests for notice 10 days before the date of your notification. (UCC Sec. 9-611(c)). In order to insure you have the right parties to send notice to, you should obtain a certified lien search using the appropriate state's official search logic system. If you send notice to all parties who have perfected liens of record with the state, which were obtained from a search not later than 20 days or earlier than 30 days before the notification, you will have complied with your search and notice requirements as it relates to dealing with third parties who are entitled to notice. (UCC Sec. 9-611(e)).

If you are fortunate enough to find yourself in a situation where the collateral is worth more than the debt, you have the right to retain the collateral in full satisfaction of the debt. You may also retain the collateral in partial satisfaction of the debt. (UCC Sec. 9-620). This requires that you send notice of this intention to the debtor, guarantors, subordinate lien creditors and those who have sent authenticated requests for notice. If you have not received a waiver from the debtor and all guarantors in a peaceful possession letter, and if there are other lien creditors, you will need to send notice of your intent to retain the collateral in full or partial satisfaction of the debt. A party entitled to such notice has 20 days in which to object to your retaining the collateral in full or partial satisfaction of the debt. (UCC Secs. 9-620(a) and 9-620(c)). If the debtor or other lien creditor objects, you will need to dispose of the collateral via a foreclosure sale. If a subordinate lien creditor objects and there is sufficient equity in the collateral, you may be able to strike a deal with that objecting creditor and still retain the collateral in full satisfaction of the debt by paying the objecting creditor.

If you are required to dispose of the collateral, you may sell or otherwise dispose of the collateral via a lease, license, or other transaction. You need not credit the debtor until you receive actual payment (UCC Sec. 9-608(a)(3)), but your conduct must be commercially reasonable. Your notice of sale will be deemed reasonable if it complies with the form of UCC Sec. 9-611(d) and is sent 10 days before the sale. (UCC Sec. 9-612(b)). The UCC does not favor one form of sale over another. So long as your sale is commercially reasonable in all aspects, it does not matter whether you proceed via private or public sale.

A public sale generally requires that you put up the collateral for competitive bidding to the general public. You must advertise the sale in a manner sufficient to attract interest. If you have a debtor in a specialized business, you should advertise in publications geared to attract interest in the sale. It is also advisable that you hire a reputable auction company to conduct the public sale. Experience counts in these situations. A secured party is allowed to credit bid at a foreclosure sale if nobody shows or the offered price is not high enough. As a rule of thumb, you should credit bid somewhere in the neighborhood of the collateral appraisal. If you conduct an auction, the general rules of the particular state regarding auctions will apply.

A private sale is a transaction between the creditor and the buyer to buy or obtain via a lease or license all or a portion of the collateral. Generally a secured party may not buy assets at a foreclosure sale unless the collateral is in danger of speedily declining in value, or is perishable, or is something which is customarily sold on a recognized market. (UCC Sec. 9-610 (c)).

Once you conduct the foreclosure sale, you are allowed to apply the proceeds to the reasonable expenses of collection and enforcement, reasonable attorney's fees as provided for by your transaction documents and satisfaction of the obligations. (UCC Sec. 9-608(a)). If there are any proceeds of the sale left after paying your debt, the remainder shall be paid to subordinate lien interests upon reasonable proof of the debt and amount owed. (UCC Sec. 9-608(2)). If there is anything left after paying subordinate lien creditors, the remainder shall be paid to the debtor. (UCC Sec. 9-608(4)). Of course, if there is a deficiency, the debtor and all guarantors are liable thereon. (UCC Sec. 9-608(4)).

Once you have completed the foreclosure sale and assessed the deficiency, you now have the right to look to the debtor and guarantors for repayment. Generally the challenge to the sale begins here. If you have kept up a dialogue and the foreclosure has been friendly, it is advisable to initiate a further dialogue with the debtor and all guarantors. In exchange for agreeing to engage in settlement discussions and possibly to extend the date in which a deficiency suit may be brought, you should seek to enter into some form of forbearance agreement, which includes the necessary acknowledgements of the deficiency amount and reasonableness of the foreclosure sale, along with further releases from the debtor and guarantors in your favor. That way if your settlement talks do not work out, you will have a writing executed by the debtor and guarantors acknowledging the deficiency and the reasonableness of your foreclosure sale.

If you need to file actions to enforce the deficiency, there is a rebuttable presumption in favor of the secured party that the sale was reasonable and that the value of the collateral is the remaining deficiency. (UCC Sec. 9-626(a)(3)). However, the debtor or guarantor raises the reasonableness of the foreclosure sale in any court pleading; the secured party must prove that the sale was conducted according to the UCC. If the secured party is not able to prove compliance with the UCC, it is the debtor or guarantor's burden of proof to show what would have been realized had the sale complied with the UCC. (UCC Sec. 9-626(a)(3)).

Your default remedies are fluid and flexible. The key to a successful liquidation is to make sure all of your transaction documents are in order before you enforce your rights. The notice requirements are spelled out and provide safe harbors so long as they are followed. Every aspect of your liquidation and foreclosure must be reasonable, however, reasonableness does not mean extreme second guessing. If you follow the rules and use common sense, your actions during a liquidation should not be second guessed by a reviewing court. One of the best ways to ensure a successful liquidation is to continually assess your exit strategy at all phases of the relationship. abfj

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