Assignment 5
Article 9 Foreclosure and Deficiency
Reference: Understanding Secured Transactions Chapters 17-19

Disposition of Collateral: Article 9
• After default, secured party can sell collateral via judicial process (i.e., as described in Assignments 1-4) [§§ 9-601(a)(1), 9-601(f)]
• But secured parties typically use Article 9’s sale/disposition process, which is entirely nonjudicial
  – After repossession, secured party can hold either (1) a public auction or (2) a private sale, but any sale must be “commercially reasonable” in all respects [§§ 9-610(a), (b), (c)]

Commercial Reasonableness
• Rationale for § 9-610(b): “one size fits all” sale process may not always produce sale prices that reflect collateral’s fair market value
• Time, place, manner, terms of sale should follow “good practices” for selling property of that type (which may vary based on the type of property)
  – Comment 2: “This section encourages private dispositions on the assumption that they frequently will result in higher realization on collateral for the benefit of all concerned.”
  – Advertising for some types of collateral may need to be targeted, rather than in general newspapers

Problem 5.1
Bank repos/sells Maxwell’s Hummer in “dealer auction.” Maxwell got notice, sale was commercially reasonable. Debt = $100K. Sale price = $70K. Car’s FMV = $80K.
What amount can Bank now recover from Maxwell?

A. $0 (no deficiency)
B. $20,000
C. $30,000
D. Can’t say
Order of Applying Sale Proceeds

- (1) Reasonable expenses of repossession and sale [§ 9-615(a)(1)]
- (2) Debt owed to the foreclosing secured party [§ 9-615(a)(2)]
- (3) Debt owed to subordinate lienholders, if any, in order of priority [§ 9-615(a)(3)]
- (4) Remaining surplus to debtor [§ 9-615(d)(1)]
- If proceeds are not sufficient to satisfy (1)-(3), obligor is liable for a deficiency [§ 9-615(d)(2)]

Problem 5.1(a)

- $100,000 debt - $70,000 sale proceeds = $30,000 deficiency
- Article 9 generally provides that obligor is liable for any deficiency [§ 9-615(d)(2)]
- So is there any reason why Maxwell wouldn’t be liable to Bank for the $30,000 deficiency?

“Debtor” vs. “Obligor”

- Debtor = owner of collateral [§ 9-102(a)(28)(A)], “whether or not the person is an obligor”
- Obligor = person liable for debt [§ 9-102(a)(59)]
- Usually, “debtor” and “obligor” are same person
  - E.g., if Maxwell borrowed $100,000 from Bank and granted SI in his Hummer, Maxwell is both the “debtor” and an “obligor” (and thus he’d be liable for $30,000 deficiency judgment) [§ 9-615(d)(2)]

“Debtor” vs. “Obligor”

- Debtor and obligor could be different persons!
  - E.g., Smith borrows $100,000 from Bank, and Maxwell grants a SI in his car to secure Smith’s obligation to repay (but Maxwell does not co-sign Smith’s note to the Bank!)
  - On these facts, Maxwell is a “debtor” [§ 9-102(a)(28)(A)], but not an “obligor” [§ 9-102(a)(59)]
  - On these facts, Maxwell would have no liability for the $30,000 deficiency (although Smith would!)
Bank repos Maxwell’s Hummer. Maxwell gets notice but sale hasn’t occurred yet. Debt = $100,000. FMV = $80,000. What amount must Maxwell pay Bank to redeem the car and prevent the sale?

A. $80,000 (the car’s FMV)
B. $100,000 (the balance of the debt)

Problem 5.1(b)

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Redemption

• Until sale occurs, debtor may “redeem” the collateral [§§ 9-623(a), (c)]
• To redeem, debtor must pay secured party
  – (1) the full amount of the outstanding debt, and
  – (2) the secured party’s reasonable expenses of collection/enforcement, including any attorney fees to which secured party is legally entitled [§ 9-623(b)]

Problem 5.1(c)

• Assume Maxwell has $100K cash (with which he could redeem the car)
• Assume car is worth $80K
• What should he do?
  – Pay $100K to redeem the car?
  – Try to buy the car at the sale?
  – Ignore the sale and buy a similar car for $80K?

• Even if Maxwell doesn’t redeem, he shouldn’t ignore the sale (if he would also be liable for any deficiency as obligor)
  – He should participate at the sale and bid up to $80,000 (his replacement cost) to minimize his deficiency liability
  • Otherwise, if car sold for $70,000, he could have to pay $30,000 deficiency, + $80,000 to buy a replacement (more than the $100,000 debt)
Bank repos Maxwell’s Hummer. Maxwell got notice. Sale at dealer auction for $70,000. Friend of Maxwell’s had offered Bank $80,000 prior to the auction, but Bank had refused. In a deficiency action, Bank can recover …

Problem 5.1(d)

<table>
<thead>
<tr>
<th>Option</th>
<th>Description</th>
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<tbody>
<tr>
<td>A: $0</td>
<td>(no deficiency)</td>
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<tr>
<td>B: $20,000</td>
<td></td>
</tr>
<tr>
<td>C: $30,000</td>
<td></td>
</tr>
</tbody>
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§ 9-627 Determination of Whether Conduct Was Commercially Reasonable

(a) The fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.

(b) A disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

Problem 5.1(d)

• Code: Maxwell is liable for $30K deficiency
  – Fact that Bank got a higher offer doesn’t by itself establish that Bank’s manner of sale was commercially unreasonable [§ 9-627(a)]
  – A dealer auction is “in conformity with reasonable commercial practices among dealers” of cars [§ 9-627(b)(3)], and thus manner of sale was commercially reasonable

Sound Policy?

• Institutional lender could reasonably decide to sell its collateral via wholesale dealer auction (rather than making ad hoc judgments)
  – Bank might reasonably conclude that evaluating 3rd party bids, on case-by-case basis, may not be justified based on cost-benefit analysis
Problem 5.1(d): Counterargument

- Bank might reasonably choose to sell in dealer auction, as matter of policy
- However, where Bank has already received a third-party offer, one might argue Bank’s auction sale should not be treated as “reasonable” unless Bank establishes a “reserve price” for the auction = third-party bid received from Maxwell’s friend

Article 9 Sale Process: Notice

- Sale process begins with secured party giving notification of sale [§ 9-611(b)]
- Article 9 rules address:
  - Required recipients of notice [§ 9-611(c)]
  - Amount of notice needed [§ 9-612]
  - Content of notice [§§ 9-613, 9-614]

Rationales for Notification

- § 9-611(b): Secured party must give pre-sale notification to the following persons:
  - The debtor (i.e., owner of collateral) [§ 9-611(c)(1); § 9-102(a)(28)(A)]
  - Any secondary obligor (i.e., a guarantor of the obligation) [§ 9-611(c)(2); § 9-102(a)(71)], and
  - If the collateral is other than consumer goods,
    - Any person that notified the secured party of a claimed interest in the collateral [§ 9-611(c)(3)(A)], or
    - Any person that has filed a UCC-1 covering the collateral [§ 9-611(c)(3)(B)]
  - Thus, these parties need notice so they can protect their interests in the collateral (e.g., by paying off the senior secured party, or by bidding at the sale to acquire the collateral)
When Notification Excused [§ 9-611(d)]

- Pre-sale notification is excused only if collateral:
  - is perishable, or
  - threatens to decline speedily in value, or
  - is of type customarily sold in recognized market [§ 9-611(d)]
- Rationale: notice should not be required where delay occasioned by notice would be harmful or unnecessary to evaluate the fairness of the sale

Problem 5.3. East Bank sells repossessed cars via dealer auctions. East Bank: “Sending notice to debtors is a waste of time and money; they can’t get into a dealer auction anyway.” Can East Bank dispense with sending notice to debtors?

A. Yes, b/c notice is futile if debtor can’t buy at the sale
B. Yes, b/c a dealer auction is a “recognized market”
C. No

Article 9 Sale Process: Notice

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Hypo: On Sept. 1, Bank gives Debtor notice that public sale of collateral will occur Sept. 8. Is this sufficient notice?

A. Yes, 7 days is “commercially reasonable”
B. No, 7 days is not a reasonable time
C. Maybe

Notice: Notice Period

- § 9-612(a): whether notice is sent w/in reasonable time is a question of fact
- § 9-612(b): “safe harbor” provision — notice sent 10 or more days prior to sale is deemed sent w/in reasonable time, in nonconsumer transactions
  - Rationale: 10 days’ notice should be sufficient to protect debtor’s right to redeem (should be enough time for debtor to find a loan, or other buyers)

“Consumer Transactions”

- If debtor bought the car using secured credit and uses it primarily for personal, family, or household purchases, this is a “consumer transaction” [§ 9-102(a)(26)]
  - In some cases, Article 9 provides different rules for consumer transactions
  - E.g., “10 days prior notice” safe harbor in § 9-612(b) wouldn’t apply in consumer transaction; so, creditor might provide longer notice period (just to be safe)

Now suppose that the security agreement said: “Bank will be deemed to have given reasonable notice if it gives notice to Debtor at least 7 days prior to the sale.” Now would the notice be sufficient?

A. Yes; this provision in the security agreement is reasonable
B. No; the agreement wouldn’t matter; Bank can’t contract around Article 9
Contracting re: Standards of Behavior

- Parties “may determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party … if the standards are not manifestly unreasonable” [§ 9-603(a)]
- If the collateral is a simple car, a 7-day notice period is not manifestly unreasonable
  - This gives the debtor still needs chance to redeem or to try other arrangements to sell it (more time might be needed for a piece of specialized/custom equipment)

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Article 9 Notification Requirements

- **Minimal** content requirements [§ 9-613(1)]
  - Identify debtor and secured party
  - Identify the collateral
  - State method of disposition (e.g., sale, lease)
  - State that debtor is entitled to accounting (i.e., explanation of balance and its calculation)
  - State time/place of public sale, or time after which private sale will occur

Notification and Redemption

- While Article 9’s provides only minimal requirements for content of pre-sale notice, these minimal requirements are sufficient to give debtor the information it needs to take steps to redeem the collateral and avoid sale
  - Debtor can redeem by paying off full balance [§ 9-623(b)], but once sale occurs, debtor’s redemption right extinguished [§ 9-623(c)]
Bank’s notice says: “Balance due is $75,000. Unless Debtor has paid this sum prior to October 1, 2013, Debtor’s inventory will be sold in a private sale.” Does this notice comply with Article 9?

A. No, it doesn’t say when or where the sale will happen
B. No, it doesn’t identify the buyer at the sale
C. Yes, it is sufficient

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**Notice: Contents [§ 9-613(1)]**

- Notice of a private sale does not have to identify a specific buyer, the price, or the place of the sale
  - Secured party should be free during sale period to negotiate w/multiple possible buyers; this should facilitate a higher sales price from the collateral
  - Selling the collateral would be more confusing and cumbersome if notice had to reference a specific offer (e.g., possibility of multiple notices)
- Compare: notice of public sale (public auction) must identify the specific time/place of sale

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- Additional notification content is required in “consumer goods transactions” [§ 9-614(1)]
  - Description of any liability for a deficiency
  - Telephone number to obtain payoff amount
  - Telephone number or mailing address for other information about sale
- Rationale: more information appropriate where recipient is likely less sophisticated
  - “Consumer goods transaction” is one where (1) debt was incurred for personal purposes and (2) collateral is consumer goods [§ 9-102(a)(24)]

**Problem 5.4**

- Debtor owes Bank $345,000, secured by helicopter (which had a value of $345,000)
  - Debt is guaranteed by 4 wealthy individuals
- Bank repossesses helicopter after Debtor’s default, but engine and electronics have been removed (leaving it effectively valueless); Bank wants to know how to proceed
Bank wants to haul the helicopter to the dump. Can it do that?

A. No, Bank has to sell it
B. No, Bank has to fix it first, then sell it
C. Yes, Bank can dump it without conducting a sale

Now suppose the helicopter is broken, but has a salvage value of $50K. The same model, in good repair, is worth $300K. Can Bank sell it “as is,” or does Bank have to repair it first?

A. Bank has to fix the helicopter first, before trying to sell it
B. Bank can sell it “as is”

Although disposition commonly occurs by sale, Article 9 does not require secured party to sell the collateral

- Secured party may “otherwise dispose” of the collateral in its present condition, or following any commercially reasonable preparation [§ 9-610(a)], as long as the secured party’s chosen method of disposition is “commercially reasonable” in all respects [§ 9-610(b)]

- Secured party can dump it if it has no resale value (i.e., if costs of sale would exceed likely sale price)

§ 9-610 is not “crystal clear”
- § 9-610(a) appears to give secured party the choice to dispose of collateral “in its present condition” or following preparation/processing
- Still, § 9-610(b) suggests that all aspects of secured party’s conduct must be reasonable
- Comments: secured party can’t dispose of collateral “as is” if doing so would be commercially unreasonable [§ 9-610 cmt. 4]
• Is it reasonable to expect Bank to “fix-up” the helicopter before selling it?
  – *Chavers*: failure to consider cost and potential benefit of engine work before auction sale of plane was commercially unreasonable [p. 87]
  – § 9-610 cmt. 4: courts should use judgment, and consider not only cost/benefit of repair but also “the fact that the secured party would be advancing the costs at its risk” (e.g., is court confident that a $100,000 investment by the secured party would have generated a sale price increased by more than $100,000?)

Suppose Bank repossesses the helicopter and puts it in the Columbia Mall parking lot with a “FOR SALE” on it. Bank then sells it to Lambert in a private sale for $250K [assume a helicopter would go for $300K from a dealer]. Debtor argues: “the sale was unreasonable because you didn’t advertise it in the newspaper or aviation magazines.” Is Debtor correct?

A. Yes; sign wasn’t a reasonable ad
B. No; a “for sale” sign is sufficient
C. It doesn’t matter, as the sale brought a reasonable price

Advertising

• Duty to conduct a “commercially reasonable” sale requires reasonable steps to publicize sale
  – § 9-610, cmt. 7: in a public sale, public must have “meaningful opportunity for competitive bidding,” which presumes “some form of advertisement”
  – Even a private sale must provide potential buyers with some means of awareness that the collateral is for sale
• What is “reasonable” will vary depending on collateral
  – For “standard” collateral and collateral of minimal value, minimal and mass-directed advertising may be sufficient
  – For “custom,” unique, or high-value collateral, more targeted advertising is required (e.g., *Contrail Partners*: secured party did not act reasonably when it sold a plane using only newspaper ads, rather than aviation mags)

Contracting re: Reasonableness

• Ambiguity re: type/volume of advertising provides a good example of the potential benefit of § 9-603(a)
  – Debtor and secured party can agree, *in the security agreement*, as to the nature/extent of advertising that secured party will do prior to foreclosure sale
  – This agreement will be enforced unless it is “manifestly unreasonable”
Consequences of “Unreasonable” Sale

- Secured party is liable for damages caused by its failure to comply w/Art. 9 [§ 9-625(b)]
- Loss to debtor due to “unreasonable” sale typically would be measured by actual sale price MINUS price at a “reasonable” sale
  - Problem: it is difficult to say exactly what price a “commercially reasonable” sale would have brought (as even a reasonable sale doesn’t always bring FMV)
  - Thus, courts typically use FMV as proxy for “reasonable” sale price

Damages Hypo

- Debtor owes Bank $20,000, secured by SI in Debtor’s car (business vehicle)
- After default, Bank repos the car, sells it for $20,000, without giving notice to Debtor
- Car’s FMV = $25,000
- Debtor’s damages under § 9-625(b) = $5,000 (FMV – sale price)

Deficiency Judgments and the “Absolute Bar” Rule

- If collateral is consumer goods, injured party can recover
  - Actual damages [§ 9-625(b)], OR, IF GREATER,
  - Statutory damages = “credit service charge + 10% of principal amount of the obligation” or “time-price differential + 10% of cash price” [§ 9-625(c)] (the “consumer penalty”)
- E.g., Assume Maxwell bought the car 2 years ago
  - Cash price = $30,000
  - Total payments over 5 years (7% interest) = $35,400
  - Time-price differential = $5,400
  - Consumer penalty = $5,400 (time-price differential) + $3,000 (10% of cash price) = $8,400

- Pre-2000: some courts held that after commercially unreasonable sale, secured party could not recover a deficiency judgment (“absolute bar” rule)
  - E.g., McKesson Corp. v. Colman’s Grant Village, 938 S.W.2d 631 (Mo. Ct. App. 1997)
  - Rationale: better incentive for creditor to conduct reasonable sale, would produce higher sale prices
Why Not an “Absolute Bar” Rule?

- Creditor’s loss of any deficiency would often be disproportional to actual damage caused by creditor’s failure
- Absolute bar is too harsh because secured party is being held to ambiguous “commercial reasonableness” standard (unclear, requires secured party to exercise judgment)
- May be wasteful (secured party may run “too many” ads to protect its ability to pursue deficiency)

Rebuttable Presumption Rule

- If secured party fails to comply w/Article 9, deficiency = total debt MINUS the greater of:
  - the actual proceeds of disposition, or
  - the proceeds that would have resulted if secured party had complied with Article 9 [§ 9-626(a)(3)]
- Presumption: proceeds at a “reasonable” sale would’ve been = balance of debt (no deficiency)
  - Secured party has to rebut this presumption with evidence of collateral’s FMV [§ 9-626(a)(4)]
  - If secured party proves FMV << balance of debt, it can recover a deficiency to extent of the difference

Exception: Consumer Transactions

- If sale isn’t commercially reasonable, and loan was a “consumer transaction,” court doesn’t have to apply “rebuttable presumption” rule; court is free to adopt “established approaches” [§ 9-626(b)]
  - This would permit (but not require) a court to apply “absolute bar” rule!
  - Some (but not all) courts have continued to apply absolute bar rule in consumer transactions, e.g., Hicklin v. Onyx Acceptance Corp., 970 A.2d 244 (Del. 2009)

Strict Foreclosure

- Secured party can propose, in an authenticated record, to retain collateral in full satisfaction of debt
  - If debtor accepts, or fails to respond w/in 20 days [§ 9-620(c)(2)], secured party acquires debtor’s interest, subordinate liens extinguished [§ 9-622(a)], obligation fully satisfied
- Secured party can also propose to retain collateral in partial satisfaction (i.e., stipulated deficiency), but debtor must formally accept [§ 9-620(c)(1)]
Article 9 Media-Neutrality
• Proposal for strict foreclosure (and debtor’s necessary acceptance) must be in “authenticated record”
  – “Record” = information that is inscribed on a tangible medium or that is stored in an electronic or other medium as is retrievable in perceivable form [§ 1-201(b)(31)]
  – “Authenticate” = to sign a record or attach or associate with the record a sound, symbol or process w/present intent to adopt the record [§ 9-102(a)(7)]

Problem 5.5
• Lamp Fair (LF) sells store to Pedro
  – Pedro signed a $277,000 promissory note, granted LF a security interest in all of store’s equipment/inventory
• Later, Pedro defaulted, and turned store over to LF
• LF inventories the remaining collateral, which appraises for $146,000
• LF sends letter to Pedro’s lawyer, crediting Pedro w/value of collateral, demanding payment of $131,000

In Problem 5.5, What Happened?
A. Partial strict foreclosure; LF owns the collateral; Pedro owes $131K
B. Full strict foreclosure; LF owns the collateral; Pedro owes LF nothing (debt is satisfied)
C. Nothing; Pedro still owns the collateral; LF can sue Pedro for $277K
D. Nothing; Pedro still owns the collateral; LF can’t sue Pedro on the debt until it conducts a foreclosure sale.

• (a) is incorrect
  – No partial strict foreclosure occurred here: even if LF’s letter was a “proposal” [§ 9-102(a)(66)] (which it isn’t), it was not accepted by Pedro [§ 9-620(c)(1)]
• (b) is incorrect
  – No full strict foreclosure occurred here: no unconditional proposal was sent to Pedro [§ 9-620(c)(2)]
• (d) is incorrect
  – LF does not have to sell collateral before suing Pedro for a judgment: Article 9’s remedies are “cumulative” [§ 9-601(a), (c)], LF can sue on the debt before attempting to sell the collateral
In Problem 5.5, Pedro still owns the equipment and inventory [§ 9-617(a), § 9-623(c)], despite fact that LF has taken possession of it.

What does this mean for Pedro and LF?

- LF has duty of care re: collateral [§ 9-207(a)]
- If LF operates the store and starts selling inventory to customers to liquidate the collateral, each sale to a customer is an Article 9 “private sale”
- Thus, notice would have to be given [§ 9-611], sale proceeds would have to be applied to reduce Pedro’s debt [§§ 9-207(c)(2), 9-615(d)]

Resales of inventory to customers would be private sales under Article 9.

- Thus, as to inventory, LF can give one notification (“we’ll sell at a private sale after 10 days from this notification”) would be sufficient
- Repeated notifications prior to every sale would be impractical, expensive, uselessly repetitive

But what about Pedro’s equipment (like cash registers, computers, delivery trucks)?

“Disposition” is not limited to “sale” [§ 9-610 cmt. 2]; if it is commercially reasonable for LF to use the equipment in operating the store (and the security agreement doesn’t forbid it), LF may do so [§ 9-207(b)(4)]

- Thus, LF could use the equipment until all inventory was liquidated, and then sell the equipment
- Note, however, that LF must still give notice to Pedro that it is “disposing” of the equipment in this way (notice of “disposition” is required!)
Problem 5.7(b): Debtor Rejects Chavers’ Proposal. Chavers Ignore Rejection and Begin Using the Plane. Which Statement Is Correct?

A. The Chavers own the plane (they’ve sold it to themselves)
B. Debtor still owns the plane; Chavers must sell it
C. Debtor still owns the plane; Chavers can use it

• Note: secured party cannot buy the collateral at its own private sale [§ 9-610(c)]
  – Risk of abuse/self-dealing (buy at low price, sell at a profit, get higher deficiency)
  – Theoretically, public sale minimizes this risk (bidding should prevent “bargain” sale), so secured party can buy at public sale