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DISPATCHES FROM THE TRENCHES

More On Default & Enforcement Under Article 9 Of The Uniform Commercial Code

By Kenneth P. Weinberg

The last issue of dispatches from the trenches discussed various statutory rules with which lessors must comply when repossessing and disposing of leased equipment whenever the underlying "lease" is governed by revised Article 9 of the Uniform Commercial Code ("Revised Article 9"). Recall that Revised Article 9 is applicable whenever the underlying "lease" contains a mandatory purchase option or a bargain purchase option or otherwise constitutes a loan instead of a true lease. It is also applicable whenever a broker or originator assigns the underlying lease and the leased equipment as collateral for a loan made by a bank or other funding source regardless of whether the underlying "lease" constitutes a true lease or a loan. The last issue of this column focused on disposing of the leased equipment pursuant to a commercially reasonable sale and the various notices and other procedures that needed to be followed in that regard. This issue focuses on other methods of realizing upon collateral under Revised Article 9.

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 (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) 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.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit www.leaselawyer.com or contact Weinberg at 205-251-8307.

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