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DISPATCHES FROM THE TRENCHES

DEFAULT AND ENFORCEMENT UNDER ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

By Kenneth P. Weinberg

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.¹ 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.² 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.³

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 process⁴ or without judicial process so long as doing so will not result in a breach of the peace.⁵ 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.⁶ 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.⁷ 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).⁸ 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.⁹ 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.¹⁰ 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 waive its right to receive this notice but only after default.¹¹ A lessor is not, however, liable for failure to provide disposition notification to a guarantor or other secondary obligor unknown to the lessor.¹² 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.¹³ 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.¹⁴ 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.¹⁵ 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 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.¹⁶ 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.¹⁷

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.¹⁸ 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 transaction¹⁹ as well as a sample form which is statutorily sufficient.²⁰

Details Regarding the Actual Disposition

As did its predecessor, Revised Article 9 requires that every "aspect" of the disposition be commercially reasonable.²¹ The lessee cannot waive this requirement but can agree in advance upon what standards will be considered by the parties to be commercially reasonable.²² These standards will be honored by courts as long as they are not "manifestly unreasonable."²³ Revised Article 9 allows this disposition to take the form of a lease, license or sale.²⁴ 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.²⁵ 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 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.²⁶ However a low price obtained at the disposition sale "suggests that the court should scrutinize carefully all aspects of a disposition."²⁷

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.²⁸ Unfortunately the revised Act does not specifically determine what is a "public" or "private" sale, leaving that determination to the courts.²⁹ 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.³⁰ 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.³¹ 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.³² 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).³³ 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 re-leases 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.³⁴ 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.

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¹ U.C.C. §9-601(b)

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- ² U.C.C. §9-601(b)
³ U.C.C. §9-601, Comment 5
⁴ U.C.C. §9-609(b)(1)
⁵ U.C.C. §9-609(b)(2)
⁶ U.C.C. §9-610(a)
⁷ U.C.C. §9-611
⁸ U.C.C. §9-611(d)
⁹ U.C.C. §9-102(59)
¹⁰ U.C.C. §9-102(70)
¹¹ U.C.C. §9-624(a)
¹² U.C.C. §9-628(a) and (b)
¹³ U.C.C. §9-611(3)(A)
¹⁴ U.C.C. §9-611(B)
¹⁵ U.C.C. §9-611, Comment 4
¹⁶ U.C.C. §9-612(b)
¹⁷ U.C.C. §9-611, Comment 6
¹⁸ U.C.C. §§9-613 and 614
¹⁹ U.C.C. §9-613
²⁰ U.C.C. §9-613(5)
²¹ U.C.C. §9-610(b)
²² U.C.C. §9603(a)
²³ *Id.*
²⁴ U.C.C. §9-610(a)
²⁵ See *Solfanelli v. Corestates Bank N.A.*, 203 F.3d 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).
²⁶ U.C.C. §9-627(a)
²⁷ U.C.C. §9-610, Official Comment 10
²⁸ U.C.C. §9-610(c)
²⁹ U.C.C. §9-610, Official Comment 7
³⁰ U.C.C. §9-610, Official Comment 9
³¹ U.C.C. §9-615(f)
³² U.C.C. §9-610(d) and (e)
³³ U.C.C. §§9-608 and 615(a)
³⁴ U.C.C. §9-615, Comment 3