Enforcement of Creditors' Rights Under the UCC: Is Shareholder Consent Required?

By Larry G. Halperin and Keith N. Sambur

Boards of directors of troubled companies must balance their fiduciary obligations to shareholders and creditors. Insolvent companies owe duties to creditors and not solely to shareholders and, under evolving case law, companies acting in the "zone of insolvency" owe a duty to creditors as well as to shareholders.

Black letter law provides that shareholder consent is necessary for the sale of all or substantially all of a corporation's assets. It also provides that a board of directors has the authority, *without the consent of shareholders*, to enter into a credit facility which facility provides for a blanket lien on substantially all of a corporation's assets. What does the board do when a secured creditor offers to accept all or substantially all of the corporation's assets, in full or partial satisfaction of the corporation's debt to the secured creditor? Does the board need to obtain the consent of a corporation's shareholders when it effectively sells all of the assets to a creditor enforcing its legitimate contract rights as a secured creditor?

This note will analyze the interplay between two statutory regimes regarding the disposition of all or substantially all of a corporation's assets; namely, general corporate law governing shareholder consent and the Uniform Commercial Code (the "UCC"), which governs creditors' rights. Under the UCC, secured creditors enjoy foreclosure rights, which if exercised, naturally conflict with shareholders' rights. While the law generally resolves this tension in favor of creditors' rights, some states have corporate statutes protecting shareholders that conflict with the rights afforded secured creditors under the UCC.

The end result both (i) puts directors in peril—they cannot effectively discharge pre-existing duties owed to secured creditors, and (ii) disadvantages secured creditors—they cannot exercise the rights afforded to them under the UCC.

Corporate Law

Corporate statutes[1] generally provide that a corporation may sell, lease or exchange all or substantially all of its property and assets upon such terms and conditions as recommended by its board of directors and approved by a majority of its shareholders. These statutes generally apply to non-ordinary course transactions, the nature of which is at the heart of the corporation's existence.[2] The corporate statutes were enacted to overcome common law holdings that required unanimous approval of shareholders for the sale of a corporation's assets, while preserving some protection to minority shareholders. Moreover, the corporate statutes require the board of directors, who are bound by fiduciary duties, to approve the transactions.[3]

On the other hand, corporate statutes expressly provide that authorization or consent of shareholders is not necessary to

1 For example, Section 909 of the New York Corporate Business Law ("NYCBL") and Section 271 of the Delaware General Corporate Law ("DGCL").

2 *See* Section 909 of NYCBL; *see, e.g.*, *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) (critical factor is whether the sale is not one that occurs in the ordinary course of business).

3 For example, the DGCL requires the board of directors to determine that the transaction is in the best interests of the corporation.

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Memorandum

June 19, 2008

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mortgage or pledge a corporation's property and assets unless the certificate of incorporation expressly provides to the contrary.[4] From a procedural point of view it would be unworkable for a corporation to seek shareholder approval every time it wanted to offer collateral in exchange for a lower cost of capital.

Uniform Commercial Code

Section 9-620 of the UCC provides that a secured party may accept collateral in full or partial satisfaction of the obligation it secures only if (i) the debtor consents in the manner prescribed in Section 9-620(c)[5] or (ii) the secured party does not receive notice of objection to its proposal within the time periods prescribed in 9-620(d). The commentary to Section 9-620 highlights that the drafters of the UCC expected Section 9-620 to require interaction with other sections of the UCC, as well as other statutes, and expected state legislatures to conform the laws so they mesh together and work harmoniously.

Analysis

On its face, the corporate statutes requiring shareholder approval of asset sales seem to cover foreclosure sales – the sales constitute transfers of the debtor's property for the forgiveness of debt. Given that the underlying rationale for such provisions is to protect shareholders from improper dispositions proposed by a board of directors, there does not seem to be a material difference between (i) a sale either initiated by an unsolicited third party, and (ii) a foreclosure sale proposed by a secured creditor. In each case, the board of directors needs to determine whether it is in the best interest of the corporation to endorse and facilitate the transaction with the counterparty.

In the foreclosure context, the board of directors needs to fulfill its fiduciary duties by examining potential alternatives, such as refinancing the obligations owed to the secured party, filing for bankruptcy protection or negotiating for relief with the secured party. In negotiating with the secured creditor the board of directors would want to maximize the transfer of its liabilities to the secured creditor and to obtain a sufficient carve out to provide for a wind-down budget to finalize the corporation's affairs.

However, shareholder approval should not be required merely to permit the secured creditor to exercise rights and remedies properly granted without shareholder approval. Indeed, if lenders thought that shareholder approval would be required to exercise rights and remedies in the future, lenders would require, as a condition to the initial funding, that shareholder approval be obtained in advance to comply with any corporate statute requiring such approval at the time of disposition.[6]

While not directly on point, *Gunnerman v. Talisman Capital Talon Fund, Ltd.*, C.A. No. 1894-N (Del. Ch. 2006), provides some reassurance. In *Gunnerman*, the Court of Chancery held that a board of director's failure to obtain shareholder approval under DGCL section 271 in the face of a secured creditor's proposed 9-620 foreclosure sale was not actionable.[7]

There, a secured creditor initiated a 9-620 foreclosure sale by sending the borrower's board of directors a letter indicating that it intended to accept its collateral in full satisfaction of the outstanding obligations if the debtor did not consent or object within twenty days. After receiving no objection, the secured creditor foreclosed on the collateral. Subsequently, certain

4 For example, Section 961 of the NYCBL and Section 272 of DGCL.

5 Subsection (c)(2) of the UCC states: "Debtor's consent . . . For purposes of this Section: . . . (2) a debtor consents to an acceptance of collateral in full satisfaction of the obligation it secures only if the debtor agrees to the terms of the acceptance is a record authenticated after default or the Secured Party: (A) sends to the debtor after default a proposal that is unconditional. . . ; (B) in the proposal, proposes to accept collateral in full satisfaction of the obligations it secures and (C) does not receive a notification of objection authenticated by the debtor within twenty days after the proposal is sent.

6 By analogy, the Bankruptcy Code does not require a corporation to obtain shareholder approval prior to filing for bankruptcy protection - either under chapter 7 or chapter 11 - or prior to effectuating a sale of substantially all of its assets to a third party or secured creditor under Bankruptcy Code section 363.

7 Importantly, in *Gunnerman*, the plaintiffs did not attempt to undo the completed foreclosure sale. In fact, under Delaware Law, failure to enjoin timely such a sale may prevent a court from undoing or stopping the sale. *See Elster v. American Airlines*, 128 A.2d 357 (Del. Ch. 1955).

shareholders of the company filed suit against the board of directors alleging, among other things, that the foreclosure triggered shareholder consent under DGCL section 271.

In response to that claim, the defendants argued that a 9-620 foreclosure did not trigger the approval requirements of DGCL section 271 and moved to dismiss for failure to state a cause of action. In a ruling from the bench dismissing the suit, the court held that the DGCL:

> clearly makes a distinction between financing transactions, mortgage transactions, collateral transactions and sales of assets and [the Court] does not think you can have a situation where there's the original financing transaction that pledges the collateral is outside 271's reach and then say when the creditor exercises rights under that that are within the four corners or arguably a lesser included option, that somehow then triggers a stockholder vote.

Although *Gunnerman* involved a 9-620 foreclosure sale where the borrower's board implicitly consented, we believe there is every indication that the ruling would apply to situations where the corporation's board of directors affirmatively consents, as the board in *Gunnerman*—by taking no affirmative action—effectively decided that it was not going to stop the foreclosure sale.[8]

Conclusion

Although there is ambiguity in the interplay between the UCC and corporate statutes requiring shareholder approval of asset sales, it appears the better view is that shareholders do not have an ability to prevent foreclosure sales or bring claims against the a board of directors for failing to obtain shareholder consent prior to authorizing foreclosure sales. As Delaware courts have concluded, foreclosure sales are statutory remedies – wholly separate from transactions where a corporation undertakes a voluntary asset disposition. Logically, if a corporation can pledge assets to a lender without shareholder consent then shareholders should not expect to be able to interfere with the lender's right to foreclose upon such assets. Therefore the statutory framework governing "all asset" sales should not apply to the enforcement of remedies under such pledge.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

Larry G. Halperin
New York, NY
212 530 1870
lhalperin@rkollp.com

Keith N. Sambur
New York, NY
212 530 1815
ksambur@rkollp.com

8 To date, there are no published opinions on point resolving this conflict with respect to the New York UCC or New York corporate law. In addressing what constitutes acceptance under New York Commercial Code section 9-620, the United States Court of Appeals for the Second Circuit stated, without discussion, that there must be a writing "'authenticated,' which means it must be signed by both parties." *Cardell Fin. Corp. v. Suchodolski Assocs.*, 2006 U.S. App. LEXIS 8957 (2d Cir. 2006); *see also* N.Y. U.C.C. § 9-207. As discussed this does not directly resolve, however, the question of whether directors can consent to a foreclosure sale without first obtaining shareholder consent.