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Strict Foreclosure in Private Credit Restructuring

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A Practice Note providing guidance on strict foreclosure as a post-default remedy for secured creditors under Article 9 of the Uniform Commercial Code (UCC). This Practice Note explains how private credit lenders can use this powerful out-of-court restructuring tool to take ownership of collateral in full or partial satisfaction of a defaulted debt, offering a potentially faster and more cost-effective alternative to a Chapter 11 bankruptcy. It outlines the core mechanics of the process, including the requirements for a proposal and the necessary consents from the borrower, guarantors, and other stakeholders. This Practice Note also examines the critical strategic decision between foreclosing on equity versus assets, detailing the distinct challenges and advantages of each path as it relates to legacy liabilities, change-of-control provisions, and operational continuity. It also compares the benefits of a strict foreclosure with an asset sale under section 363 of the Bankruptcy Code, highlighting the important trade-offs for lenders to consider.

Article 9 of the UCC permits a secured creditor to effectively buy the collateral of a borrower in default. Known as strict foreclosure, a secured creditor will forgive the borrower's debt in exchange for ownership of the underlying collateral. Strict foreclosure can benefit both parties to the transaction because:

- The borrower's debt is forgiven.
- The secured creditor now owns property free of subordinate interests and can bypass a sale process.

Other methods of obtaining ownership of collateral, including Chapter 11 bankruptcy, can be expensive and not always necessary when the borrowing company suffers from an overlevered broken balance sheet rather than a flawed business model requiring operational changes. Strict foreclosure is an alternative to in-court restructuring and can be a powerful tool for private credit lenders. Strict foreclosure has significant advantages in terms of speed, privacy, and cost. However, private credit lenders must be adept in using these tools to minimize costs and risk and maximize recovery.

As with the general purpose of the UCC, Article 9 is intended to create a uniform system across the country for creating, perfecting, and enforcing security interests in personal property. Although Article 9 has been adopted by every state, some states have made modifications to the law or have not adopted the most recent version of the law. Counsel must therefore consult local law whenever conducting an Article 9 Sale. For more information on UCC Article 9, see Practice Note, UCC Article 9 Secured Party Sales. All section references contained in this Note refer to Article 9 of the 2022 Revised Model UCC.

Foreclosure on Equity Versus Assets

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 requires consent or non-objection from the borrower, guarantors, and any other creditors with liens on the 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 is completed entirely out of court as a private transaction.

The speed and efficacy of strict foreclosure depends on whether the lender is foreclosing on either:

- Equity of the borrower held by a guarantor holding company.
- Assets of an operating company.

As an example, assume that a lender made a $100 million loan to an operating business (borrower), which is secured by a first-priority security interest on substantially all the borrower's 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 the parent will not fund. The borrower and parent have exhausted their 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 these facts, the lender has two potential paths for strict foreclosure. It can foreclose either on:

- The borrower's equity, owned by the parent.
- The borrower's assets, owned by the borrower.

In either scenario, the lender would typically form a wholly owned acquisition vehicle (NewCo) to either own the equity or the assets.

Equity-Level Strict Foreclosure

Strict foreclosure on equity pledged by a parent to secure its guarantee is the preferred path when the lender is prepared to own the borrower on an "as is" basis with no operational restructuring or compromise of any kind of other debts owed the borrower. It is faster, easier, and less complex than a strict foreclosure of assets pledged by borrower to secure the loan.

However, if the borrower has other material liabilities and requires an operational restructuring (for example, terminating unprofitable contracts), then equity foreclosure is not an effective tool because an equity-level foreclosure does nothing to address these other liabilities. These other liabilities are generally not critical for the go-forward business, but if not addressed will impair the lender's ability to execute on a business plan.

A strict foreclosure on equity must also navigate change of control implications in key contracts or licenses. Equity foreclosure might be challenging when the borrower:

- Operates in a regulated industry such as health care, gaming, or broadcasting.
- Maintains material contracts with unmanageable consequences for changes in control such as a franchise agreement.

Because an equity-level strict foreclosure is the preferred path when a borrower defaults, the lender should consider at the outset of the loan transaction whether to structure the loan parties to include at least one intermediate holding company between the private equity sponsor vehicle and the operating business. The creation of the intermediate holding company will increase the ease of executing a strict foreclosure at the equity level.

Asset-Level Strict Foreclosure

The primary reason a lender would consider a strict foreclosure on a defaulting borrower's assets, as opposed to on the borrower's equity, is because of the existence of a borrower's material legacy liabilities. Executed correctly, an asset-level strict foreclosure allows the lender to acquire the assets with all legacy liabilities remaining with the borrower (RemainCo).

While being able to separate the assets and liabilities into different companies is desirable, an asset-level strict foreclosure presents additional obstacles to navigate, including:

- Successor liability risk for NewCo (see Practice Note, Successor Liability Concerns in Distressed Transactions).
- The risk of an involuntary Chapter 7 bankruptcy filing against RemainCo and the resulting appointment of a Chapter 7 trustee to investigate transfers (see Practice Note, The Involuntary Bankruptcy Process).
- Fraudulent transfer risk if the strict foreclosure was, for example, a lopsided exchange of value involving an insolvent borrower (see Practice Note, Fraudulent Conveyances in Bankruptcy: Overview).

Additionally, an asset-level strict foreclosure must address a host of complexities that are avoidable in an equity-level strict foreclosure (absent change-in-control provision complications), including:

- Navigating anti-assignment clauses in key contracts (see Practice Note, UCC Issues: Excluded Property and Anti-Assignment Provisions: Dealing with Anti-Assignment Provisions).
- Onboarding employees and establishing benefit plans at NewCo.
- Developing a plan to acquire non-Article 9 collateral or any assets that were excluded from the lender's collateral at origination that may be important for the operation of the business at NewCo, such as:
  - fee-owned real estate;
  - commercial leases; or
  - rolling stock.
- Establishing new bank accounts and obtaining new insurance.
- Developing a wind-down plan for RemainCo.

Mechanics of Strict Foreclosure

The requirements for strict foreclosure are set out in Article 9 of the UCC. In a strict foreclosure, a secured creditor acquires the borrower's collateral in partial or full satisfaction of a secured debt. This transaction is considered a sale of collateral.

- A partial strict foreclosure occurs when the secured party has a deficiency claim after taking possession of the collateral.
- A full strict foreclosure occurs when there is no deficiency claim and the debt is fully discharged.

The key requirements of strict foreclosure include:

- A written proposal, which can be electronic.
- Notice to and acceptance by (or no objection from) certain interested stakeholders.

The secured creditor must make a written proposal to the borrower after an event of default to accept collateral in full or partial satisfaction of the debt:

- For partial satisfaction, the borrower must affirmatively consent (UCC § 9-620(c)(1)).
- For full satisfaction, the borrower must either affirmatively consent or fail to object within 20 days after their receipt of the proposal (UCC § 9-620(c)(2)).

The secured creditor must also send the proposal to:

- Any creditor that:
  - held a junior, senior, or equally ranking lien on the collateral ten days before the borrower consents to the proposal; and
  - satisfied specific perfection requirements.
- Any other person that has notified the secured creditor of their interest in the collateral.

(UCC § 9-621(a).) These other secured creditors must either consent or fail to object within 20 days of receipt of the proposal (UCC § 9-620(d)).

In the case of a partial strict foreclosure, the secured creditor must also send the proposal to any guarantors of the debt. Guarantors must consent or fail to object within 20 days of receipt of the proposal. (UCC §§ 9-621(b) and 9-620(d).)

The secured creditor's acceptance of the collateral in partial or full satisfaction of the outstanding debt:

- Discharges the debt to the extent consented to by the borrower.
- Transfers the borrower's rights in the collateral to the secured creditor.
- Discharges the security interest and any subordinate security interest in the collateral.
- Terminates any other subordinate interest.

(UCC § 9-622(a).) Even if the secured creditor does not comply with the requirements for acceptance of collateral set out in UCC § 9-622(a), the subordinate interests in the collateral are still discharged (UCC § 9-622(b)).

For more information on strict foreclosure, see Practice Notes, Non-Bankruptcy Alternatives to Chapter 11 Restructurings and Asset Sales: Strict Foreclosure and Mezzanine Loan Foreclosures: Strict Foreclosure.

Required Lender Consent

Strict foreclosure is an exercise of remedies. When a strict foreclosure transaction is consummated, the lenders will receive either or a combination of:

- A pro rata distribution of NewCo equity to match their pro rata holdings of the original loan.
- New loans from NewCo instead of or in addition to NewCo shares (also known as take back debt).

If the debt is equitized to ownership, the existing lenders will need to negotiate:

- How NewCo will be run, including governance rights and board composition.
- Whether, and on what terms, NewCo requires additional financing.

Required Borrower Consent: Tip and Release

Strict foreclosure requires the consent of the borrower and, in the case of a partial strict foreclosure, consent of any guarantors. Usually, the negotiation for the borrower consent focuses on two things:

- An equity tip, where the borrower's sponsor is given a small ownership stake in NewCo.
- Releasing the sponsor from further liability.

There are no established norms for how much of a tip is given or the form it should take. The form and amount of a tip (if any) varies greatly depending on the facts and circumstances, including:

- The existing relationship between parties.
- The degree of the borrower's financial distress.
- The amount of additional funding required for the business.
- The circumstances leading to the borrower's distress.
- Whether the sponsor's continued involvement in the company is necessary.

Many deals have tips in the range of 2% to 5%, but others fall outside that range based on the circumstances. Similarly, there are often governance negotiations around the terms of minority equity holder protections, if any are offered to the sponsor.

Strict Foreclosure Versus 363 Sales

When the challenges of asset-level strict foreclosures become too difficult to manage, parties will often pivot to a Chapter 11 asset sale under section 363 of the Bankruptcy Code. Section 363 offers a host of tools to eliminate the out-of-court obstacles that can arise with strict foreclosure.

Some of the benefits of a section 363 sale include that:

- Most contractual anti-assignment clauses are unenforceable (see Practice Note, Executory Contracts and Leases: Overview: Anti-Assignment Clauses).
- A new postpetition loan can pick up collateral that might have been excluded from the original collateral grant.
- Fraudulent transfer and successor liability can be eliminated in most jurisdictions. An Article 9 buyer also faces a potential risk that the sale may later be attacked as a fraudulent transfer (see Practice Notes, Fraudulent Conveyances: Issues and Strategies for Lenders and Private Equity Sponsors and Fraudulent Conveyances in Bankruptcy: Overview).
- The borrower can sell the entire business. It can prove difficult to sell an entire business under a strict foreclosure, particularly when the sale involves coordinating a conveyance of additional assets not subject to the secured creditor's security interests. In bankruptcy, a debtor can sell all or substantially all of its assets under a plan of reorganization (see Practice Note, Buying Assets Under a Chapter 11 Plan) or to any good faith purchaser in a section 363 sale.
- There is protection from other creditors. The borrower may be subject to additional collection efforts from other creditors, which may interfere with the secured creditor's ability to transact a strict foreclosure. By contrast, in bankruptcy, the automatic stay is triggered immediately on the filing of the bankruptcy petition and stops almost all acts and proceedings against the company, including virtually all creditor collection activities (see Practice Note, Automatic Stay: Overview).

For more information on the advantages of section 363 sales, see Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview: Key Advantages of Section 363 Sales.

The benefits of section 363 of the Bankruptcy Code, however, are not absolute. A strict foreclosure under UCC Article 9 will generally involve:

- A faster process. A conveyance of collateral under UCC Article 9 can be accomplished in weeks (or faster), which is significantly less than the usual time necessary to conduct a section 363 sale (for a timeline of a typical section 363 sale, see Timeline of a Section 363 Sale).

- Lower costs. The costs of collateral repossession and sale are significantly less than the costs associated with a Chapter 11 bankruptcy and section 363 sale.
- Fewer constituencies. Only the secured creditors generally participate in the process, and it is possible to do a private third-party sale transaction under UCC Article 9. In contrast, a bankruptcy sale will involve the bankruptcy court, the creditors' committee, and the US Trustee. These additional parties can cause numerous difficulties to arise during a bankruptcy case and add to the costs.

For more information on the disadvantages of section 363 sales, see Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview: Disadvantages of Section 363 Sales.