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COVID-19 Advice: Post-Default Enforcement Against Equity Collateral

Finding the Balance

By Craig Unterberg and Alex Grishman[1]

The pledge of equity interests of a privately held company as collateral is a common occurrence in a wide variety of financing structures. What is not as common perhaps is for secured creditors to analyze, at the initial stages of a transaction, the road maps that may serve to mitigate any meaningful delays or diminution in the value of such collateral in a foreclosure scenario. When a secured party takes as collateral equity interests of privately held companies, the potential for a drawn out and difficult foreclosure process should be vetted at the structuring stage of a transaction. In connection with such vetting, the secured party should analyze the applicable provisions of Article 9 of the Uniform Commercial Code, as enacted pursuant to applicable state law (the ‘‘UCC’’). In particular, the secured party should be aware of the parameters and uncertainties regarding the permitted scope of its conduct after a default but prior to a foreclosure with respect to such collateral, especially in light of the 2019 Novel Coronavirus (“COVID-19”) pandemic and the resulting effects on general commercial activity and volatility in financial markets across the world.

In order to manage and mitigate such risks while simultaneously avoiding any lender liability claims after a default, a secured creditor needs to consider (i) its rights under the applicable UCC provisions and the applicable loan documents and (ii) the scope of the power of attorney and proxy in relevant security documents. Such considerations will help to formulate a well-informed foreclosure strategy going into the applicable transaction.[2]

When a secured creditor takes equity interests as collateral, it is not uncommon to hear such creditor speak as though it will simply take over the rights to such equity interests and control the issuer upon an event of default. In practice, foreclosing on equity interests of a privately held company, such as those representing ownership interests in limited liability companies, limited partnerships or other non-public entities, is not quite as cut and dried.[3] A secured creditor may acquire the equity of the company in certain situations, but a secured creditor

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[2] In addition, for a secured party that plans to take equity interests in limited liability companies, partnerships or foreign entities as collateral, it is also important to determine whether the secured party must obtain the consent or acknowledgement of the underlying issuers, general partner, or managing member in order to obtain the economic or non-economic rights (such as voting) related to the applicable equity interest. In certain situations, a failure to obtain such a consent can eliminate a secured party’s ability to enforce or foreclose on the non-economic rights related to such equity interests.

[3] For publicly traded equity interests that are listed on an exchange that satisfies the recognized market requirement under the UCC (which most U.S. listed equities will satisfy), the foreclosure process is significantly less restrictive. This is due to the fact that a commercially reasonable determination of the price has already been established by such recognized market. So, foreclosing on publicly listed shares can be relatively simple by just selling them on the relevant exchange (assuming there

should not make any blind assumptions regarding the timing and manner of such acquisition. Rather, it is very important that a secured creditor that has private company equity interests as collateral understands the foreclosure provisions of the UCC.

When foreclosing on collateral, a secured creditor must follow the UCC foreclosure provisions in order to sell or otherwise dispose of such collateral. Article 9 of the UCC provides three primary foreclosure options: (i) a public sale under § 9-610, (ii) a private sale under § 9-610 or (iii) retention of collateral in full or partial satisfaction of the debt, also known as strict foreclosure, under § 9-620 and § 9-621. With respect to all aspects of public or private foreclosure, Article 9 of the UCC requires that the secured creditor act in a manner that is commercially reasonable. A major distinction between a private and public foreclosure sale is the ability of the secured creditor to credit bid at a public foreclosure sale and acquire the collateral for itself. A note to the reader, strict foreclosure is rarely relied upon as a viable option prior to a default given that it requires post-default consent from the debtor, which consent may not be easily obtained.

Public or Private Sales, Taking Control

The problem with relying on either a public or private sale option is the potential for delay, during which the value of the collateral could deteriorate. A private sale can, in theory, be accomplished quickly since § 9-612 of the UCC provides the secured party with a relatively short 10-day safe harbor period for satisfying advance notice requirements. This, however, assumes the secured creditor can find a suitable third party buyer for such equity interests, which is the most unpredictable aspect of executing an expeditious private sale, particularly in periods of volatility in capital markets such as the current economic downturn that we are facing due to the COVID-19 pandemic. In a public sale, additional delays are common due to the advertising requirements that must be satisfied. Such requirements can lead to multiple weeks of delay in the sale of the collateral. These potential delays that are inherent in the UCC foreclosure sale process are a central concern and a secured creditor should plan its strategies for dealing with such delays in the event the debtor defaults.

With the potential for delay a secured creditor must mitigate risks with respect to the diminution in value of the collateral. In a loan structure in which the major collateral is represented by equity in a private company that is distressed and losing value, the question that arises is what can be done to protect the collateral until it can be sold. Can the secured creditor step in and run the company? Security documents will often include a power of attorney in favor of the secured creditor that permits it to exercise broad rights with respect to such equity interests in order to ‘‘protect the secured party’s interest in the collateral,’’ especially after a default by the debtor. It would make sense from a contractual standpoint then that the secured creditor could step in and exercise its rights to run the company and make company decisions in a manner consistent with protecting the collateral’s value. However, while the contractual language may be broad from a practical standpoint, the courts have imposed certain limits on what actions can be taken by a secured party on a pre-foreclosure basis. If a secured creditor exercises too much control prior to a foreclosure, a court could find such actions to be commercially unreasonable, violative of Article 9 of the UCC, breach of a duty owed to the debtor and/or indicative of a manager of the business and subject to liability. Unfortunately, the courts and the UCC do not provide clear guidance for secured creditors

are no securities law restrictions on such sales). As a result, this Article will focus on collateral consisting of privately held equity interests as collateral when exercising their pre-foreclosure rights to manage a company to avoid or limit diminution in the value of the equity.

In order to assess the risk of taking any actions to control the company prior to foreclosure, a secured creditor needs to understand the applicable case law and also understand the commercial reasonableness standard under the UCC. In *In re LaRoche*[4], the court allowed a secured creditor to re-register the pledged securities in its own name, so the secured party could receive dividends and vote, citing language from the pledge that explicitly allowed the creditor "at its option without notice" to "transfer into its name or the name of its nominees all or any part of the collateral including stock, bonds, and other securities"[5]. The court rejected the debtor's "implied election" theory that secured creditor's reregistration of the pledged securities in its own name constituted conduct indicating an intent to retain or strictly foreclose on the securities and waive any deficiency without actual written notice[6]. This case indicates that at least nominally taking control of the company should be commercially reasonable, especially where the security documents are drafted to allow such right. In that instance, the secured creditor at least passively obtains some control of the company in that the prior owner is unable to vote in any manner that would cause deterioration in the value of the collateral, either through voting for detrimental actions or distribution of dividends. The next question though is what steps can be taken by the secured creditor to actively control the company? It is clear that not all voting rights are authorized. In *Raible v. Puerto Rico Industrial Development Co.*[7], a secured creditor voted for a merger where the pledge agreement did not expressly grant such voting right to the secured creditor. The court held that the secured creditor was not authorized to vote for a merger, and such voting was a deemed election of a strict foreclosure[8]. In this instance, the court found that voting for a merger went too far.

So where is the line? The answer is not clear as these cases only address two fact scenarios. However, it seems clear from these cases that one bright line is whether the action taken is to protect the collateral rather than to realize on the collateral. Whether actions that fall in between would be permissible is a risk assessment that will be made on a case by case basis until further guidance is provided by the courts. Accordingly, prior to taking any action, a secured creditor should conduct sufficient due diligence with respect to the organizational documents of the company in order to understand the mechanics of the voting rights of the pledged equity, including the necessity of obtaining the proper corporate/partnership consents. In addition, the secured creditor needs to

[4] 969 F.2d 1299 (1st Cir. 1992).
[5] *Id* at 1301-02.
[6] "Under the 'implied election' theory, the absence of written notice of election by the secured creditor would not bar the debtor's recourse to [UCC § 9-620] as a *defense to payment* of the debt if the secured creditor (1) failed to dispose of the collateral within a "reasonable" time after default…or (2) engaged in other conduct (*e.g.*, interim use of collateral) that indicates an intent to retain the collateral and waive any deficiency" *Id* at 1303. *But see, e.g.*, *In re Boyd*, 73 Bankr. 122, 124-25 (N.D. Tex. 1987).
[7] 392 F.2d 424 (1st Cir. 1968).
[8] "There is no specific mention of voting rights in the agreement" but "even if we accept the contention that under the agreement ordinary voting rights were in the pledgee, there are some votes which cannot be justified by this authority…Initially, it constituted a change in the very nature of the pledged property, rendering the return of the res on tender of payment of the secured debt impossible. Further, it resulted in a substantial change of the terms of the agreement." *Id* at 426-27.

analyze the debt structure of the underlying company to determine whether any other creditors have structurally senior liens on the assets of the company.

As noted above, the actions taken must also be commercially reasonable to avoid any violations of Article 9 of the UCC and exposure to lender liability claims by interested third parties. Specifically, if the actions taken by the secured creditor result in the value of the pledged equity interests decreasing, even indirectly, then the actions of such secured creditor may be scrutinized and challenged by the debtor, the debtor's bankruptcy trustee or even third parties who were impacted by the diminution in value, e.g., other shareholders. It appears that the most important factor for the secured creditor to consider is whether the action is taken solely to ''protect the secured party's interest in the collateral'' and the extent of the specific granting of rights under the power of attorney. In each instance, a secured creditor should ask at least three questions: (i) is the power of attorney language broad enough to permit the contemplated action? (ii) is the action solely to protect the secured creditor's interest in the collateral? and (iii) is the action commercially reasonable?

Any actions taken by the secured creditor will need to be analyzed on a case by case basis to determine whether such actions are being made consistent with the points above. In order to avoid potential damages under §§ 9-625 and 9-626 of Article 9 or pursuant to a lender liability claim, such as conversion or a similar tort claim, for wrongful actions by a creditor, a secured creditor should try to limit exercising its power of attorney and pre-foreclosure rights within the context of collateral protection as described above.

Understanding the applicable UCC provisions discussed above and the nuances related to the power of attorney provisions contained in applicable security documents will allow a secured creditor to have a well-informed foreclosure strategy going into the applicable transaction, which strategy should seek to avoid and mitigate unexpected delays in collateral realization and any resulting diminution in value related to such delays. Furthermore, a secured creditor will be able to navigate such process in a manner that is less likely to solicit lender liability claims or assertions that the relevant secured creditor failed to act in a commercially reasonable manner. Particularly during these turbulent times amidst the COVID-19 pandemic, it is important for secured creditors to take these factors into account while developing post-default strategies.