

Chapman Client Alert

July 23, 2020

Current Issues Relevant to Our Clients

Strictly Speaking, Part II: How Can a Lender Effect a Strict Foreclosure?

This is the second Client Alert of a three-part series relating to executing a Strict Foreclosure. As discussed in our previous Client Alert, *Strictly Speaking: Strict Foreclosure Can Provide an Efficient Smooth Exit for Lenders in the Right Circumstances*, the first step in executing the Strict Foreclosure is for the lender to consider exercising voting rights under the pledge agreement to remove the old board and appoint an independent board to act on behalf of the borrower. The independence of the board will ensure that the borrower will consider, in earnest, the lender's desire to effectuate the Strict Foreclosure enforcement remedy.

Step 1 Proposal for Exchange of Assets for Obligations

The lender will first need to present a proposal to the borrower for the terms of the Strict Foreclosure and specify which assets of the business will be accepted and which liabilities of the business will be assumed in exchange for the satisfaction of all or a portion of the existing debt. Once the proposal is accepted by the borrower, a Strict Foreclosure agreement is typically structured such that a new entity ("Newco") will acquire the assets of the business, other than specifically designated assets which will be retained by the borrower, and conversely, Newco will assume only specifically designated liabilities such that the borrower retains all other liabilities, including but not limited to unknown and undisclosed liabilities.

A. Confirm Perfection of Liens

The Uniform Commercial Code ("UCC") provisions providing for a lender to accept assets for existing loan obligations is premised upon the lender having a validly perfected security interest in the assets accepted by the lender. When a lender has a blanket "all asset" lien on the borrower's assets, however, there often are some assets where a lien was not perfected because it may have been too cumbersome to perfect the lien when the loan was initially made or the asset may have had insufficient value, such as perfecting on vehicle certificates of title or real property leases. In such cases, if the lender would like to receive those assets, the borrower can agree to sell those assets to Newco in exchange for the release of a portion of other loan obligations not part of the original exchange.

There may also be validly perfected non-UCC collateral, such as real estate. Real estate can similarly be sold to Newco in

exchange for a release of a portion of the loan obligations. To the extent that lender wishes to exercise an enforcement action (such as a deed-in-lieu of payment) on real estate, compliance with state and local laws may be required to transfer the real property (e.g., some states require court intervention to transfer real property).

Lastly, it might be possible to structure the transaction as a transfer of stock of such subsidiary if the desired assets are held by a subsidiary. This would avoid the transfer of assets and the need to obtain third party consents that may otherwise be required. Naturally, when Newco acquires stock of a subsidiary it automatically inherits all liabilities of that subsidiary. If Newco plans to leave behind any subordinated debt or other unsecured obligations (trade payables), it will be imperative, if taking stock, to understand what obligations are at the subsidiary level, including whether that subsidiary is an obligor on such subordinated debt.

B. Releasing or Terminating Senior and Junior Liens

The provisions of the UCC, along with any applicable subordination agreement and/or intercreditor agreement between the senior debt and the subordinated debt, may assist the senior lender in effecting the release or termination of junior liens on the applicable property being transferred to the senior lender. To the extent another creditor has a lien that is senior in priority to the liens of the lender, Newco will not be able to obtain a release of that lien and will have to assume that asset subject to the senior lien. In our experience, this situation is most common with a creditor that holds a purchase money security interest in a particular piece of equipment. Newco can notify the creditor after the Strict Foreclosure to consent to Newco assuming the payment obligations of the borrower or decide to leave the asset behind with the borrower.

C. Obtaining Consents

Another factor to consider is whether any consents are necessary for the transfer of the borrower's contracts. To the extent a contract is material to the business, Newco and management can discuss with the contract counterparty its willingness to allow the assumption of the contract prior to or contemporaneously with the consummation of the Strict Foreclosure. To the extent the contract is not material to the business, the counterparty can be contacted after the effectiveness of the Strict Foreclosure. Absent such comfort, Newco takes the risk that a particular contract is not ultimately transferred to Newco. To the extent a contract is critical to the business and a contract counterparty is unwilling to allow the transfer, then a bankruptcy filing may be necessary to address the transfer restriction.

D. Confirmation of Ownership of Assets

Another potential pitfall is whether all the assets used in the business are actually owned by the borrower and its subsidiaries. It is not uncommon for a borrower's holding company ("Holdco") to not be an obligor under the senior secured facility and Holdco may inadvertently hold title to certain assets necessary for the business. Although covenants in credit agreements usually prohibit necessary assets for the business from being owned by a party that is not an obligor under the credit agreement, such a situation is not uncommon – and may be just another breach under the credit agreement, along with the failure to pay the principal and interest. If this is the situation, Newco will need to negotiate with the owners of Holdco for their cooperation in the transfer of such assets. One possibility is that payment or consideration to the equity for such assets may be provided in the form of a release of liability from the borrower and the lender. That approach may not work, however, if Holdco is not a true holding company; i.e., if Holdco has creditors of its own.

Creating Newco Capital Structure

The lender will need to create a capital structure for Newco and provide answers to such questions as: (i) what is the right amount of leverage for the business to "right size" the balance sheet; (ii) what interest rate should be charged under the new loan facility undertaken by Newco (the lender should consider a pay-in-kind interest component so that if the business hits a liquidity speed bump, the business will have the ability to clear that bump); (iii) how do the contemplated interest payments match up to cash flow projections; and (iv) is additional capital and liquidity needed? The terms of the new facility will also

need to be flexible to ensure feasibility of the business going forward. Accordingly, given that the lender will own the equity of Newco, negative financial covenants should be drafted liberally in applicability (*i.e.*, start testing at a later time period) and in compliance. The lender needs to balance putting the maximum amount of debt on Newco that the business can support with the rightsizing of the balance sheet so vendors will provide non-distressed credit terms and customers have confidence that the business is financially stable. Because the lender will own all of the equity of Newco and look to recapture the debt write-down based on returns on the equity, the lender must remember that with respect to its equity position, it is moving from a senior position in the capital structure to a position that is subordinated to all liabilities of the business.

Although it is an issue for the borrower's equity and not an issue for the lender, the forgiveness of indebtedness generated by the foreclosure will generally create income for the borrower. Depending on whether the borrower is taxed as partnership, a pass through entity or a corporation, there may be an exception to recognizing income. In addition, the borrower may be able to utilize net operating losses to shelter its equity from income generated from the forgiveness of indebtedness.

Structure of Transaction

To effectuate the Strict Foreclosure, the lender generally transfers or assigns the existing senior secured debt owed by the borrower ("Borrower Debt") to a new entity (*i.e.*, Newco) in exchange for (i) new secured debt from Newco ("New Debt") and (ii) 100% of the equity of Newco. It is therefore Newco, as the holder of the Borrower Debt, that will actually foreclose on and accept the assets of the borrower in exchange for satisfaction of some or all of the Borrower Debt.

As discussed above, the amount of New Debt placed on Newco needs to be supportable by Newco's business and consistent with the value of Borrower Debt transferred to Newco. In the unlikely event that Newco stumbles going forward, Newco's creditors could attempt to argue that the transfer of Borrower Debt to Newco was a fraudulent conveyance - in other words, that the value of Borrower Debt that was transferred to Newco was not equivalent to the amount of New Debt placed on Newco. In any event, Newco should receive all of lender's right, title and interest in and to Borrower Debt even though the actual market value of Borrower Debt may be less than the face amount of Borrower Debt under the existing facility.

Upon completion of the transfer, Newco (as the holder of Borrower Debt) will have sufficient consideration (in the form of loans) to effectuate the Strict Foreclosure. If the borrower agrees that the acceptance of borrower's assets is for less than the full face amount of Borrower Debt, then any excess amounts can remain on Newco's balance sheet and stay an obligation of the borrower. This will protect Newco and the lender should some unforeseen value be realized by the borrower, as Newco will still be senior in right to any subordinated debt and any other creditor's claim that is not assumed by Newco.

Administrative Considerations

There are many administrative matters that must be attended to in connection with a Strict Foreclosure. Newco will need to obtain a new suite of insurance, including a directors and officers policy (without such a policy, new board members will be unwilling to sit on the board). New bank accounts will need to be opened. Although old bank accounts could be transferred to Newco, opening up new accounts with Newco's EIN is often more efficient as many banking institutions will not allow the transfer of accounts. Payroll services under Newco's EIN will need to be established. Procedures for collecting outstanding accounts receivable (which were transferred to Newco) will need to be established because payments on them will likely be made to the borrower for some time following the Strict Foreclosure.

Employees will also need to receive offers of employment from Newco. It is important to note that employees will be concerned about the business and how the lender's exercise of remedies will affect their jobs and compensation. A communication plan needs to be put in place and timely town hall meetings need to be held to address employee concerns. Similarly, customers and vendors will need to be informed and assured of the support of the business by its new owner.

It should be kept in mind that competitors of the business may try to spread rumors in the market and try to pick off talented employees. It is thus imperative that employees understand their new compensation and benefit arrangements and receive assurances that Newco has the financial capital it needs for its future success. (Our upcoming third Client Alert in this series will address issues related to incentivizing the management team and employee retention.)

Conclusion

In any Strict Foreclosure transaction, the newly appointed independent directors of Newco will need to understand and assess what liabilities are proposed to be left behind with the borrower. The more liabilities Newco is going to assume, the easier it will be for the independent directors to conclude that Strict Foreclosure is in the best interests of the borrower's constituents and the lender's proposal should be accepted. In addition, the independent directors will want to negotiate a wind-down budget for the borrower because, after giving effect to the Strict Foreclosure, the borrower will have no ability to fund the costs associated with its liquidation, whether through a state liquidation proceeding or the filing of bankruptcy under Chapter 7 of the Bankruptcy Code. Upon the liquidation of the borrower, Newco can write off the remaining obligations owed by the borrower on the Borrower Debt. Lastly, the independent directors will likely want a third-party valuation of the borrower so that they can rely on such valuation to comply with their duty of care and ensure that there is a sound basis for accepting the lender's proposal and consummating the Strict Foreclosure.

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.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors. © 2020 Chapman and Cutler LLP. All rights reserved. Attorney Advertising Material.