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[Blogs](#)

Planning Commercial Collection Litigation: A Primer

Consider the common commercial loan collection situation: a business debt collateralized by relatively permanent collateral (real property or durable non-mobile equipment such as a printing press) and transient collateral (inventory, accounts receivable and cash).^[1] Frequently, there is also potentially recoverable unsecured debt because the collateral is insufficient to pay the entire debt and (a) the collateral does not include all the borrower's assets so it is possible to collect the unsecured debt from the borrower, and/or (b) there are unsecured guarantees^[2] supporting the credit. What is counsel to do when the time^[3] arrives to plan litigation?

Planning collection litigation requires consideration of: (i) the safety and value of your collateral; (ii) issues impacting how to maximize the value of your collateral; (iii) moral and morale issues related to the borrower and guarantors; (iv) the existence, liens and potential activity of other creditors; and (v) planning for the collection of unsecured debt. Each of these considerations will be addressed in turn.

Issues Related to the Secured Creditor's Collateral

The secured creditor's attention first falls nearly always on its collateral because this is usually the easiest source of involuntary payment. A creditor's concerns are security of the collateral and maximizing the collateral's value, in that order.

With permanent collateral, the security concerns are usually easy to address since this collateral is unlikely to disappear to thieves or buyers. So long as permanent collateral is insured and secured from vandals, the lender's value in the collateral is probably protected. Hopefully, the lender's documents include information on the borrower's insurance covering its assets; barring that, the choices may be (a) the lender's own insurance that protects against casualty losses to otherwise uninsured collateral, or (b) force-placed insurance is sometimes permitted by loan documents.

Security for portable collateral is more problematic. Whether (i) inventory held for sale, (ii) vehicles, (iii) items of small equipment, or (iv) cash, a lender needs to worry that portable collateral may be sold, stolen or lost. Of course, different situations bring different concerns:

- When the concern is sales by the borrower, the main question is what happens to the lender's security interest? Items are often sold to a buyer who qualifies as a "buyer in the ordinary course of business." See UCC §§ 1-201(b)(9) and 9-320. Sales to a BIOC or sales authorized by the lender extinguish the security interest. If property can be sold and the lender's lien lost, then counsel needs control over the sale proceeds be they cash or accounts receivable – the UCC and local law provide multiple mechanism to obtain this control (see the discussion below). The appropriate securing mechanism will often depend on the borrower's cooperation or lack thereof;
- Legalities aside, sales (or thefts) of lienied items below a certain value are effectively free of the lender's security interest since chasing the item and the buyer/thief is not practical. The relevant dollar amount will vary; but, chasing lienied property that wandered from the borrower's location is not easy or cheap; and
- Cash is wonderful collateral because it requires no property sales or account collections. Unfortunately, cash is also the collateral most in danger of disappearing. Cash can be lienied as the proceeds of other collateral or secured directly in its own right.^[4] Hopefully, the borrower's cash is kept at the lender's location and thus subject to the common law setoff rights that exist in most states. See, for example, Keeffe, *Setoff and Security Interests in Deposit Accounts*, 17 Colo. Law 2107 (Nov. 1988) and 26A *Strong's North Carolina Index* 4th Secured Transactions Section 85 (2018). Usually, setoff rights can be exercised immediately and without warning to the borrower if that is the best choice.

After you identify the collateral and assess its security, you must decide if immediate protection is needed for collateral that is in danger from waste (perishable items, deferred maintenance), theft

or misuse – assuming the value of the endangered collateral warrants protection efforts. If the answer is yes, you need to secure the collateral. They are four routinely available options for securing collateral at the beginning of litigation: (i) self-help if you can do so peacefully, see UCC § 9-609; (ii) prejudgment attachment if available, see for example Ohio Revised Code Chapter 2715; (iii) an asset freeze injunction, see *Grupo Mexicano de Desarrollo v. Alliance Bond Fund*, 527 U.S. 308 (1999) and subsequent cases [see also relevant state law because a state court’s authority arises from its state law]; and (iv) appointment of a receiver, see for example Ohio Revised Code Chapter 2735.[\[5\]](#)

When determining if and how to secure collateral, lender’s counsel needs to know if any other creditors have rights in the collateral. This question is explored in more detail below. I raise it now to emphasize the importance of the question as you plan. If a non-borrower co-owner has rights in the collateral that are not pledged to the lender or if another lienor has rights in the collateral, then (i) the collecting creditor’s options are limited, (ii) the recovery may be reduced,[\[6\]](#) and (iii) counsel and client may decide that certain collateral should be ignored. The limitations that come with others having property rights in your collateral must be considered.

Once you have secured the collateral and determined who has rights therein, the final collateral-related planning concern is maximizing its value: balancing the cash realized against the time required. More time nearly always means (i) more accrued interest that might not be recovered, (ii) more fees, (iii) cash used to fund the business if it is being sold as a going concern, (iv) expenses for collateral that “eats” (property taxes accrue, insurance required, refrigeration for perishable collateral, etc.), and (v) more time invested by the lender’s personnel. You need to go into the litigation with a collateral disposition plan – foreclosure sale, a receiver’s sale, a commercial auction, sale as a going concern, *ala carte* sale of property by the borrower, etc. – because that plan will (i) shape the relief sought in the complaint, (ii) direct the terms of the receivership order you may present and (iii) inform how you attack the collateral (perhaps you should not use setoff rights to seize the cash of a business you hope to keep operating during its marketing). [\[7\]](#)

[1] For purposes of this post, it is assumed that: (a) any real property lien is secured through a properly prepared, executed and recorded mortgage or deed of trust; (b) any necessary fixture filing has been made correctly; and (c) all personal property collateral is properly liened. In nearly every state, that personal property lien is obtained using Revised Article 9 of the Uniform Commercial Code (the “UCC”), except on vehicles that have government issued title documentation. References to the UCC herein will be to the section numbers assigned by the promulgators thereof, The National Conference of Commissioners on Uniform State Laws.

[2] Secured guarantees should be analyzed just as if the collateral was owned by the borrower. This is particularly true if you have a “guaranty of payment” and not a “guaranty of collection,” meaning that there is no requirement to exhaust the borrower’s assets before collecting from the guarantor.

[3] This blog post assumes that appropriate work-out efforts including forbearance, voluntary sale of the collateral by the borrower, and loan modification have been exhausted.

[4] The UCC provides for a security interest to attach to accounts at a non-lender financial institution if the necessary requirements are met. See UCC §§ 9-312 and 9-314.

[5] Loan documents often grant a lender the right to seek appointment of a receiver after a borrower defaults on its obligations to the lender. Said provisions are generally enforceable in commercial contracts. See, 75 C.J.S. *Receivers* § 39 titled “Appointment By Consent of Parties.” But, see 37 Fla. Jur. 2d *Mortgages* § 414.

[6] The desired “return” for any given collection action is usually money. But sometimes, the desired return is an interim step that is designed to lead to money such as pressure on a borrower. We once seized from a defaulted borrower only the CEO’s desk because we believed (correctly) that the borrower could pay if motivated. In another case, we seized only one of several items of collateral: the vehicle driven by the borrower’s owner’s wife who was at a park with her son – we got paid the next day. Knowing this, you may choose to act against collateral that has only modest

market value but high emotional value.

[7] Often, pre-litigation activity included a borrower's efforts to sell the business as an operating concern or the collateral *ala carte*. Lender and counsel should review the extent and quality of the borrower's efforts. Despite the lack of success, you can gain information on the market for your collateral and inform your decision on how to proceed. Do not ignore this opportunity for free intelligence concerning the market for your collateral.

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