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## DEFAULT AND ENFORCEMENT UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

No matter how carefully a lessor analyzes a lessee's credit, there are bound to be times when the lessee is unable to satisfy its lease obligations and the lessor is forced to minimize its losses by repossessing and disposing of the leased equipment. If the underlying "lease" contains a mandatory purchase option or a bargain purchase option or otherwise constitutes a loan instead of a true lease, any such repossession and disposition must comply with detailed provisions in revised Article 9 of the Uniform Commercial Code ("Revised Article 9"). If a lessor fails to comply with these provisions, it may lose its ability to recoup any deficiency in the event the proceeds from the disposition of the leased equipment are less than the amount owed by the lessee. In addition, a lessor may also be held liable for any loss caused by its failure to comply with the provisions of Revised Article 9.

Although many people in the industry are familiar with Revised Article 9 and the changes it made with respect to where to conduct UCC searches, where to file financing statements and what to do when lessees transfer collateral or change their organizational structure, far less have reviewed the changes made by Revised Article 9 with respect to repossessing and disposing of collateral. Ironically, this is where the most voluminous changes were made in Revised Article 9. The prior version of Article 9 contained only seven provisions regarding default and enforcement whereas the Revised Article has been expanded to include twenty-eight provisions. In general, these provisions merely codify the majority of existing case law in an effort to obtain more uniform results. Nonetheless, there are a few potential traps lurking for the unfamiliar lessor. In addition, although it repeats many of the provisions contained in the prior version of Article 9 with respect to repossessing and disposing of collateral, Revised Article 9 provides

much more detail. For example, it contains provisions detailing to whom and when notices of disposition should be sent and the contents of the notification.

### **Remedies Generally and Repossessing of Leased Equipment**

Like its predecessor, the remedies that Revised Article 9 provides to secured parties, such as lessors under leases intended as security, can only be exercised after a default by the lessee.<sup>1</sup> These remedies are in addition to those granted by the underlying agreement and all remedies are "cumulative." Revised Article 9 differs from its predecessor and clarifies that these cumulative remedies may be exercised simultaneously.<sup>2</sup> It is worth noting that this provision does not override non-UCC law (including common law tort laws or statutes regulating the collection of debts such as the Fair Debt Collection Practices Act) under which the simultaneous exercise of remedies in a particular case may constitute abusive behavior or harassment giving rise to liability.<sup>3</sup>

As under the earlier version of Article 9, following a default the lessor may repossess collateral and can do so either through the use of judicial process<sup>4</sup> or without judicial process so long as doing so will not result in a breach of the peace.<sup>5</sup> What constitutes a "breach of the peace" is left to the courts to determine. The official comments to Revised Article 9 recommend that courts "hold the [lessor] responsible for the actions of others taken on the [lessor's] behalf, including independent contractors engaged by the [lessor] to take possession of the collateral." This is strong language warning lessors to be careful with respect to which companies it hires to repossess leased equipment.



As was the case under the earlier version of Article 9, Revised Article 9 validates an agreement by the lessee to assemble the collateral and make it available to the lessor prior to a default. Regardless of whether such right is specified in the agreement, the lessor can, *after default by the lessee*, require the lessee to assemble the collateral and make it available to the lessor at a place to be designated by the lessor which is reasonably convenient to both parties. Lessors should continue to specify this right in their lease agreements so as to be sure there is no debate as to what constitutes a "reasonably convenient" place.

### **Disposing of Leased Equipment and New Details Regarding Notices**

As long as the lessor complies with certain requirements, Revised Article 9 authorizes it to dispose of the leased property in a variety of forms including a lease, license or sale.<sup>6</sup> However, prior to any such disposition, "reasonable authenticated notices of disposition" must be sent to certain persons in a timely manner and must contain specified information.<sup>7</sup> No notification is required if the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market (*e.g.* marketable securities).<sup>8</sup> It should be noted that the exception relating to items customarily sold on a recognized market is extremely narrow.

Notification must be sent to the "debtor", any "secondary obligors" and certain lienholders or other parties who have an interest in the collateral in accordance with section 9-611 of Revised Article 9. A "debtor" includes any person who has an interest in the collateral securing the debt, whether or not that person is obligated on the debt.<sup>9</sup> A "secondary obligor" includes: (a) any obligor who's obligations are secondary and (b) who has a right of recourse against the lessee, any other obligor or the property of either.<sup>10</sup> The classic example of a "secondary obligor" is a guarantor and Revised Article 9 eliminates the debate that went on in a minority of jurisdictions as to whether a guarantor was entitled to notice. The lessee and/or the secondary obligor may



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waive its right to receive this notice but only after default.<sup>11</sup> A lessor is not, however, liable for failure to provide disposition notification to a guarantor or other secondary obligor unknown to the lessor.<sup>12</sup> Revised Article 9 also requires notice to be given to any other person from which the lessor has received, before the date it sends out notifications, an authenticated notification of a claim of interest in the collateral.<sup>13</sup> This requirement is the same as under the prior version of Article 9.

One *major change* is that notice must *also* be given to all secured parties (senior and junior) who, ten days before the date the lessor sends out notifications to the lessee, any other debtors and any secondary obligors (the "Notification Date"), have perfected their security interests by filing a financing statement or complying with other applicable law (e.g. a certificate of title statute) as long as the filing statement identifies the collateral, is indexed under the name of the lessee as of that date and was filed in the office in which to file a financing statement against the lessee covering the collateral as of that date.<sup>14</sup> The lessor who is foreclosing generally need not worry about effective financing statements that are more difficult to locate because of a change in the lessee's name or location or because of rules relating to proceeds.<sup>15</sup> In other words, the lessor must make conduct a UCC search prior and notify certain persons prior to disposing of the collateral. There is a safe harbor provision that protects secured parties from delays of the filing office. A lessor is deemed to have complied with the foregoing requirements if it runs a search with the filing office not more than thirty nor less than twenty days before the Notification Date and it either: (i) does not receive a response for the request of information or (ii) receives a response and sends notice to all lienholders listed on that response, regardless of whether that list turns out to be factually inaccurate.

The notification to the lessee, any other debtors and any secondary obligors must be sent sufficiently in advance of the date the disposition is to be made that the person notified has time to react. That time period is a question of fact answered on a case by case basis. However, there is



a safe harbor for commercial transactions and ten days notice is considered reasonable.<sup>16</sup> Revised Article 9 leaves to judicial resolution, based on the facts of each case, the question whether a "second try" is required when the lessor learns or has knowledge that the lessee or other party entitled to notice did not receive the initial notice.<sup>17</sup>

The notice of sale being sent must indicate basic identifying information, what type of disposition is anticipated (sale, lease or license), whether the sale being conducted is to be a private or public sale and other pertinent information.<sup>18</sup> Additional terms other than those required by the statute can be included. The Revised Article sets forth in detail what information must be included in the notice of sale in a non-consumer transaction<sup>19</sup> as well as a sample form which is statutorily sufficient.<sup>20</sup>

### **Details Regarding the Actual Disposition**

As did its predecessor, Revised Article 9 requires that every "aspect" of the disposition be commercially reasonable.<sup>21</sup> The lessee cannot waive this requirement but can agree in advance upon what standards will be considered by the parties to be commercially reasonable.<sup>22</sup> These standards will be honored by courts as long as they are not "manifestly unreasonable."<sup>23</sup> Revised Article 9 allows this disposition to take the form of a lease, license or sale.<sup>24</sup> The sale may be a private sale or a public sale (i.e. auction) provided that it is commercially reasonable to dispose of the collateral in that manner.

The timing of the sale must also be commercially reasonable and any delay in selling items of collateral that are subject to fast depreciation in value may be commercially unreasonable.<sup>25</sup> Section 9-610(a) of Revised Article 9 allows the lessor to dispose of collateral "in its present condition or following any commercially reasonable preparation or processing." This language is identical to that used in the prior version of Article 9 which often resulted in litigation. The



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official comments to this section of Revised Article 9 clarify the landscape somewhat stating: "[a]lthough courts should not be quick to impose an affirmative duty on the lessor to process or prepare the collateral, [this section] does not grant the [lessor] the right to dispose of the collateral in 'its then current condition' in all circumstances [and the lessor should take into account] the costs and probable benefits of preparation or processing and the fact that the [lessor] would be advancing the costs at its risk. . . ."

There has been much debate over the years on whether the requirement that all "terms" of the disposition be commercially reasonable means that the sale price itself be commercially reasonable. Revised Article 9 indicates that a low price "of itself" will not make a disposition sale commercially unreasonable.<sup>26</sup> However a low price obtained at the disposition sale "suggests that the court should scrutinize carefully all aspects of a disposition."<sup>27</sup>

The lessor can purchase the collateral at a public sale, but may not purchase collateral at a private sale unless the collateral is of a kind customarily sold on a recognized market or is the subject of standard price quotations.<sup>28</sup> Unfortunately the revised Act does not specifically determine what is a "public" or "private" sale, leaving that determination to the courts.<sup>29</sup> It should be noted that the "recognized market" exception mentioned above is very narrow and includes only that type of collateral which is sold in markets where the prices are not subject to individual negotiation.<sup>30</sup> In addition, Revised Article 9 looks closely at any disposition where the collateral is purchased by the lessor, a person related to the lessor, or a guarantor of the secured debt. In those cases, if the purchase price is "significantly below the range of proceeds that a complying disposition to a person [other than one of those persons] would have brought," the amount of any surplus or deficiency will be based on the amount that the disposition sale would have brought had some other person purchased the collateral at the sale.<sup>31</sup> This provision helps protect the lessee in connection with sales to persons who do not have the economic incentive to bid for the collateral



at prices that approximate its fair value. Indeed, the incentive to these parties is actually to the contrary: the lower the bid, the greater the deficiency claim against the lessee.

Revised Article 9 provides that any sale of collateral includes implied warranties of title, possession and quiet enjoyment unless specifically disclaimed.<sup>32</sup> All other warranties which by operation of law accompany voluntary transactions are also made in connection with a disposition sale, such as implied warranties of merchantability and, if applicable, fitness for a particular purpose. The extent to which a lessor can disclaim these warranties will depend upon whether it is commercially reasonable to sell the collateral without such warranties. For example, if the lessor is a dealer in the goods in question and regularly sells such goods with full warranties, it would almost certainly be commercially unreasonable for such a lessor to disclaim warranties in connection with the disposition sale.

### **Application of Proceeds**

Cash proceeds received from a disposition must be applied first to the reasonable expenses of sale, including attorney's fees in connection with the sale. Note, however, that in order to apply proceeds to attorney's fees incurred in connection with enforcing the lease generally, the lease must specifically provide for attorney's fees. Next, proceeds are applied to the satisfaction of the obligations secured, then to the satisfaction of any subordinate obligations or interest of a consignor (if the lessor has received an authenticated demand for such proceeds from such subordinate obligation holder or such consignor).<sup>33</sup> Any remaining amounts will be given to the lessee, and if none are available, the lessee will be liable for any deficiency. A lessor may sometimes receive something other than cash at a disposition sale. For example, if the lessor releases the equipment, it will receive a lease. If the noncash proceeds "are of the type that the lessor regularly generates in the ordinary course of its financing business in nonforeclosure transactions," it may be commercially unreasonable to fail to apply the noncash proceeds at that



time.<sup>34</sup> The rationale is that it is unfair for the original lessee to bear the risk of the lessor's credit judgment with respect to the new lessee.

### **Accepting Collateral in Full or Partial Settlement**

One method of realizing upon leased equipment as collateral is to accept the equipment in full or partial satisfaction of the lessee's lease obligations. Accepting collateral in this manner obviates the need to comply with the requirements relating to commercially reasonable sales.

This method of enforcement has been significantly changed and expanded by Revised Article 9. Under the prior version of Article 9, collateral could only be retained by the secured party in full satisfaction of the debt (sometimes referred to as a "strict foreclosure"). Under Revised Article 9, a secured party in a commercial transaction can retain collateral in partial satisfaction of the debt as well. It is worth noting that, under Revised Article 9, a secured party may retain collateral in satisfaction of the debt even if the secured party is not in possession of the collateral at that time.

In order to take collateral in satisfaction of a debt, a secured party must notify the debtor. If the secured party intends to accept the collateral in partial satisfaction, instead of full satisfaction, it must also notify all secondary obligors, such as guarantors. In addition and in both cases, the secured party must notify the following persons: (a) any person from which the secured party has received, before the debtor consented to the retention of the collateral, an authenticated notification of a claim or interest in the collateral; and (b) any other secured party or lienholder who, ten days before the date the lessor sends out notifications to the debtor and any other persons entitled to notice: (i) has perfected its security interest by filing a financing statement which identifies the collateral, is indexed under the name of the debtor as of that date and was filed in the office in which to file a financing statement against the debtor covering the collateral as of that date; or (ii) has perfected its security interest by complying with other applicable law



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(e.g. a certificate of title statute). These persons are very similar to those who are entitled to receive notice of any disposition of collateral by a commercially reasonable sale. However, unlike the rules governing notices required for such sales, the rules governing notices required for retention of collateral in satisfaction of debt do not provide any safe harbor to protect the secured party from the errors or delays of the filing office.

The debtor can only accept the secured party's offer to retain the collateral in *partial satisfaction* of the debt by agreeing to the terms of the retention in a record authenticated (e.g. signed) after the default. On the contrary, if the secured party sends notification to the debtor of the secured party's intent to retain the collateral in *full satisfaction* of the debt and the debtor doesn't object within twenty (20) days, the secured party can treat the debtor's silence as an acceptance of the secured party's offer.

Any secured party or other person who is not a debtor and to whom the secured party sent notice, must object within twenty (20) days from the date the secured party sent the notice or that person will be deemed to have consented to the retention of the collateral. Any person who was not sent notice but who has the right to object (e.g. because they have an interest in the collateral), can object within twenty (20) days of the date the last notice was sent by the secured party to any other person. If a secured party receives an objection from the debtor, any other person entitled to notice or any person having an interest in the collateral, the debtor cannot retain the collateral in satisfaction of the secured debt.

Under Revised Article 9, a secured party will not be deemed to have retained collateral in satisfaction of the debt unless the secured party takes the affirmative statutory steps required in Revised Article 9 to retain the collateral in satisfaction. However, a secured party may be penalized for holding on to collateral such a long time that it is commercially unreasonable.



**Collection and Enforcement With Respect To "Account Debtors"**

A special set of rules in Revised Article 9 govern the enforcement of a secured party's interest by collection. These rules come into play when a funding source takes an interest in an equipment lease as collateral for its loan. One key definition in this section of Revised Article 9 is the term "account debtor." An "account debtor" means any person obligated on an account, chattel paper or general intangible and would include lessees since equipment leases constitute "chattel paper" under Revised Article 9 regardless of whether they are true leases or loans. In other words, if a broker/originator borrows money from a funding source and pledges the one or more equipment leases as collateral for the loans, the funding source will be taking a security interest in chattel paper (i.e. the leases) and the lessees under such leases are referred to as "account debtors" under Revised Article 9.

Revised Article 9 provides that a secured party may, *after a default by the borrower*, notify an "account debtor or other person obligated on the collateral" to make payment directly to the secured party. If the underlying security agreement specifically provides, a secured party may exercise these rights prior to a default by the debtor. A secured party may also notify an "account debtor or other person obligated on the collateral" to render performance for the benefit of the secured party. This right is broader than the mere right to demand payment and would, for example, allow the secured party to enforce a breach-of-warranty claim arising out of a defect in equipment that serves as collateral. It is important to note that the provisions of Revised Article 9 which grant a secured party these rights only relate to the secured party's rights as against the debtor. Different rules create, regulate, or otherwise affect the duties or rights of the actual account debtor or other person obligated on the collateral and a detailed discussion of those rules is beyond the scope of this issue of dispatches from the trenches. For example: (a) section 9-406 of Revised Article 9 generally states that account debtors who are notified to make payment to a secured party (i.e. the funder) of the original party entitled to payment (i.e. the original lessor)



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can only discharge their obligations by making payment to the secured party; and (b) section 9-408 would generally govern the rights and duties of the warrantor in the event a secured party tried to enforce a breach-of-warranty claim against such warrantor.

As with any disposition of leased equipment, the concept of "commercial reasonableness" is intertwined with any collection under a lease that is assigned as collateral for a loan. Revised Article 9 specifically notes that, *where there is credit recourse to the debtor*, the collection must be made in a commercially reasonable manner. This provision arises from the fact that: (a) true sales of chattel paper, accounts, payment intangibles, and promissory notes are governed by Revised Article 9; and (b) there is no need to apply the commercial reasonableness standard if the transaction is a true sale without any recourse against the seller/debtor, because the seller/debtor will not be affected by a poor disposition.

Although many people only consider the foregoing remedies when its time to realize upon collateral after a deal has gone bad, it is helpful to have a prospective understand of these provisions.



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<sup>1</sup> U.C.C. §9-601(b)

<sup>2</sup> U.C.C. §9-601(b)

<sup>3</sup> U.C.C. §9-601, Comment 5

<sup>4</sup> U.C.C. §9-609(b)(1)

<sup>5</sup> U.C.C. §9-609(b)(2)

<sup>6</sup> U.C.C. §9-610(a)

<sup>7</sup> U.C.C. §9-611

<sup>8</sup> U.C.C. §9-611(d)

<sup>9</sup> U.C.C. §9-102(59)

<sup>10</sup> U.C.C. §9-102(70)

<sup>11</sup> U.C.C. §9-624(a)

<sup>12</sup> U.C.C. §9-628(a) and (b)

<sup>13</sup> U.C.C. §9-611(3)(A)

<sup>14</sup> U.C.C. §9-611(B)

<sup>15</sup> U.C.C. §9-611, Comment 4

<sup>16</sup> U.C.C. §9-612(b)

<sup>17</sup> U.C.C. §9-611, Comment 6

<sup>18</sup> U.C.C. §§9-613 and 614

<sup>19</sup> U.C.C. §9-613

<sup>20</sup> U.C.C. §9-613(5)

<sup>21</sup> U.C.C. §9-610(b)

<sup>22</sup> U.C.C. §9603(a)

<sup>23</sup> *Id.*

<sup>24</sup> U.C.C. §9-610(a)

<sup>25</sup> See *Solfanelli v. Corestates Bank N.A.*, 203 Fad 197, 40 UCC Rep Serv. 2d 914 (3rd Cir.2000) (The decline in value of securities held by secured party for 11 months after repossession, is commercially unreasonable).

<sup>26</sup> U.C.C. §9-627(a)

<sup>27</sup> U.C.C. §9-610, Official Comment 10

<sup>28</sup> U.C.C. §9-610(c)

<sup>29</sup> U.C.C. §9-610, Official Comment 7

<sup>30</sup> U.C.C. §9-610, Official Comment 9

<sup>31</sup> U.C.C. §9-615(f)



<sup>32</sup> U.C.C. §9-610(d) and (e)

<sup>33</sup> U.C.C. §§9-608 and 615(a)

<sup>34</sup> U.C.C. §9-615, Comment 3

