Chapman and Cutler LLP

Chapman Client Alert

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Current Issues Relevant to Our Clients

Strictly Speaking: Strict Foreclosure Can Provide an Efficient Smooth Exit for Lenders in the Right Circumstances

This Client Alert is part of a three Alert series. This Alert focuses on when Strict Foreclosure can be a lender's best option and the potential path to execute a Strict Foreclosure. The next Alert will discuss issues associated with executing a Strict Foreclosure and the third Alert will discuss issues related to retaining and motivating management following the Strict Foreclosure.

The current pandemic has hit all businesses hard, causing an increase in bankruptcies and restructurings. As companies default under their credit agreements, lenders have to decide what course of action is appropriate to effectuate their goals. Should the lender give the borrower breathing room by entering into a forbearance agreement in exchange for certain milestones or is more aggressive enforcement action required?

Obviously, every circumstance is different and to the extent more drastic action is required, a lender has to assess its goals and tailor its enforcement actions accordingly. In cases where the senior secured debt is the fulcrum security (i.e., that the value of the company is not sufficient to fully satisfy the amount owed on the secured debt) and all parties in the capital structure are prepared to engage in a consensual reorganization of the borrower that would result in the lenders owning the borrower with a new "right sized" balance sheet, the process will be relatively easy. However, more often than not, one or more of the other parties in the capital structure will demand too high a price for their consent and a consensual deal is not feasible.

Bankruptcy

One alternative is to have the borrower file for bankruptcy and to execute a restructuring and transfer of the equity to the lenders under the requirements and protections of the Bankruptcy Code, whether it be a 363 sale, a debt for equity swap or some other restructuring through a plan of reorganization. For instance, lenders may purchase the business or assets of the borrower with the protection of a bankruptcy court order that approves the lenders' acquisition of the assets free and clear of all liens. Pursuant to such an order, the lenders may also be able to obtain a release from liability by means of release provisions commonly contained in a plan of reorganization. Of course, in cases where the amount owed under the secured debt is greater than the value of the business, the lenders of course will bear the not-insignificant expense of the bankruptcy.

Strict Foreclosure under Article 9 of the Uniform Commercial Code

If the protections afforded by the Bankruptcy Code are considered to be less valuable to the lenders than the cost of the bankruptcy, then exercising remedies under the Uniform Commercial Code ("UCC"), particularly a Strict Foreclosure under Article 9-620, may be an excellent alternative to bankruptcy. For purposes of this Client Alert, we refer to a Strict Foreclosure as a transaction whereby lenders receive, with the consent of the borrower, the borrower's assets and also assume certain liabilities necessary to operate the business in exchange for all or part of the senior secured debt. A Strict Foreclosure certainly is not viable in all circumstances but often is a potential alternative where the secured debt is the fulcrum security and the lenders are willing to write down their debt to right size the balance sheet and try to recoup their initial loss through the equity ownership in the reorganized business. If the relative values are such that the only the secured lender will obtain a recovery from the sale of the business, and if the other constituents generally agree on the value of the business, a strict foreclosure should be explored. In this circumstance, neither the board nor any other creditor has any financial incentive to object to a Strict Foreclosure by a secured lender because a sale of the business would provide no additional recovery for the borrower's other constituents. However, if a secured lender proposes a Strict Foreclosure where the value of the business either exceeds or is relatively close to the amount of the secured debt, Strict Foreclosure will likely not be a viable alternative. The board, which must consider the interests of all constituents in exercising its fiduciary duties, should object to the Strict Foreclosure and consider other restructuring alternatives, including filing for bankruptcy protection.

A. Replacing the Board of Directors

Once the lenders make the decision to pursue a Strict Foreclosure, the first step is usually exercising rights under a pledge or security agreement to vote the equity interests of the borrower and replace the board of directors or managers with independent directors or managers. There are a plethora of reasons for initially changing the board, including (i) the existing equity holders may realize they are out of the money and no longer want to spend time and resources on the borrower, (ii) even if the equity is willing to participate and facilitate a transaction, they may be unwilling to affirmatively take action that eliminates the position of another lender or creditor in the capital structure, particularly, for instance, if a mezzanine lender has participated in several of the equity sponsor's other deals, (iii) the existing board may not be versed or comfortable with the issues associated with a distressed situation, and (iv) the board may want to put the borrower into bankruptcy to obtain the comfort and protection of a court overseeing the restructuring process.

An important initial point to note is that the newly appointed director(s) or managers(s) should be independent and not beholden to the lenders, as they are going to be the governing body that will negotiate the terms of the Strict Foreclosure. Subject to exculpation provisions in the borrower's organizational documents, the directors or managers will have fiduciary duties to the borrower and will need to consider the interests of the borrower's creditors and equity holders. The fulfillment of those duties will be carefully scrutinized by the creditors and equity holders that are not going to be receiving any recovery. There are many individuals willing to serve on boards that are well-versed in distressed situations and the contours of the attendant fiduciary duties that would be comfortable approving the Strict Foreclosure under appropriate circumstances.

B. Exercising Voting Rights

A well-drafted pledge agreement will entitle a secured party, as the pledgee, to not only foreclose on the equity interests but, even prior to such foreclosure, vote the pledged equity interest following an event of default with prior or simultaneous notice to the borrower and the pledgor. Many state statutes require the pledge of the equity interest to be coupled with an interest; meaning, for lending situations, the right to exercise the voting rights needs to be given in connection with the lending of money. Lenders receiving an equity pledge must be cognizant of two important issues in addition to ensuring appropriate granting language: (i) the lender needs to ensure that appropriate steps were taken to perfect the security interest in the equity and, (ii) the lender should confirm that the underlying organizational documents of the borrower provide the authority to not only receive the economics rights represented by the pledged equity, but also the control rights associated with such equity interests.

(i) Perfection of the security interest

Equity interests in a limited liability company and a partnership are generally treated under the UCC as general intangibles and lien perfection occurs by filing a UCC-1 financing statement unless the borrower opts to treat the equity interest as investment property under Article 8 of the UCC. In such a case, lien perfection can be obtained by filing, possession or control over the collateral. Security interests perfected by control or possession generally have priority over a competing security interest perfected by filing. Thus, if the equity interests are certificated, then the collateral agent or lender should take physical possession or control of the certificated interest in order to perfect the security interest. Shares in a corporation are generally certificated and should be perfected in a similar manner to a certificated limited liability company or partnership interest.

(ii) Control Rights

State statutes governing limited liability companies, partnerships and corporations dictate a specific result unless specifically overridden by the entity's governing documents (e.g., the operating agreement, partnership agreement or certificate of incorporation or bylaws). For instance, under Delaware Law, the economic rights are generally transferable except as prohibited under the operating agreement. Control rights, such as voting, however, are generally prohibited from being transferred except to the extent permitted under the operating agreement. Furthermore, under Delaware Law, an assignee of a membership interest may only become a member of the limited liability company with unanimous approval of the members unless an alternative provision is contained in the operating agreement. In addition, there could be provisions in the organizational documents that could prohibit or trip up the action that the lenders want to take. For example, minority equity holders may have negotiated for minority protections which may require their consent for the action to be taken by the lenders. Thus, the governing document must themselves be analyzed to make sure the action to be taken by the lenders is permitted or not otherwise prohibited.

Similarly, under New York Law, unless otherwise provided in the operating agreement, assignment of a membership interest is only effective as to the economic rights of the member in the limited liability company and voting rights do not transfer. In addition, by making an assignment of 100% of its membership interest, the assigning member ceases to be a member, loses the ability to exercise their membership rights and, unfortunately, the assignee of the interest does not obtain the ability to exercise the membership rights. However, simply pledging, or granting a security interest, lien or other encumbrance against any or all of a membership interest does not trigger the loss of such membership interest or governance rights.

If the borrower is organized under the laws of a state other than Delaware or New York, then the applicable state's laws will need to be analyzed as states can vary in their approach to a member's ability to transfer control as well as admit new members.

Accordingly, if a lender wishes to effectuate a Strict Foreclosure and actually "step into the shoes" of the pledgor under the applicable governing document, it needs to make certain that it has the full ability to do so under the pledge or security agreement, the applicable state law and the underlying organizational documents. The lender needs to make sure that after an event of default, it can vote the pledged equity to change the composition of the board. The lender may also want to reduce the number of board members, so it needs to be certain it has the requisite authority to amend the operating agreement or bylaws of the borrower, as applicable. It is important to remember that at this stage of the enforcement process, the existing equity holder still owns, and continues to be, the existing equity holder; the lender is simply exercising voting/control rights over the equity interest. If the lender plans on selling the equity interest, the lender will also need to make sure that it has the power to have the buyer of the interest admitted as an equity holder of the company under the relevant organizational documents.

While it is important for lenders to understand their rights under applicable law and the governing loan documents prior to exercising their remedies, it is critical that the ability to exercise remedies is appropriately drafted at the time the loan is originated. The lenders' enforcement strategy will be shaped by the rights the lenders have under the applicable loan documents and relevant state law. As stated above, the key fact to determine if a Strict Foreclosure is viable starts with value.

For More Information

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.