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THE SECURED LENDER'S STATE LAW REMEDIES ON DEFAULT: A PRACTICAL APPROACH TO FORECLOSURE AND REPLEVIN

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In this article, the author explores the practical implications of foreclosing on mortgaged real estate and instituting a "replevin" action.

A bank's longtime borrower experiences a business downturn and defaults under its secured line of credit. The borrower is a mid-market manufacturer and closely held family business. Typically, the bank holds a blanket lien on the assets of the borrower under a security agreement and filed UCC-1s and a mortgage on its antiquated factory in an equally gritty industrial city. The lender also has personal guarantees from the principals of the business, three brothers who are the grandsons of the founder. While the business has provided a comfortable living for the family members over the decades, the guarantors do not have liquid assets sufficient to come close to satisfying the outstanding and defaulted debt. The lender is faced with the prospect of foreclosing the mortgaged real estate and foreclosing the hard assets and accounts receivable collateral through a remedy known as replevin. What are the potential pitfalls?

REAL PROPERTY FORECLOSURE

The foreclosure of the factory raises a host of potential issues, ranging from environmental liability to the practical problem of whether there exists a market for the sale of the foreclosed real estate. In some states, the transfer of title of real property, whether through a deed in lieu of foreclosure or through a sheriff's sale, triggers environmental clean-up and compliance obligations on the part of the seller and/or the buyer. Moreover, in many states, once a foreclosing mortgagee obtains a foreclosure judgment and takes possession of the property, the lender becomes a "mortgagee in possession." In that position, the lender may have all of the responsibilities of an owner, such as provision of insurance, payment of taxes and utilities, provision of security, and the like, even though the lender does not yet possess marketable title. In the event that the sheriff's sale process is delayed, or the lender, for strategic or market reasons, decides to delay the sale, the carrying costs of this mortgagee in possession status can quickly mount.

For these reasons, many sophisticated lenders set up separate corporate subsidiaries or affiliates to act as foreclosing mortgagee (under an assignment of the lender's rights under the mortgage) and to hold title to the real estate through the foreclosure process. That way, the parent lender never succeeds to the obligations imposed upon a mortgagee in possession or fee owner of the real estate, and the carrying costs accrue as claims against the subsidiary and its only asset, the real estate. Another approach is for the lender or its subsidiary to assign its right to bid at the sheriff's sale to the ultimate buyer of the property, so that neither the lender nor the subsidiary enter the chain of title. This assumes, of course, that a purchaser for the property is located prior to the sheriff's sale.

The last point indicates another practical consideration that must be weighed when the decision to foreclose is made: Can the real estate actually be sold to a buyer willing to pay a price approaching the lender's conception of market value? In the case of many areas and parcels of real estate, a ready market exists and this consideration is of minimal concern. However, with an old factory building in a depressed milltown, the foreclosing mortgagee must weigh the real possibility that a market may not exist and that the lender may well hold title to the property for an extended period of time until conditions improve. A related issue arises from the fact that the borrower may be entitled to a fair market value credit in the lender's action for a deficiency on the note. That fair market value credit, typically determined at a hearing before the Court, may far exceed what the foreclosing mortgagee realized from the actual sale of the property under distressed circumstances and thus substantially reduce the amount of the money judgment that the

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lender can obtain against the borrower and the guarantors. While there may not be a practicable way to avoid this result, the potential impact of this reality must be analyzed when the decision to foreclose is weighed.

REPLEVIN

Replevin is the remedy by which a secured lender forecloses upon a security interest in personalty, the non-real estate collateral pledged under a security agreement. Assuming that the lender has a duly perfected, first priority security interest in such collateral (i.e. no liens are ahead of the bank and all requisite UCC filings have been made and updated), the lender is free to institute a replevin action. This type of lawsuit is typically instituted by way of an expedited proceeding known in many jurisdictions as an "order to show cause" supported by a verified complaint laying out the factual bases for the lender's right to replevy the collateral, accompanied by an application for a temporary restraining order prohibiting the borrower from wasting or transferring the collateral during the pendency of the replevin action. The order to show cause and temporary restraining order may also require that the borrower cooperate with the lender during the pendency of the action to provide access to the collateral and the borrower's business records for purposes of inspection and ascertaining information about collection of the borrower's pledged accounts receivable.

If the lender intends to proceed to replevy and sell the collateral, consideration must be given in advance as to how the collateral will be sold once the replevin is accomplished and the lender is in possession of the property. All secured party sales of replevied collateral must comply with the notice and other requirements of Article 9 of the Uniform Commercial Code, absent which the secured party runs the risk, among others, of having the seizure and sale of the collateral deemed a satisfaction of a greater part of the underlying debt than that actually realized from the sale. As a practical matter, the lender may not have the expertise to sell the type of goods or equipment that comprise the collateral and may thus need to retain an industry-savvy broker or auctioneer to conduct a public or private sale. With respect to the collection of replevied accounts receivable, if the lender does not have a factoring or other division accustomed to account collections, such an agent may need to be retained. In the typical case where the lender holds a guaranty from the principals of the borrower, the guarantors' cooperation in these collection efforts may well be forthcoming as they try to minimize their guaranty exposure.

While the lender may not have a practical alternative to the replevin of collateral, the reality exists in many cases that the value of collateral at a distressed sale, further reduced by the costs of the sale process, can be significantly less than the value of the collateral in the ordinary course of the borrower's business on a going concern basis. As a result, when determining whether to pursue replevin (as well, in many cases, real estate foreclosures), the ancient maxim "be careful what you wish for" often applies.

SUMMARY

As is evident from this brief overview, the remedies of mortgage foreclosure and replevin, while powerful weapons in the lender's arsenal, are not without potential roadblocks and costs that can be avoided with careful planning and strategy. The borrower's overall circumstances should be carefully analyzed before launching a campaign of collateral foreclosure. Often, these remedies are best deployed as tools to motivate the borrower and the guarantors to refinance the defaulted debt and take the lender out or to negotiate a reasonable workout of the debt that can be serviced under the borrower's weakened condition. Opportunities exist for the lender to improve its collateral position through the workout process. As always, the best preparation is sound credit analysis and collateral monitoring from the inception of the lending relationship. If, however, the lender finds that these remedies must be employed, counsel must be quickly consulted and a case specific strategy developed prior to the commencement of litigation.

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