AMERICAN BANKRUPTCY INSTITUTE

2022 Annual Spring Meeting

The Use of Article 9 as a Sale Method for a Distressed Company

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CONCURRENT SESSION

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AMERICAN BANKRUPTCY INSTITUE

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THE USE OF ARTICLE 9 AS A SALE METHOD

FOR A DISTRESSED COMPANY

APRIL 30, 2022

I. Key Learning Objectives

A. Understand the basic issues involving the sale of a going concern business through an Article 9 sale.

B. Understand the concerns of the constituents in an Article 9 sale.

C. Identify complex issues to watch for in a sale.

II. Article 9 Basics[1]

A. Key aim - achieve a commercially reasonable, defensible sale.

B. Provide notice to borrower, other lienholders, judgment creditors, guarantors and other parties.

1. Run UCC and judgment lien searches prior to sale to benefit from the safe harbor provisions of section 9-611(c).

2. Provide notice – section 9-611(e)

a. What constitutes reasonable notice will vary depending on the type of collateral and the circumstances surrounding the sale. Generally, a secured creditor is deemed to have given sufficient notice if it gives at least

[1] All section references in this paper refer to Article 9 as enacted in New York State. Although Article 9 has been enacted in all 50 states, some states have made modifications or have not enacted its most recent version. Counsel should consult the applicable version before conducting an Article 9 sale.

ten days' notice of the sale to the debtor and other required parties

C. Every aspect of a disposition of collateral must be commercially reasonable, including the method, manner time, place, and other terms. In determining whether a sale was commercially reasonable, courts consider:

1. Price

a. Although most Article 9 sales result in below market prices, a particularly low price may cause a court to more closely scrutinize the sale or the sale procedures.

2. Manner of disposition

a. Public or private sale? See, Section 9-610(b)("If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.")

b. Notice requirements - see, Section 9-611(c)

i. The debtor

ii. Any secondary obligor

iii. If the collateral is anything other than consumer goods, then (a) any other party from which the secured creditor received an authenticated notification of an interest in the collateral, (b) a secured party or lienholder that, ten days before the notification date, held a security interest or other lien on the collateral perfected by the filing of a properly recorded financing statement and (c) a secured party that ten days before the notification date held a security interest in the collateral perfected by compliance with a statute, regulation or treaty described in UCC section 9-611(c)(3)(B).

iv. The secured creditor must conduct a lien and judgment search to determine who is entitled to notice. Section 9-611(e) contains a safe harbor if "not later than twenty days or earlier than thirty days before the notification date, the secured party requests, in a commercially reasonable manner, information concerning financing statements indexed under the debtor's name in the office indicated in subsection (c)(3)(B) and (2) before the notification date, the secured party; (A) did not receive a response to the request for information; or (B) received a response to the request for information and sent an authenticated notification of disposition to each secured party or other lienholder named in that response whose financing statement covered the collateral."

v. Ten-day notification period is reasonable in a non-consumer transaction. Whether less than ten days' notice is reasonable is a question of fact. Section 612(a) and (b).

vi. Exceptions to notice where the collateral is perishable (such as produce), where it threatens to rapidly decline in value (such as stocks) or where it is sold on a recognized market. See, UCC section 9-611(d).

vii. Section 9-611(a) provides that, to be sufficient, the notice should:

   i. Describe the debtor and the secured party;

   ii. Describe the collateral that is the subject of the intended disposition;

   iii. State the method of the disposition;

   iv. State that the debtor is entitled to an accounting of the unpaid indebtedness and states the charge, if any, for an accounting; and

v. State the time and place of a public disposition or the time after which any other disposition is to be made.

c. Advertising.

i. Determine the appropriate media for advertising

d. Marketing.

3. Timing of disposition

4. Maximizing the Sale Price

5. Determining whether a sale was commercially reasonable:

a. Section 9-627 provides that “[t]he fact that a great amount could have been obtained by a collection, enforcement, disposition, or acceptance at a difference time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.”

b. A disposition of collateral is made in a commercially reasonable manner if the disposition is made;

i. In the usual manner on any recognized market;

ii. At the price current in any recognized market at the time of the disposition; or

iii. Otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition. See, section 9-627(b)

c. A collection, enforcement, disposition, or acceptance is commercially reasonable if it has been approved:

i. In a judicial proceeding;

ii. by a bona fide creditors' committee;

iii. by a representative of creditors; or

D. iv. by an assignee for the benefit of creditors. See, section 9-627(c).Private or public sale considerations

III. Using Article 9 to Sell a Going Concern Business

A. Why use Article 9

1. Speed

2. Cost

3. Fewer constituencies

4. No advance notice to trade debt required

5. Minimal administrative expenses

a. No creditors' committee

6. Continuity of operations

a. Value preservation

7. What are the key factors needed for a successful Article 9 sale of a going concern business?

a. Cooperative borrower

i. Likely incentivized by obligations on a guaranty and satisfied that an Article 9 sale will maximize value

ii. Uncomplicated capital structure

B. Why Not Use Article 9?

1. Inability to sell entire business

a. Can only sell assets that are subject to the secured creditor's lien.

b. Cannot sell real property in an Article 9 sale.

c. Cannot assume and assign leases in an Article 9 sale

2. Cannot stop other creditors' actions during the sale process including collection actions, eviction proceedings and foreclosure actions that can adversely impact the sale.

3. Risk of a post-sale attack on the transaction through a fraudulent conveyance or successor liability action.

4. Possibility that an involuntary bankruptcy will be filed.

5. Need for ownership cooperation

C. What are the alternatives to Article 9 Sales?

1. Sales under section 363 of the Bankruptcy Code

a. Benefits.

i. Ability to sell the entire business, including real property and real estate leases, as a going concern.

ii. The Bankruptcy Code's automatic stay enjoins creditor actions during the sale process.

iii. Assets can be sold free and clear of liens and claims, including post-sale fraudulent conveyance and successor liability claims.

b. Risks.

i. Lender may have to fund the borrower's operations and legal fees and other administrative expenses pending the closing of the sale.

ii. The creditors' committee will likely investigate the validity of liens as well as any lender liability claims.

2. Receivership (federal or state)

3. Assignment for the benefit of creditors

4. Equity sale

5. Note/debt sale

   a. Sale to a third party

   b. Sale to insiders

D. What are the lender's concerns?

1. Will the sale be free and clear?

2. Can all of the assets needed to operate the business be sold under Article 9? What are the workarounds/costs associated with selling/transferring assets not subject to Article 9?

3. Can the sale be challenged by creditors?

   a. Constructive fraudulent conveyance.

   b. Junior lienholders and PMSI holders.

4. What reps and warranties will the lender have to provide?

5. Will the borrower or a creditor commence a bankruptcy proceeding to stop the sale?

6. Does the borrower's management have authority to agree to an Article 9 sale?

E. What are the borrower's concerns?

1. Why should the borrower agree to an Article 9 sale?

2. What claims can be asserted against directors and officers for consenting to Article 9 sale? Or not taking steps to prevent it from occurring?

3. What will happen to entity once Article 9 sale is concluded and how will that entity be dissolved/wound down?

F. What are the purchaser's concerns?

1. Will the sale be free and clear?

2. Can all of the assets needed to operate the business be purchased under Article 9?

   a. Real estate issues

   b. Leased equipment

3. Need to do business with the holders of the trade debt following the sale – will need to negotiate with trade creditors post-closing

4. Need to determine which employees will be offered employment and on what terms?

5. Potential need for transition services agreement for some period of time.

6. Successor liability risks

   a. Is there a continuity of ownership or management between the purchaser at the UCC sale and the borrower?

   b. Multiple factors considered (under applicable state law) in connection with successor liability claims.

   c. See, Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Publishing Corp., 635 F.3d 48 (2d Cir. 2011), discussed below.

IV. Key Issues

A. Private Sale v. Public Sale

B. Taxes

1. Sales taxes

2. Payroll taxes

3. Add valorum taxes

C. Successor Liability Risks

D. Real Estate

1. Dealing with Landlords

2. Borrower owned real estate

E. Avoidance Risks in a subsequent bankruptcy proceeding

F. PPP loan issues

V. Potential Attacks on the Sale

A. Avoidance Risks in a Subsequent Bankruptcy Proceeding

1. Actual fraudulent transfer.

2. Constructive fraudulent transfer

B. Successor Liability Risks

1. A purchaser may be held liable for the seller's liabilities in four circumstances:

a. The purchase agreement expressly or impliedly provides for the purchaser's assumption of the seller's debts;

b. There is a merger or consolidation of the purchaser and the seller;

c. The purchaser is a mere continuation of the seller; or

d. The transaction was consummated fraudulently for the purpose of escaping the debtor's liabilities.

C. The "Mere Continuation Theory" is the most likely theory to apply to Article 9 sales.

1. Courts examine whether there is a continuity of ownership and a continuity of enterprise.

a. Courts disagree whether the mere continuation theory requires both continuity of enterprise and continuity of ownership.

2. Continuity of Ownership – courts examine whether there is a continuity of stock, stockholders and directors between the buyer and the seller.

3. Continuity of Enterprise – courts examine whether the successor continues the business of the predecessor. Is the successor maintaining the same business with the same employees doing the same jobs and producing the same products for the customers?

D. Successor liability risks in an Article 9 sale of an entire business versus a Section 363 sale of the business under the Bankruptcy Code.

1. Article 9 sales - the Second Circuit addressed successor liability risks in connection with an Article 9 sale of a business in *Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Publishing Corp.*, 635 F.3d 48 (2d Cir. 2011). In *Call Center*, the Second Circuit focused on the "mere continuation" exception under Connecticut law and stated that successor liability may attach where the asset purchaser maintains the same business, with the same employees and supervisors doing the same jobs in the same location, and producing the same products for the same customers. Continuity of ownership is not required.

2. Section 363 Sales – courts have generally held that successor liability claims can be extinguished through section 363 sales under the Bankruptcy Code. See, *In re Leckie Smokeless Coal Co*., 99 F.3d 573 (4th Cir. 1996); *In re Trans World Airlines*, 322 F.3d 283 (3d Cir. 2003).

Faculty

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