Secured Creditor's Pre-Petition Strict Foreclosure Strips Debtor of Ownership of Assets

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In the face of the exercise of a secured creditor's default remedies, a debtor can usually count on a prompt bankruptcy filing to delay, sidetrack or altogether stymie the secured creditor. While laypeople and practitioners alike often view bankruptcy as a panacea for all things that threaten a debtor's financial well-being, the truth is that bankruptcy can only "stop the music" if the music is still playing when the debtor files. Delaying a filing until the debtor has lost its redemption rights under state law and until the secured creditor's ownership rights in what was merely collateral securing its debt have fully ripened, can render a belated filing futile and ineffectual.

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Bankruptcy's limitations are particularly acute where pre-petition a secured creditor properly effectuates the remedy of strict foreclosure under Article 9 of the Uniform Commercial Code (UCC). The bankruptcy court in *In re CBGB Holdings LLC*[2] recently considered the validity of a secured creditor's pre-petition strict foreclosure of substantially all of the debtor's assets. The court particularly focused on the timing of the secured creditor's notice of its intention to strictly foreclose and the debtor's consent to the same. The bankruptcy court found that the secured creditor's notice of its intention to strictly foreclose on the pledged assets was effective after the debtor's default under its promissory note obligation. This was notwithstanding the fact that the secured creditor did not issue another notice after the debtor did not cure under the subsequent forbearance agreement.[3] The message for potential debtors is clear: If the secured creditor follows the steps prescribed by the UCC and the debtor fails to object, a strict foreclosure may leave the debtor with no property interest to preserve and restructure in bankruptcy.

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Facts of CBGB

Pursuant to a May 2008 asset-purchase agreement, the debtor, CBGB Holdings LLC, purchased substantially all of CBGB's assets from the estate of Hillel Kristal. The sale was financed in part by the debtor's issuance of a promissory note for $2,387,500 secured by the purchased assets. The remaining consideration of $1,112,500 was to be paid in cash at or before the closing. As security for the debtor's obligations under the note, the debtor delivered certain documents to be held in escrow as additional security. The escrowed documents were designed to unwind the sale in the event of a default.[4]

The parties later amended the transaction and promissory note to provide that the secured creditor could avail itself of several default remedies including the ability to exercise all rights under Article 9 and obtain a release of the escrowed documents.[5] On Feb. 12, 2010, the debtor defaulted on the amended promissory note and the secured lender issued its default notice.[6] Approximately one month later, the secured creditor and debtor entered into the surrender of collateral, consent to strict foreclosure and release agreement (the "forbearance agreement"), wherein the debtor acknowledged its default and consented to a foreclosure on the collateral pursuant to § 9-620 of the UCC, including the release of the escrowed documents, while the secured creditor agreed to forebear from exercising its default remedies until May 18, 2010.[7] Pursuant to the forbearance agreement, if the debtor failed to redeem (by satisfying its obligation) or sell the collateral (while providing for repayment of the debt) prior to the expiration of the forbearance period, the secured creditor could commence with the strict foreclosure without further notice.[8] The debtor further acknowledged that it had received sufficient notice under §§ 9-620 and 9-621 of the New York UCC and affirmatively waived any additional notice.[9] The debtor failed to cure its default during the forbearance period, and the secured creditor took steps to complete its strict foreclosure. The debtor then filed its chapter 11 case on June 10, 2010.[10]

Shortly after the commencement of the chapter 11, the secured creditor moved to dismiss the chapter 11 case pursuant to 11 U.S.C. § 1112(b) on the grounds that it—not the debtor—owned all of the assets. The debtor argued that the strict foreclosure was ineffective because the secured creditor's notice of its intention to strictly foreclose on the collateral was not done in accordance with § 9-621 of the UCC.[11] The debtor asked the court to find that the remedy of strict foreclosure as proposed by the secured creditor was unconscionable.[12]

Feature

Strict Foreclosure's Effectiveness

Section 9-620 governs how and when a secured creditor may elect to accept its collateral in partial or full satisfaction of the debt owed. As a prerequisite to the remedy, the debtor must consent to acceptance of collateral in satisfaction and the secured party must not have received an objection from the debtor and/or holders who claim an interest in the collateral.[13] A secured party's acceptance of collateral in partial or full satisfaction of debt "(1) discharges the obligation to the extent consented to by the debtor; (2) transfers to the secured party of all of a debtor's right in the collateral; (3) discharges the security interest...that is the subject of the debtor's consent and any subordinate security inter-

[1] The author is grateful to **David M. Green** (Stevens & Lee PC; New York) for his assistance in writing this article, as well as colleague Ligee Gu.
[2] 2010 WL 4026104 (Bankr. S.D.N.Y. Oct. 13, 2010) (*CBGB*). CBGB & OMFUG (Country Bluegrass Blues and Other Music for Uplifting Gormandizers), formerly located at 315 Bowery at Bleeker Street in New York, was founded by Hillel "Hilly" Kristal in December 1973. The club took its place in American music history as the launching pad for some iconic music acts as the Ramones, Talking Heads, Blondie and Patti Smith. The club closed its doors on Oct. 15, 2006.
[3] *CBGB* at *3. The debtor filed a notice of appeal of the bankruptcy court's decision, which is pending. The court dismissed the debtor's case by order date Dec. 1, 2010.
[4] *Id.* at *1.
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.* at *2.
[11] N.Y. UCC § 9-620 (McKinney 2010).
[12] *CBGB* at *2.
[13] UCC § 9-620(a).

est or other subordinate lien; and (4) terminates any other subordinate interest."[14]

A secured creditor may only avail itself of strict foreclosure after the debtor has defaulted.[15] The secured creditor then generally provides the debtor with a written notification of its intention to strictly or partially foreclose on its collateral.[16] In addition, § 9-621 requires that the secured party serve notice of its intention to strictly foreclose on any third parties who assert an interest in the collateral.[17]

The remedy of strict foreclosure is deemed effective only where the debtor consents to the acceptance as provided for in § 9-620(c). If a timely objection is received from the debtor or any third party within 20 days after receiving the notification, the secured party cannot strictly or partially foreclose.[18] What constitutes the required form of consent depends on whether the secured creditor is seeking to partially or strictly foreclose on its collateral. In the case of a partial foreclosure, the debtor's consent must be stated in a record authenticated after default.[19] Where strict foreclosure is invoked, the debtor's consent may be either express or implied. Implied consent may be found if the debtor does not object to the secured creditor's *unconditional* proposal to take ownership of collateral in full satisfaction of the debt within the 20-day period. If the strict foreclosure election is conditional, the debtor must affirmatively consent.[20] The requirements of § 9-620(c) cannot be waived.[21]

14 UCC § 9-622(a).

15 There is no concept under the UCC of consent to strict foreclosure in anticipation of a future default. *CBGB* at *2.

16 Although such notifications are generally written, the weight of the case law supports the proposition that where the intention is clear to strictly foreclose, the lack of a writing is not fatal. *See In re Clarkeies Market LLC*, 2004 WL 768651 at *6 (Bankr. D. N.H. April 8, 2004), citing *Lamp Fair v. Perez-Ortoz*, 888 F.2d 173, 176 (1st Cir. 1989) (listing cases); *see also Lamp Fair*, 888 F.2d at 177 (listing cases for minority view that lack of written notice invalidates exercise of strict foreclosure).

17 The failure to provide such notice to third parties, however, is not fatal to the strict foreclosure. *CBGB*, 2010 WL 4026104 at *2, citing 4 James J. White and Robert T. Summers, *Uniform Commercial Code* § 34-10 at 394 (5th ed. 2002).

18 UCC § 9-620(a)(2).

19 UCC § 9-620(c)(1).

20 UCC § 9-620(c)(2).

21 *CBGB* at *2.

Which Default Counts?

After the debtor defaulted on the amended promissory note, the secured creditor and debtor entered into the forbearance agreement wherein the secured creditor expressly declared its intention to strictly foreclose on the collateral if the debtor failed to redeem or sell the collateral during the forbearance period. The debtor argued that for purposes of § 9-620 and specifically the timing of the secured creditor's notice of strict foreclosure, the relevant default occurred after the debtor failed to perform under the forbearance agreement. Thus, the debtor maintained that because notice of the secured creditor's intention to strictly foreclosure was not given following the alleged "default" under the forbearance agreement, the secured creditor's prior notice and the debtor's consent thereto invalidated the strict foreclosure.[22]

In examining the notice issue, the *CBGB* court found that although "default" is not defined in Article 9, the term generally means the failure to perform a legal or contractual duty or pay a debt when due.[23] The debtor had no contractual duty to redeem or sell the pledged collateral under the forbearance agreement, but rather it had the chance to do so and thereby avoid the exercise of the secured creditor's right to strictly foreclose. Because the forbearance agreement did not create additional contractual or legal duties that the debtor could be deemed in default of, the debtor's Feb. 12, 2010, default on its amended promissory note was the relevant default under § 9-620.[24] The debtor's failure to take advantage of its opportunities under the forbearance agreement did not invalidate the secured creditor's election of strict foreclosure after the first and only relevant default.[25] In retrospect, without the ability to repay its debt or provide for repayment, the debtor sealed its fate with respect to its property interests when it executed the forbearance agreement.

22 *CBGB* at *3.

23 *Id.*

24 *Id.*

The court also did not find that the strict foreclosure provisions in the forbearance agreement rose to the level of unconscionability.[26] The court initially observed that the concept has little applicability in a commercial setting. Although strict foreclosure may seem like a harsh result, the court found neither procedural nor substantive unconscionability, as the debtor had a meaningful opportunity to participate in the contract formation (procedural unconscionability) and the contract terms were not unreasonable (substantive unconscionability). Ultimately, the debtor bought property on credit and agreed to unwind the transaction if it could not abide by the credit terms. Because the court found nothing untoward about the arrangement or its outcome, it concluded that the strict foreclosure was valid and effective.[27]

Conclusion

The remedy of strict foreclose is a powerful weapon in a secured creditor's arsenal. Where there is a valuable property right to preserve, it is incumbent on the debtor to take timely action to preserve its ownership rights by, among other things, responding to a notice of strict foreclosure. Once consent is given to a strict foreclosure, a second chance afforded the debtor to make the secured creditor whole does not start the default process anew; strict foreclosure may follow without further grace period or notice. Debtors must be wary when confronted with the possible surrender of collateral. If the secured creditor's title has ripened according to strict foreclosure, a bankruptcy will not reset the playing field. ■

25 The *CBGB* court noted that the authorities cited by the debtor for insufficient notice under § 9-620 dealt with situations, unlike the case at bar, where the notice was provided prior to the occurrence of the default. *CBGB*, citing *Forbes v. Four Queens Enters. Inc.*, 210 B.R. 905, 910 (D. R.I. 1997); *In re Cadiz Props Inc.*, 278 B.R. 744, 749 (Bankr. N.D. Tex. 2002); *Chen v. Profit Sharing Plan of Dr. Donald H. Bohne, DDS PA*, 456 S.E.2d 237, 240 (Ga. Ct. App. 1995); *Emmons v. Lemaster Inc.*, 10 P.3d 33, 36 (Kan. Ct. App. 2000).

26 *Id.* at *7.

27 *Id.*

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