

CLIENT ALERT

Delaware Chancery Court Rejects Claim That Article 9 Sale Was Not Conducted in a Commercially Reasonable Manner

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The process of disposing of collateral in a public or private sale under Article 9 of the Uniform Commercial Code was designed to be quick and cost-effective. Under the right circumstances, an Article 9 disposition may be a good alternative to a potentially more costly and time-consuming asset sale under Section 363 of the Bankruptcy Code. But the drafters of Article 9 left room for interested parties to challenge an Article 9 sale. A frequently litigated challenge is based upon allegations that a sale had not been conducted in a "commercially reasonable" manner. In *Edgewater Growth Capital Partners LP v. H.I.G. Capital, Inc., et al.*¹, Edgewater, an equity sponsor and guarantor of the borrower's debt obligation, challenged, among other things, the commercial reasonableness of an Article 9 asset sale. The court ultimately rejected the challenge, but only after costly and protracted litigation.

Pendum, a company which had been acquired by Edgewater, received a loan from a predecessor to H.I.G. at the time of Pendum's acquisition by Edgewater. The loan was secured by a senior lien on all of Pendum's assets pursuant to a Security Agreement in which the parties selected Illinois law as the governing law. Edgewater's equity contribution at the time of the acquisition was minimal. Shortly after the loan was made, Pendum defaulted and Edgewater became more active in the management of the company. During the months following the first default, the loan documents were amended nine times. During the amendment process, Edgewater was required to post a limited guaranty.

H.I.G., having purchased a majority of the Pendum's senior debt, became involved in discussions with the Pendum about how to best to sell the business or liquidate the collateral. The senior secured lenders and the board recognized and agreed that the business was so impaired it could not be sold as a going concern, and that a sale of Pendum's assets under Article 9 was the only option. To that end, the senior secured lenders and the Pendum board negotiated a Foreclosure Sale Agreement that allowed Pendum's board to hire a financial advisor – paid for by the senior secured creditors – to identify potential buyers. The Agreement provided that if Pendum's board could not find a buyer by a date certain, then the senior secured creditors could proceed with a UCC foreclosure sale.

The financial advisor conducted a comprehensive marketing process; nevertheless, when the process ended, none of the solicited parties were willing to bid for Pendum's assets. The senior secured creditors then proceeded with the UCC foreclosure process, setting up the sale as a public auction as opposed to a private sale. The only interested bidder to show up at the public auction was an affiliate of H.I.G., which, as a permitted bidder in a public auction under Article 9, was the eventual purchaser of the assets. Edgewater did not appear at the auction. Edgewater then sued the senior secured creditors and, among other allegations, complained that the sale of Pendum's assets was not conducted in a commercially reasonable manner under the Illinois Commercial Code.

Determining "commercial reasonableness" for Article 9 purposes is done on a case-by-case basis. Under Article 9 as adopted in Illinois, a commercially reasonable sale is one that is conducted "in conformity with reasonable commercial practices among

dealers in [that] type of property..."^{810 Ill. Comp. Stat. Ann. 5/9-627(b) (2013)}. The court recounted the steps taken by both the company's board and by the secured creditors to maximize the sale of the company or the company's assets, all without the help or encouragement of Edgewater. The court noted that the Foreclosure Sale Agreement allowed for Pendum's board to retain a financial advisor and to attempt to sell itself prior to any sale efforts by the senior secured creditors. This concession by the secured creditors evidenced their desire to achieve maximum recovery on the asset sale, as well as their attempts to assuage Edgewater, which was already threatening litigation. The court also determined that the board negotiated a reasonable time frame to try to sell Pendum, and that the time frame reflected the economic realities and management obstacles plaguing the business. Further, the court scrutinized the financial advisor's marketing of Pendum's assets, and the subsequent efforts that the senior secured creditors took to promote the public auction, including notices of sale placed in the Wall Street Journal. In evaluating the overall process leading up to the sale, the court concluded that the sale was a public, not a private sale as argued by Edgewater, and that the sale was conducted in a commercially reasonable manner.

Edgewater also complained about the price bid by H.I.G.'s affiliate. Under Article 9, a low price – on its own – is generally not sufficient to establish that a sale was not conducted in a commercially reasonable manner. In fact, even evidence of the possibility of obtaining a higher price does not preclude a finding of commercial reasonableness. The court supported its finding of price appropriateness by recalling testimony and evidence that showed even Edgewater doubted the true value of the company's assets.

The opinion reflects a court frustrated with plaintiffs' attempt, through the use of aggressive litigation tactics, to avoid compliance with contractual obligations and to thwart the efforts of the secured creditors to realize on their collateral. The court documented its belief that Edgewater acted imprudently in contesting the sale process noting that "Edgewater's primary motivation for this litigation was to exert leverage over H.I.G. in hopes that H.I.G. would walk away from demanding payment under the Limited Guaranty." *Edgewater* at *63-69. The court concluded its discussion of Edgewater's tactics by rejecting Edgewater's assertion that it should not be required to pay H.I.G.'s legal fees and expenses. Edgewater argued that the language of the fees and expenses section of its guaranty was not broad enough to require Edgewater to reimburse H.I.G. for the costs associated with defending Edgewater's affirmative claims. The court disagreed with Edgewater's position and, in addition to ordering payment of the guaranteed amount, also ordered Edgewater to reimburse H.I.G. for litigation fees and expenses incurred.

H.I.G. prevailed because it complied with the standards established for a public sale under Article 9 and because it was able to demonstrate to the court compliance with those standards. Secured creditors should keep in mind that the concept of "commercial reasonableness" under Article 9 is a fact-based standard. Therefore, a secured creditor should navigate and document each step of the sale process with care and consider how best to create a defensible sale process that will withstand court scrutiny. This case also stands as a cautionary note to parties who wish to contest a secured party sale. Contesting parties should consider the potential consequences that may ensue should a court determine that the challenge to a sale was brought to advance ulterior motives.

¹ No. Civ. A. 3601-CS, 2013 WL 749375 (Del. Ch. Feb. 28, 2013).

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