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### Maximizing Recovery on a Secured Loan Through an Article 9 Sale of a Going Concern

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#### Introduction

In working out of a troubled commercial credit, often the optimal exit strategy for the senior lender is a sale of the borrower's business as a going concern. However, frequently it is not feasible for a distressed borrower simply to execute a sale of its assets directly to a buyer and pay the senior secured debt at closing. This is often due to pressures on the borrower from various parts of the debt structure. For example, the anticipated sale price may be insufficient to clear junior liens (or even senior liens), and the junior lienholders may not be willing (or obligated) to release their liens at closing unless they are paid in full. Moreover, trade creditors or other unsecured creditors who are left holding the proverbial "bag" after closing may try to unwind the sale in court on the ground that it was for less than "fair consideration" or "reasonably equivalent value" and therefore was a fraudulent transfer under applicable state law, or under the U.S. Bankruptcy Code should the borrower later be subject to a voluntary or involuntary bankruptcy proceeding. A buyer may also be concerned with the risk of liability for claims of creditors against the borrower/seller under a theory of "successor liability." These potential risks may lead the buyer to condition its offer on the sale occurring in an insolvency proceeding. Typically, this would take the form of a so-called "Section 363 sale" in a bankruptcy proceeding, or alternatively, a sale in a state or federal court receivership or assignment for the benefit of creditors (ABC) proceeding under state law. To a greater or lesser degree depending on the type of insolvency proceeding, the court order authorizing the sale will help insulate the buyer from most, if not all, such claims.

As the discussion below illustrates, however, an out-of-court foreclosure sale by the secured lender of its collateral under Article 9 of the Uniform Commercial Code (UCC) may, under appropriate circumstances, result in a much better result for the secured lender, by minimizing the lender's expense and expediting the execution of the sale. Here, we recount a recent engagement where our secured lender client

employed an Article 9 sale to quickly sell its borrower's business as a going concern, thereby maximizing the value of its collateral and the recovery on its credit facility.

## The Circumstances

Our client's borrower was a private equity portfolio company in the food industry. The borrower had approximately 100 employees and recent annual sales of approximately \$60-70 million. The company's difficulties stemmed from a downward trend in sales, resulting cash flow difficulties, and an over-leveraged capital structure.

Our client had extended an approximate \$14 million senior secured credit facility, consisting of a revolving loan and a term loan. The loans were collateralized by a blanket lien on the borrower's assets, which did not include owned real estate. The borrower also had a layer of subordinated secured mezzanine debt totaling about \$7 million and outstanding trade debt. The borrower had breached financial covenants under the senior credit agreement. Our client and the borrower had entered into a forbearance agreement, which had been extended multiple times. Due to the borrower's heavily overleveraged condition, other headwinds facing it, and the sponsor's unwillingness to inject additional equity, a debt restructuring was not viable. The borrower and sponsor agreed to market the business for sale with the assistance of an investment banker. But, being "out of the money," the sponsor was not willing to incur any further potential liability and thus was unwilling to enter into an asset purchase agreement directly with the buyer.

## The Transaction

After a period of active marketing, viable interested purchasers of the borrower's business as a going concern were identified. The leading candidate was willing, under certain conditions, to purchase the assets from our client as the secured party under Article 9, as well as through an insolvency proceeding.

As is generally recognized, a Chapter 11 bankruptcy, even when predicated on an expedited Section 363 asset sale process that the lender supports, will require the lender to incur significant legal expense; will likely require the lender to fund the borrower's operations and professional fees and other administrative expenses pending the closing through debtor-in-possession financing or a use of cash collateral arrangement; will likely require the lender to submit to an investigation by an unsecured creditors' committee concerning the validity of its liens and whether the bankruptcy estate holds any claims against the lender; and presents the potential for execution risk should the sale not go off as planned. A state court proceeding such as a receivership or ABC is typically less expensive for the lender, but also presents a less defined process and arguably less certainty of outcome. From our client's perspective, given these considerations, an Article 9 sale offered a distinctly superior alternative, and the borrower's capital structure was not of such complexity that a Chapter 11 filing was warranted. And while Article 9 cannot be used to convey real estate, here, because there was no real estate collateral, there was no need to pursue a real estate foreclosure or deed-in-lieu-of-foreclosure in tandem with the Article 9 sale.

Once the buyer was identified, the transaction was executed through an Article 9 sale. The notices required by Article 9 to be provided to other lienholders, the borrower and guarantors were sent and the transaction closed approximately two weeks thereafter. The asset purchase agreement between the lender and the buyer provided for very minimal representations and warranties on the part of the lender as seller, though sufficient to provide the buyer with assurance that the requirements of Article 9 had been

satisfied. The borrower and sponsor cooperated in the transaction by entering into a disposition agreement with the lender, agreeing that the sale was “commercially reasonable” (a requirement of Article 9) and to surrender the collateral to the buyer upon the closing of the sale, on an “as-is, where-is, with all faults” basis. Post-closing, the buyer negotiated directly with trade creditors to resolve their claims without the involvement of the lender.

## Reflections

As far as Article 9 sales go, a sale of collateral consisting of a going concern presents complexity not faced in a liquidation sale of assets of a business that has shut down. However, as this transaction shows, under the right circumstances, a going concern Article 9 sale can be executed with very favorable results for the lender and the buyer.

In order for the transaction to be successful, the buyer obviously must be willing to proceed outside of an insolvency proceeding. If significant unsecured debt is left unpaid, then the buyer and lender must be aware of the risk that the Article 9 sale could be challenged by creditors as a “constructive” fraudulent transfer (meaning that intent to defraud creditors need not be proven) under applicable state law or, if there is a bankruptcy filing, by a trustee under the U.S. Bankruptcy Code. Depending on which state’s law applies, this type of litigation can be brought as long as four to six years after the sale. To prevail, the party challenging the transaction must establish, *first*, that the borrower was insolvent on a balance sheet basis or similarly financially challenged on a cash flow or capitalization basis, *and second*, that the sale was for less than “fair consideration” or “reasonably equivalent value,” depending on whether state law or the U.S. Bankruptcy Code governs the claim. Where the borrower was in default under its credit facility (a requirement of Article 9) and creditors were left unpaid, the insolvency prong would likely not be difficult to prove. But if the sale was an arm’s-length sale to a non-insider of the borrower after a fulsome marketing effort, it may be quite difficult to prove that insufficient value was paid in the sale. The value issue, together with the expense of bringing a fraudulent transfer claim, can be a significant deterrent to an attack by unsecured creditors, but the risk needs to be evaluated on a case-by-case basis. While the risk of such a challenge can be significantly minimized if not nullified by a sale through bankruptcy or other insolvency proceeding, an insolvency proceeding, as noted above, may entail significantly more expense, delay and execution risk. Additionally, from the buyer’s perspective, there is risk that it may lose the deal to a competing bidder. Moreover, an insolvency proceeding is a public proceeding, whereas an Article 9 sale can be conducted outside the public view.

In addition to the risk of potential attack from unsecured creditors who will not be paid all, or an agreed portion, of their claims in connection with the sale, junior lienholders (if any) who are not paid from the sale proceeds can challenge the sale under provisions of Article 9 if it is not a “commercially reasonable” sale. Again, in the context of a private Article 9 sale as a going concern, a professional marketing and sale process will significantly mitigate the risk of a successful challenge on commercial reasonableness grounds. In the particular case described herein, the subordinated lenders and our senior lender client were party to a customary intercreditor agreement under which, after the borrower’s default, the sub debt holders were substantially precluded from contesting any sale or other disposition of collateral that the senior lender supported.

Because an Article 9 sale is a remedy available to a secured creditor after the borrower's default, the sale can be accomplished without the borrower's cooperation, but not without the intervention of a court ordering the borrower to relinquish possession of its assets. Therefore, if the sale is to be a going concern sale, securing the borrower's cooperation is exceedingly important. Continuity of operations will be critical and the parties will desire as seamless a transition as possible. Equity owners, especially a private equity sponsor, may cooperate within reasonable limits in order to preserve a relationship with the lender or to preserve its reputation more generally. If these intangible benefits are insufficient to gain the necessary cooperation, then it may be worth considering whether financial incentives, such as granting relief on guaranties, if any, or other consideration, are necessary to execute the transaction.

Please feel free to contact your Vorys attorney with any questions you may have about collateral dispositions or any other debt restructuring, workout or bankruptcy issues that you may confront.