Private Credit Restructuring: Strict Foreclosure Spotlight

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Chapter 11 is expensive and not always the right tool, particularly for a restructuring of a company with a broken balance sheet, as compared to a business with a broken business model. We have seen a significant uptick in out-of-court activity and clients frequently ask us about foreclosure options. In this post, we highlight a page in the foreclosure playbook — strict foreclosure — and discuss its advantages and challenges.

Strict Foreclosure

Strict foreclosure is a secured creditor's post-default remedy. In its simplest form, strict foreclosure swaps debt forgiveness for collateral ownership. Strict foreclosure is sometimes called "friendly foreclosure," because it typically requires the consent (or, in some instances, non-objection) from the borrower, guarantors and any other creditors with liens on the subject collateral. Strict foreclosure is a state law remedy under Section 9-620 of the Uniform Commercial Code ("UCC") and does not require any judicial process or public notice. If executed correctly, it's entirely out of court. This means there is another added benefit — it's private.

As a threshold matter, the speed and efficacy of strict foreclosure depends on whether the lender is foreclosing on assets of an operating company or equity held by a holding company. Let's use a simple hypothetical to highlight the differences. Assume the following facts:

- A lender ("Lender") made a $100 million loan to an operating business ("Borrower"), which is secured by a first-priority security interest on substantially all of the Borrower's assets ("Assets").
- The loan is guaranteed by the Borrower's parent ("Parent"), which is secured by a pledge of the Parent's equity in Borrower ("Equity").
- There is no other secured debt, and the loan is in default.
- The Borrower needs incremental liquidity, which Parent will not fund. Borrower and Parent have exhausted efforts to refinance the debt or find a strategic or financial

buyer to acquire the business.

- The Borrower’s business plan is viable if it can reduce its outstanding debt.

Based on this fact pattern, the Lender has two potential paths for strict foreclosure — it can foreclose on the Equity (owned by the Parent) or the Assets (owned by the Borrower). In either scenario, the Lender (or more technically, the collateral agent) would form a wholly owned acquisition vehicle (“NewCo”) to either own the Equity or the Assets.

Equity-Level Strict Foreclosure

Strict foreclosure on the Equity (pledged by Parent to secure its guarantee) is faster, easier, and less complex than a strict foreclosure of the Assets (pledged by Borrower to secure the loan). That said, an Equity foreclosure is not always the right tool.

Strict foreclosure on the Equity is the preferred path when the Lender is prepared to own the Borrower on an “as is” basis with no restructuring or compromise of any kind of other debts owed the Borrower. However, if the Borrower has material “legacy” unsecured liabilities (i.e., liabilities that are not critical for the go-forward business and which, if not addressed, will impair the ability to execute on the business plan), then an equity foreclosure would not be an effective tool because an equity-level foreclosure does nothing to address the Borrower’s other liabilities.

A strict foreclosure on the Equity must also navigate “change of control” implications in key contracts or licenses. For example, if the Borrower operates in a regulated industry (*e.g.*, health care, gaming or broadcasting) or has material contracts with unmanageable consequences for changes in control (*e.g.*, franchise agreements), then an equity-level change of control must comply with applicable contract provisions and other requirements. In other words, the business plan must remain viable after the change of control is consummated.

Because an Equity-level strict foreclosure is the preferred path for a downside scenario, at the outset it is important to consider structuring the loan parties to include at least one intermediate holding company between the private equity sponsor vehicle and the operating business.

Asset-Level Strict Foreclosure

The primary reason to consider a strict foreclosure on the Assets is the existence of material legacy liabilities at the Borrower. An Asset-level strict foreclosure allows the Lender to acquire the Assets with all legacy liabilities remaining with the Borrower ("RemainCo"). While this result may be desirable, an Asset-level strict foreclosure presents an additional set of obstacles to navigate, including, among others, (i) successor liability risk at NewCo, (ii) the risk of an involuntary bankruptcy chapter 7 case filed against RemainCo and the resulting appointment of a chapter 7 trustee to investigate transfers and (iii) fraudulent transfer risk for NewCo if the strict foreclosure was, for example, a lopsided exchange of value.

Additionally, an Asset-level strict foreclosure must address a host of complexities that are avoidable in an Equity-level strict foreclosure (in the absence of change-in-control provisions), including (i) navigating anti-assignment clauses in key contracts, (ii) onboarding employees and establishing of benefit plans at NewCo, (iii) developing a plan to acquire non-Article 9 collateral or any assets that were excluded for the collateral at origination (*e.g.*, fee-owned real estate, commercial leases, rolling stock) important for the operation of the business at NewCo, (iv) establishing new bank accounts, obtaining new insurance and (v) developing a wind-down plan for RemainCo. These challenges are not insurmountable, but they can present difficulties. When these challenges become too difficult to manage, parties will often pivot to a Chapter 11 asset sale under Section 363 of the Bankruptcy Code, which offers a host of tools to eliminate the out-of-court obstacles. For example, in a Section 363 sale, most contractual anti-assignment clauses are unenforceable, a new postpetition loan can pick-up collateral that might have been excluded from the original collateral grant, and fraudulent transfer and successor liability can be eliminated in most jurisdictions.

Required Lender Consent

Strict foreclosure is an exercise of remedies. As a result, it is almost always a "required lender" decision to direct the collateral to take remedies after an event of default. When a strict foreclosure is consummated, lenders will receive a pro rata distribution of NewCo equity to match their pro rata holdings of the loan (and, sometimes, "take back debt" of NewCo). As a result of equitizing the debt, the existing lenders will need to negotiate governance rights, board composition and whether NewCo requires (as is typical) incremental financing (and on what terms).

“Tip and Release”

As noted above, strict foreclosure requires the consent of the borrower and, in the case of a partial strict foreclosure, guarantors. In most cases, the negotiation over borrower consent focuses on two things: an equity “tip” for the sponsor, and a release of liability. There are no established rules of thumb here. While most deals include a release, the form and amount of a tip (if any) varies greatly depending on the facts and circumstances, including (i) the existing relationship between parties, (ii) the degree of distress, (iii) the amount of additional funding required for the business, (iv) the circumstances leading to distress and (v) the business need (if any) for the continued involvement and cooperation of the sponsor. Many deals have tips in the range of 2% to 5%, but others fall outside that range based on the circumstances of the particular matter. Similarly, there are often governance negotiations around the terms of minority equity holder protections, if any, offered to the sponsor.

Mechanics of Strict Foreclosure

The requirements for a strict foreclosure (regardless of whether it is an equity-level or asset-level foreclosure) are set forth in Section 9-620 *et seq.* of the UCC. The key requirement involves a written proposal (which can be electronic) and notice to and acceptance by (or no objection from) certain interested stakeholders. The secured lender must make a written proposal (“Proposal”) to the borrower after an event of default to accept collateral in full or partial satisfaction of the debt. For *partial* satisfaction, the debtor must affirmatively consent. For *full* satisfaction, the borrower must either affirmatively consent or fail to object within 20 days after it’s receipt of the Proposal. The secured lender must also send the Proposal to (x) any creditor with a junior, senior or pari lien on the collateral within a 10-day window before the borrower consents to the Proposal or (y) any other person that has notified the secured lender it has an interest in the collateral. These other secured creditors must either consent or fail to object within 20 days of receipt of the Proposal. Finally, in the case of a partial strict foreclosure, the secured lender must also send the Proposal to any guarantors of the debt. Guarantors must consent or fail to object within 20 days of the receipt of the Proposal.

Conclusion

Strict foreclosure is a powerful tool. It has significant advantages in terms of speed, privacy and cost. Private credit lenders must be adept in using these tools to minimize costs and maximize recovery.

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