

Secured Party Transactions Under UCC Article 9: A Strategic Method of Acquiring Distressed Assets

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The economic downturn that began in 2008 and, in many industries, continues today has sounded the death knell for weak or over-leveraged companies. At the same time, it presents opportunities for buyers. If your company is a strategic buyer involved in the target company's industry or a financial buyer without any industry-related experience, what is the preferred means of acquiring the assets of a target that is in financial distress? For myriad reasons, a secured party transaction under Article 9 of the Uniform Commercial Code may be the acquisition method of choice.

An Article 9 secured party transaction is an out-of-court process by which a secured lender acts on its lien encumbering the borrower's personal property assets and thereby effectuates a transfer of title to those assets. The transfer may be to a third-party purchaser through a public or private disposition, known as a secured party sale, or the transfer may be to the secured party itself, who retains the collateral in full or partial satisfaction of the underlying indebtedness, in what is known as a strict foreclosure.¹

Common features of each method of disposition are that:

- There is no operative agreement with the target company, which, along with its principals, is peripheral to the process.
- The transfer of assets can often be completed within 30 days, without the scrutiny of a bankruptcy court or creditors committee and without the publicity and cost attendant to sales under [Section 363 of the Bankruptcy Code](#).

While not affording all the protections of a sale order entered by a bankruptcy court, a secured party transaction results in the termination of the senior lien that is being foreclosed, as well as the termination of all subordinate liens.² Title to the assets being acquired is thus cleansed as part of the process.

Moreover, because the secured party who holds the first, paramount lien on the debtor's assets often does not receive payment in full, the risk that an unsecured creditor will attempt to challenge the process as a fraudulent transfer or otherwise is usually not great. This is because of the realization that any recovery would first inure to the benefit of the secured lender before any such funds are available to satisfy unsecured claims.

The absence in a secured party transaction of a definitive purchase agreement with the target company is logical but, at the same time, presents challenges. Since neither the company nor its equity holders are likely to receive any of the proceeds resulting from a disposition of the company's assets, they are not the principal stakeholders in the transaction; the secured lender is. Thus, the incentives for a company and its principals to negotiate an asset purchase agreement in good faith, with an acceptable level of responsiveness and truthfulness, are

¹ U.C.C. §§ [9-610](#) and [9-620](#)

² U.C.C. § [9-617](#)

lacking, as is their willingness or financial wherewithal to provide adequate indemnification to the buyer.

Rare are the situations in which the time and cost of negotiating an asset purchase agreement directly with a failing company are justified by the protections garnered by the purchaser in the process. A secured party transaction therefore redirects the primary negotiations away from the debtor and toward the secured lender.

However, the secured lender's knowledge of the debtor company and its operations is not co-extensive with the knowledge of the company's principals. Further, in the context of a secured party disposition and the agreements in which it is memorialized, the foreclosing lender will make few, if any, representations about the company itself. The affirmative representations will be limited to the secured indebtedness that is the basis for the disposition.

How can this knowledge gap be bridged? How can the purchaser, and, in particular, a financial purchaser, who may have limited familiarity with the industry in question, obtain the relevant information and assistance that is critical to resuscitating the failed business? The answers to these questions underscore the interdisciplinary nature of making acquisitions through secured party transactions.

It should be apparent that expertise in Article 9 of the UCC is a prerequisite to navigate a secured party transaction successfully. The following are essential to the process:

- Performing due diligence to ensure that the lender has a first priority lien.
- Eliciting representations and warranties to confirm that the lender has not transferred, encumbered or otherwise compromised the rights that are the predicate to the secured party transaction.
- Verifying that landlord liens have been subordinated and the landlord has granted a right of entry that will allow the removal of tangible collateral from the target's facility.
- Monitoring or, perhaps, directing the sale process to ensure that all facets are commercially reasonable and in compliance with statutory requirements.³
- Ascertaining impediments to the purchaser's acquiring all critical assets due to the limited nature of the secured lender's lien or the scope of coverage of Article 9.

However, mastery of UCC Article 9 must be supplemented by an expertise in merger and acquisition transactions; the former enables the purchaser to acquire the target company's assets for the agreed-upon consideration, while the latter facilitates the rebuilding of the business with minimal disruption, cost and delay.

What are the M&A considerations that must be addressed in parallel with, and which inform, a secured party transaction? Knowing what sales, technical, financial and other personnel are key to ongoing business operations is usually of paramount importance. Assistance from the debtor entity may be required to identify and negotiate retention agreements with these individuals, some or all of whom may be owed back pay, as well as unused vacation and sick pay. These individuals may not be subject to restrictive covenant agreements and may be principals of the company whose egos have been wounded and whose equity has been rendered worthless.

³ See U.C.C. § [9-610\(b\)](#)

Also, are there critical vendors, such as utility companies, licensors, franchisors or suppliers of raw materials, whose claims will have to be satisfied in order to induce them to continue doing business with the purchaser?

In addition, if the resuscitated business will be operated from the same location as the failed company, a new lease or an assignment of the existing lease will have to be negotiated with the landlord, which in many cases is a real estate holding company owned by the same principals who control the operating company that has failed.

To capture the goodwill associated with the debtor's business, the purchaser may want the rights to the name under which the debtor has conducted business. That, in turn, will require the debtor to abandon that name by amending its constitutional documents.

Transitioning the business to the purchaser may also require negotiating with unionized workers, complying with environmental or health and safety laws applicable to the operations, and obtaining third-party consents from customers, vendors or regulatory authorities.

Analysis of these M&A considerations leads ineluctably to the conclusion that help from the debtor's principals will be required in order to effectuate a seamless transfer of the business by means of a secured party transaction. How can that assistance be ensured? While the equity in the debtor company will likely be wiped out, the principals of the debtor can be compensated for their assistance through consulting arrangements, employment agreements or, perhaps, an equity stake in the purchaser.

Additionally, the principals of closely held companies are often required to personally guarantee the corporate debt. Another inducement for cooperation is a promise that their personal guarantees will be limited in amount, or forgiven entirely, if the secured party transaction is consummated without delay or challenge by the debtor or its principals. Relief from the specter of financial ruin and personal bankruptcy that could result from a suit on a personal guarantee may alone be adequate incentive for full cooperation from the debtor's principals.

The willingness to pay for the cooperation of the debtor's principals, or to argue on their behalf to obtain a release of personal guaranties, must be tempered by the realization that all benefits flowing to those principals are likely to be scrutinized carefully and to engender resentment. A secured lender with a first-position, blanket lien on the company's assets that is not getting paid in full will understandably oppose above-market compensation arrangements with the debtor's principals or their receipt of a substantial equity interest in the purchaser. Conferring excessive benefits upon the principals may imperil the deal or, at a minimum, heighten the level of adversity with the secured lender. This is a meaningful concern if that same lender is providing financing to the purchaser to fund the acquisition.

Similarly, if junior secured creditors or unsecured creditors become aware that excessive consideration is being paid to the debtor's principals, they are likely to object and may be emboldened to challenge the Article 9 transaction on that basis. The argument advanced by those creditors would be that consideration that should have flowed to the debtor for the benefit of its creditors has been mischaracterized and diverted to the debtor's equity holders.

Striking the proper balance between securing the cooperation of the debtor's principals and not inflaming creditors whose claims will not be paid in full requires finesse, experience and an appreciation of the competing concerns of all parties involved.

Conclusion

Successfully acquiring a target company by means of a secured party transaction is in many ways akin to a game of chess. It requires knowledge of the applicable rules and the adoption at the outset of an overall strategy, one that takes account of the various stakeholders, anticipates the offensive and defensive moves each is likely to make, and focuses on the result to be achieved within the allotted timeframe.

Unlike a chess match, however, a secured party transaction may involve the intervention of third parties whose nexus is minor but who, nonetheless, have the potential to frustrate or delay consummation of the acquisition, unless they can be neutralized or their concerns addressed.



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