Strict Foreclosure on Personal Property – When Can a Secured Party Keep the Collateral?

By William S. Veatch

One of the most frequent questions that clients ask is the following: "Now that the debtor is in default, can I keep the collateral?" The short answer under the Uniform Commercial Code in the United States is usually "no," which often takes clients by surprise.

Why can the secured party not simply keep the collateral after the debtor defaults?

To the extent that the collateral is worth more than the obligation that is secured, the debtor has a right to the surplus. In a typical secured transaction, the debtor owes a sum of money to the secured party, and this obligation to pay is secured by collateral, usually consisting of some assets belonging to the debtor. The sum of money owed could be principal and interest under a loan, the purchase price for goods, the settlement amount in a litigation proceeding, or some other liquidated amount, but, in any event, the concepts are the same in terms of realizing on the collateral. After a default by the debtor, the secured party has the right to reduce the claim to judgment, foreclose, or enforce the claim by any other available judicial procedure or remedy provided in the contract.[1] However, there are certain rules and principles set forth in the UCC that cannot be waived in advance by the debtor,[2] including the following:

- **Notice**. The debtor is entitled to prior notice of any disposition of collateral, typically at least 10 days in advance of any foreclosure sale.[3]
- **Accounting**. The debtor has a right to an accounting of the unpaid obligations and a list of the collateral from the secured party, within 14 days of a request.[4]
- **Payment of surplus to the debtor**. The debtor has a right to any surplus collateral value after payment of the secured obligations.[5]
- **Right to redeem the collateral**. Up until the time that the collateral has been collected or disposed of, the debtor has a right to redeem the collateral, i.e., a right to fulfill the secured obligations, including payment of reasonable expenses and attorneys' fees, and then keep the collateral.

If the secured party could simply keep the collateral after a default, it would constitute a breach of the rule that the debtor is entitled to any surplus collateral value, and the debtor cannot waive this right prior to a default. Given that lenders typically are over-secured, this is a very important right for debtors.

What is the normal process for realizing on collateral?

As a general rule, after default, a secured party may sell, lease, license, or otherwise dispose of the collateral in a commercially reasonable manner.[6] The secured party may sell the collateral at a public or private sale. The secured party may sell the collateral at a private sale, however, only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.[7] (This can be particularly burdensome in the case of a foreclosure on the equity in a privately held company, where a public sale is prohibited under the securities laws.) In any event, there needs to be some objective means of valuing the collateral so that the debtor is given credit for the reasonable value of the collateral.

What must the secured party do if he/she/it wants to keep the collateral?

Under certain circumstances, the secured party may propose, after default, to keep the collateral in full or partial satisfaction of the debt, which is often referred to as "strict foreclosure." The UCC provides that the secured party may accept collateral (1) in full or partial satisfaction of the secured obligation, if the debtor consents after default, or (2) in full satisfaction of the secured obligation, if the debtor does not object within 20 days of a proposal made, after default, by the secured party.[8]

Are there any exceptions?

- **Debtor consent after default**. As discussed above, a pre-default waiver is not enforceable. The debtor, however, may waive its rights post-default.
- **Collection of receivables**. After default (and pre-default if permitted in the security agreement), a secured party may notify an account debtor or other person obligated on collateral to make payment to the secured party directly.[9] E.g., if the collateral consists of receivables, the secured party can call up the account debtor and demand that the account debtor pay the secured party directly. This is a very powerful remedy that the secured party has under the UCC, and should not be overlooked.
- **Deposit account subject to control**. A secured party has a right to apply the balance of a controlled deposit account to the secured obligations.
- **True sale of receivables**. In a "true sale" of receivables transaction, the buyer of the receivables owns the receivables. There is no definition of "true sale" in the UCC, but under case law principles, the sale must be without recourse to the seller, i.e., risk of loss must pass to the buyer, and the seller must not retain control over the receivables. Although a sale of receivables may be deemed to be a "secured transaction" in UCC parlance, many of the rules that apply to secured loans do not apply to "true sales."[10]

Example 1 – Sale of intellectual property

Although structuring a transaction for the sale of intellectual property may be driven largely by tax and accounting considerations, it is also important to consider the impact of the UCC. For example, if a seller of an asset allows the buyer to pay for all or a portion of the purchase price with a promissory note or alternatively, an ongoing royalty obligation based upon future product sales, then it is standard practice for the seller to take a security interest in the asset sold as collateral for the payment obligation. In the case of intellectual property, however, there are some important limitations of which the seller should be aware.

- First, as a general rule, unlike in the case of tangible assets, it is not possible for a secured party to have a "purchase money" priority security interest in intangible property such as patents or copyrights (although there is a limited exception for integrated sales of goods and software used in the goods).[11] As a result, it is critical to run lien searches and obtain waivers from any creditors with a prior security interest in intellectual property or general intangibles.
- Second, although it may seem counterintuitive, if the buyer does not pay for the asset sold, then, as discussed above, the seller cannot simply take the collateral back; rather, the seller must hold a foreclose sale or exercise other remedies in accordance with the UCC.
- Third, in the case of an ongoing royalty obligation, upon a debtor default it may be difficult to determine exactly what the amount of the secured obligation is if the royalty is to be determined by reference to future sales of product. Expert witnesses could be called, but bankruptcy courts are inclined to approve low valuations in such cases. As a result, a seller of intellectual property may want to consider structuring the transaction as a "license" instead of a "sale" if the purchase price is structured in whole or in part as a royalty obligation.

Example 2 – Equipment lease with a $1 purchase option

An equipment lease with a $1 or nominal purchase option is treated under the UCC as a deemed sale and grant of a security interest under UCC Article 9.[12] This is an important point to remember, as many of the provisions of UCC Article 9, as discussed above, cannot be waived by the debtor pre-default. Therefore, a provision in such a lease stating that the lessor can keep the collateral without holding a foreclosure sale or accounting to the debtor for any surplus collateral value will be unenforceable.

Example 3 – Employee loan secured by a grant of stock in the company

If an employee loan is secured by a pledge of stock in the employer company, and the employee defaults on the loan, the employer cannot simply keep the stock in satisfaction of the debt. Rather, the employer must foreclose on the stock or otherwise exercise remedies in accordance with the UCC and the securities laws, keeping in mind those provisions of the UCC that cannot be waived effectively by the debtor pre-default. As a result, rather than grant the employee ownership of the stock up-front subject to a security interest, it may be preferable to include a vesting schedule such that the employee takes ownership of the shares over time, as they are earned.

Conclusion

In summary, it is important to understand the benefits of a security interest as a tool in structuring transactions, but also the limitations. Although ultimately the structure of a transaction may be determined primarily by tax and/or accounting considerations, the law of secured transactions plays a critical role in any transaction where amounts remain owing from one party to another after the transaction closes. In some cases, the limitations inherent in security interests may lead the parties to restructure the transaction; e.g., a sale of intellectual property may be better structured as a license; a sale of goods may be better structured as a "true lease"; and a loan secured by receivables may be better structured as a "true sale." In any event, the key to success is to examine these secured transactions issues early on, while the transaction is still in the structuring stage.

About William S. Veatch

William S. Veatch is a partner in the Financial Transactions Practice Group and a member of the Business Department, resident in the San Francisco office of Morrison & Foerster LLP.

About Morrison & Foerster LLP

Morrison & Foerster LLP is one of the world's largest law firms with 1,000 lawyers in 19 offices worldwide. For more information about Morrison & Foerster LLP, please visit http://www.mofo.com.

---

[1] *See generally*, Uniform Commercial Code ("UCC") Section 9601. All references to the UCC are to the California version.
[2] *See* UCC Sections 9602 and 9624.
[3] *See* UCC Sections 9611 and 9612(b).
[4] *See* UCC Section 9210.
[5] *See* Sections UCC 9608(a) and 9615(d).
[6] *See* UCC Section 9610.
[7] *See* UCC Section 9610(c)(2).
[8] *See* UCC Section 9620.
[9] *See* UCC Section 9607.
[10] *See,* e.g., UCC Section 9601(g): "Except as otherwise provided in subdivision (c) of Section 9607, this part imposes no duties upon a secured party that is a consignor or is a buyer of accounts, chattel paper, payment intangibles, or promissory notes."
[11] *See* UCC Section 9103.
[12] *See* UCC Section 1203.