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How To, And How Not To, Foreclose On Oil And Gas Equipment

Law360, New York (May 08, 2015, 10:25 AM ET) --

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On Monday, May 4, the Federal Reserve released the results of its April 2015 Senior Loan Officer Opinion Survey on Bank Lending Practices. The survey specifically asked about lending to firms in the oil and natural gas drilling and extraction sector. The picture painted by respondents is hardly surprising: "More than half of the banks who made loans to this sector expected loan quality to deteriorate somewhat over the remainder of 2015." In other words, lenders expect that some oil and gas borrowers will default on their repayment obligations. This will leave lenders searching for ways to mitigate their losses on these loans.

One remedy frequently available to secured lenders of oil and gas borrowers is conducting a foreclosure sale of specialized drilling and well-servicing equipment. This remedy is not without its risks, however. A secured lender must protect itself by conducting foreclosure sales in a manner that withstands challenge from the defaulting borrower, a guarantor or a junior lienholder. The secured creditor that fails to properly dispose of collateral may not be able to recover for any deficiency and — worse — risks exposing itself to liability for any losses caused to the debtor or junior lienholder. See UCC 9-625(b).

Commercial Reasonableness is the Touchstone

To pass muster under Article 9, a foreclosure sale must be "commercially reasonable." The Uniform Commercial Code does not define that term. Instead, UCC 9-610(b) simply instructs that "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable." UCC 9-627 clarifies that a commercially reasonable disposition need not generate the very best sale price: "[t]he fact that a greater amount could have been obtained … by the secured party is not of itself sufficient to preclude the secured party from establishing that the [disposition] was made in a commercially reasonable manner."

To fill the gap left by the UCC's absence of a definition for "commercially reasonable," courts have developed three somewhat inconsistent tests. The "proceeds" test elevates price above all else and examines whether the price received upon sale, when compared with the value of the collateral, shows that the disposition was commercially reasonable. Only a price so inadequate that it shocks the court's

conscience fails. Price is a significant, but not overriding, factor in jurisdictions that follow the "totality of the circumstances" test. Factors beyond price receive close scrutiny when there is a significant price disparity between the value of collateral and the amount realized. Finally, under the "procedures" test, courts focus on the mechanics of the sale rather than the price; if the procedures are commercially reasonable, price is minimized as a factor, under the assumption that reasonable procedures generate market-price sales.

While it is essential for a creditor to analyze a jurisdiction's case law for specific guidance regarding commercial reasonableness before undertaking any disposition of collateral, common threads exist. Two cases concerning foreclosure sales involving oil and gas equipment — one satisfying the requirement of commercial reasonableness and the other falling short — highlight some generally applicable do's and don'ts.

An Example of How Not to Foreclose on Oil and Gas Equipment

The case of Liberty National Bank & Trust Co. v. Acme Tool Div. of Rucker Co., 540 F.2d 1375, 19 UCC Rep. 1288 (10th Cir. 1976) reads like a textbook on how not to foreclose on oil and gas assets. The secured lender in the case was a bank that lacked experience selling drilling rigs, so it inquired of others who had experience in such sales — the decision to seek professional advice was perhaps the only good decision the creditor made.

The bank was told that the industry-standard method for selling a drilling rig was to employ an auctioneer, to move the rig to a convenient location, to clean and paint it, to notify interested persons, and to advertise the sale in trade journals and newspapers. The bank ignored these suggestions and instead disposed of the uncleaned rig, on the drilling site, during a snowstorm, at a sale overseen by an attorney rather than an auctioneer, and without first advertising the sale in trade journals.

The $42,000 sale price was just enough to satisfy the bank's claim as senior creditor and the expenses of sale, giving the impression to the court that the bank was not concerned about other creditors, the borrowers or guarantors, but just wanted to come out whole. The court also focused on the $42,000 in proceeds received for the rig at the foreclosure sale compared with the $78,000 that the rig resold for two months later, without any significant change in market conditions. At the time of sale, the rig had been appraised at $60,000 to $80,000. There was no indication that the bank had included any language in the security agreement that validated its method of sale. As a result of this debacle, the bank was liable to a subordinate secured creditor in the amount of $19,000.

Paradigm Example of How to Foreclose on Oil and Gas Equipment

In In re Adobe Trucking Inc., 2011 Bankr. Lexis 4929, 76 UCC Rep.2d 365 (Bankr. W.D. Tex. 2011), aff'd 551 Fed. Appx. 167 (5th Cir. 2014)), the debtor provided contract oil drilling services and equipment to customers in West Texas and New Mexico. On Dec. 28, 2006, Adobe entered into a $37.5 million five-year revolving credit facility with various lenders, led by PNC Bank as agent. Adobe granted the lenders a blanket security interest in all of its assets, including drilling rigs, trucks, trailers and related equipment. The credit agreement provided that New York law would control. Beginning in the summer of 2007, Adobe fell into default, and when oil prices plummeted in late 2008, Adobe elected to "stack" most of its rigs, shut down its business, and "orchestrate an attack on the foreclosure process."

Right Moves Included Timely Notice and Strategically Placed Advertisements

In December 2008, PNC chose to enforce its security interest. Its counsel sent Adobe a notice that a public foreclosure sale of the collateral would occur at 11 a.m. on Jan. 16, 2009, at PNC's counsel's offices in Houston. More than once, PNC demanded possession of the collateral prior to the foreclosure sale, but Adobe refused. No writ of replevin was sought. In preparation for the foreclosure, PNC's counsel placed a notice of sale in the Dallas Morning News, the Odessa American and the Midland Reporter-Telegram on Jan. 6. The notices said that (1) PNC would conduct a public sale to the highest qualified bidder of all the collateral, including 10 drilling rigs and (2) PNC reserved the right to bid for and purchase the collateral, and to credit the purchase price against the unpaid balance of the loan and expenses of sale. On the day of the sale, PNC was still not in possession of the collateral and had not cleaned, painted or set up the collateral.

PNC was the winning bidder for all the collateral, with a credit bid of $41 million. Fifty minutes before PNC foreclosed, several Adobe affiliates that had allegedly serviced the drilling rigs sought to enforce possessory liens on the equipment based on failure to pay for services. After jousting with PNC in state court for 22 months, Adobe filed Chapter 11 bankruptcy. That led to an adversary proceeding against PNC on the ground that its foreclosure sale was commercially unreasonable.

Bankruptcy Court Finds Foreclosure Sale to be Commercially Reasonable

The Texas bankruptcy court first concluded that if a secured party is holding a foreclosure sale, the duty to sell in a commercially reasonable manner comes into play even though no repossession has occurred. The Texas bankruptcy court then determined that courts applying New York law accept both the "proceeds" and "procedures" test as commercially reasonable. Thus, the court must be satisfied that the proceeds received were adequate and that the procedures employed by PNC were commercially reasonable. The secured party had the burden of proof under both tests.

Sale Generated a Reasonable Price

As to the price, Adobe complained about the lenders' winning credit bid of $41 million, which was only about half the $81 million set by Adobe's appraisal. The Adobe court noted that property offered at foreclosure frequently produces a price substantially less than market value. This problem is exacerbated in oil and gas equipment foreclosures during a downturn: "The equipment is very expensive, and with a downturn in the industry, much of the equipment sits idle and loses its value as collateral given diminished resale opportunities." Office of the Comptroller of the Currency, Oil & Gas Production Lending: Comptroller's Handbook 10 (Apr. 2014).

In the Adobe case, the sales price (i.e. the credit bid) was slightly more than 50 percent of what Adobe argued was market value. In addition, PNC's appraiser estimated the value of the rigs at $33.5 million, which was substantially less than the PNC credit bid. The resale by an auctioneer following the foreclosure sale yielded only $9.7 million — $31 million less than PNC's winning credit bid. Based on all these factors and New York precedent accepting sale prices as low as 30 percent of market value, the court concluded that the foreclosure sale was commercially reasonable under the proceeds test.

PNC Employed Reasonable Procedures

As to the procedures surrounding the sale, Adobe complained that PNC didn't advertise the sale properly in trade journals, the Wall Street Journal, or the Internet. New York law, however, does not require a seller to advertise in any specific type of media or for any particular amount of time. The one-time ads in the three Texas papers provided adequate information for any potential bidder, and the 10-

day lead time was sufficient.

Adobe argued that a private sale should have been used rather than a public sale, but the court noted that UCC 9-610(b) and 9-627(a) bless public sales, even if a greater amount might have been obtained from a private sale. Moreover, a secured creditor is under no obligation to delay a foreclosure sale to “indulge the debtor's hope” that the market might recover — an important point in today’s depressed oil and gas markets. Adobe also complained about the small number of bidders, but the court concluded that the opportunity to bid is the key. The court also stated that failure of potential bidders to respond to public advertising of a foreclosure sale “may itself be an indication of the market value of the item offered for sale.”

Next, Adobe argued that the sale was commercially unreasonable because PNC never cleaned up the collateral to get the highest possible price. The court rejected this argument on two grounds: (1) It was Adobe that refused to give PNC access to the collateral in advance of the sale, and (2) UCC 9-610 permits a foreclosing creditor to dispose of collateral “in its present condition or following any commercially reasonable preparation or processing.” Finally, the court put its stamp of approval on credit-bidding.

Terms of Credit Agreement can Assist Secured Creditor

Importantly, the Texas bankruptcy court gave great weight to the PNC credit agreement, which carefully fleshed out a definition of commercial reasonableness. UCC 9-602 states that the documents can't waive the debtor's right to have a commercially reasonable sale of the collateral, but 9-603 states that “[t]he parties may determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor or the duties of a secured party ... if the standards are not manifestly unreasonable.” The court accepted the carefully drafted contractual provisions in the credit agreement, which filled gaps left by the statute without overreaching. Secured lenders should look for opportunities to take advantage of UCC 9-603 and establish standards for commercially reasonableness at the outset, like PNC did.

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An earlier version of this article appeared in the March 2015 issue of Clarks’ Secured Transactions Monthly.

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