

UCC Bulletin

A monthly newsletter highlighting and commenting upon recent noteworthy developments relating to the Uniform Commercial Code

February 2004

West Group

IN THIS ISSUE . . .

An article about commercial reasonableness in the disposition of collateral 1

MATTERS OF MAJOR INTEREST

Failure to Prove That Payment on Loan Occurred 4
Holder's Notice of Guarantor's Discharge 5
Lease or Security Interest 5

OTHER MATTERS OF INTEREST

Concerning Articles 2, 2A, Revised 3, 4, Revised 5, Revised 8 and Revised 9 6

COMMERCIAL REASONABLENESS IN THE DISPOSITION OF COLLATERAL: PROCEED WITH CARE*

By John P. McCahey, Hahn & Hessen LLP†

Following a default on a secured loan, the lender may decide to sell its collateral. Assuming that the sale yields an amount (net of expenses) less than the outstanding loan balance, the lender may then seek to recover the deficiency from the borrower or any guarantors. Often, such obligors will respond to the lender's claim by challenging the manner in which the collateral was sold by the lender and alleging that the loan would have been fully satisfied (and their liability to the lender extinguished) had the lender proceeded differently in the collateral's sale. In such

a scenario, the lender's right to enforce payment by the obligors will depend on whether it can establish that the collateral was sold in a "commercially reasonable" manner.

This article will highlight the provisions in Revised Article 9 of the Uniform Commercial Code (Revised Article 9 and Rev. UCC) that impose a non-waivable duty upon a secured party to sell or otherwise dispose of its collateral in a commercially reasonable manner. While the particular facts and circumstances of each disposition will determine whether or not it was commercially reasonable, Revised Article 9 provides guidelines for achieving a commercially reasonable disposition and states the consequences that may result from a commercially unreasonable disposition. Because the duty of commercial reasonableness also existed under the Uniform Commercial Code's former Article 9 (Former Article 9), cases decided before Revised Article 9's enactment will continue to guide the courts in determining whether or not a disposition was commercially reasonable.

Right of Disposition

Among the various rights that Revised Article 9 allows a secured party to exercise in the event

* Reprinted with permission from Business and Commercial Litigation Newsletter, Summer 2002, a publication of the American Bar Association Section of Litigation Commercial and Banking Litigation Committee. Copyright 2002 American Bar Association. Permission also granted to reproduce in UCCSEARCH™ and Westlaw.

† John P. McCahey is a litigation partner at Hahn & Hessen LLP in New York City and frequently represents secured lenders.



Customer Service: 1-800-328-4880
Fax: 1-800-340-9378

© 2004, West, a Thomson business. No part of this work may be copied or reproduced in any form without the written permission of the copyright owner.

of a default is the right of disposition, which permits the secured party to "sell, lease, license or otherwise dispose of any or all of its collateral." Rev. UCC §9-610(a). The proceeds received from such a disposition should be applied (including against the secured obligation) in the manner and at the time specified in Revised Article 9. Rev. UCC §9-615(a). After the application of the proceeds, the secured party will typically either be required to account to the debtor for any surplus or allowed to recover any deficiency from an obligor. Rev. UCC §9-615(d).

A disposition may be either private or public. Rev. UCC §9-610(b). A public disposition is described in the Official Comments as one at which "the price [for the collateral] is determined after the public has had a meaningful opportunity for competitive bidding," thus implying that the disposition was publicized and open to the public. Rev. UCC §9-610, cmt. 7. Any other disposition is considered private. *Id.* A secured party may not "purchase" its collateral at a private disposition except in limited circumstances. Rev. UCC §9-610(c)(2).

Unless the collateral is perishable or threatens to decline speedily in value, or is of the type customarily sold on a recognized market, the secured party usually will be required to notify the debtor and certain other persons of the time and place of any public disposition or the time after which any private disposition is to take place. Rev. UCC §9-611. Revised Article 9 specifies the contents and timeliness of such notice. Rev. UCC §§9-612, 9-613 and 9-614. Unless disclaimed by the secured party, a disposition will include those warranties that normally arise by operation of law in favor of the transferee in a sale, lease or license. Rev. UCC §9-610(d) and (f). Finally, a disposition to a good-faith transferee will discharge both the secured party's security interest and, subject to any exceptions adopted by a particular state, any subordinate security interests and liens. Rev. UCC §9-617.

Duty of Commercial Reasonableness

Revised Article 9 does not dictate how or when the secured party must dispose of its collateral other than to mandate that "every aspect of the disposition, including the method, manner, time, place and other terms, must be commercially reasonable". Rev. UCC §9-610(b). If "commercially reasonable," the secured party may dispose of collateral by either a "public or private proceeding" and "by one or more contracts, as units or parcels, and at any time and place and on any terms." *Id.* Thus, the secured party has wide flexibility and broad discretion in deciding how to dispose of its collateral, including whether to sell, lease or license the collateral by either a public or private

proceeding and the disposition's time and terms, subject only to the requirement that the disposition's "every aspect" be commercially reasonable.

Commercial reasonableness in the collateral's disposition is a duty imposed upon the secured party in favor of debtors (typically the collateral's owner and usually also an obligor) and obligors (one owing payment or performance of the secured obligation, including any secondary obligors such as a guarantor). Rev. UCC §§9-102(a)(28), (72) and 9-602. Such duty, however, is not owed by the secured party to any obligor who is not also a debtor or secondary obligor, or to any debtors or obligors not "known" to it. Rev. UCC §§9-625, cmt. 3 and 9-628. If the secured party is not proceeding in a commercially reasonable manner in the collateral's disposition, a court may order or restrain the disposition on appropriate terms and conditions. Rev. UCC §9-625(a).

The secured party's duty of commercial reasonableness may not be waived or varied by either a debtor or obligor (including a secondary obligor) before the disposition. Rev. UCC §9-602(7). After the disposition, however, debtors and obligors are free to waive, settle or compromise any claim they may have against the secured party arising from a commercially unreasonable disposition. Rev. UCC §9-602, cmt. 3.

Commercial reasonableness in the context of a disposition is not specifically defined in Revised Article 9 (nor was it in Former Article 9). Revised Article 9 does permit the parties to a secured transaction to determine by their agreement the standards "measuring fulfillment" of a commercially reasonable disposition, provided that such agreed standards are not "manifestly unreasonable." Rev. UCC §9-603(a). Absent such an agreement and except in the limited circumstances described below, the issue as to whether a completed disposition was commercially reasonable is one usually of fact, not law. See *Security State Bank v. Burk*, 995 P2d 1272 [41 UCC Rep Serv 2d 319] (Wash App 2000); *City National Bank of Fort Smith v. Unique Structures, Inc.*, 49 F3d 1330 [26 UCC Rep Serv 2d 268] (CA8 1995).

A commercially reasonable disposition has been summarized by one court as one in which the secured party "acts in good faith and in accordance with commonly accepted commercial practices which afford all parties fair treatment." *Wilkerson Motor Co. v. Johnson*, 580 P2d 505 [23 UCC Rep Serv 842] (Okla 1978). "Good faith" is a duty that attaches to all rights and duties provided by Revised Article 9, and is defined therein in both subjective and objective terms as "honesty in fact and the observance of reasonable commercial standards of fair dealing". Rev. UCC §9-102(a)(43) and cmt. 19. This dual standard is broader than

the purely subjective standard by which a party's good faith was determined under Former Article 9 and therefore raises the bar for a secured party when disposing of its collateral.

In deciding whether a disposition was commercially reasonable, courts will look at all of the facts and circumstances surrounding the disposition, "and in general, no single factor, even price, will conclusively determine the commercial reasonableness of a secured party's disposition." See *Bezanson v. Fleet Bank-NH*, 29 F3d 16 [24 UCC Rep Serv 2d 399] (CA1 1994). The facts and circumstances usually considered include "the amount of advertising done, the number of people contacted, normal commercial practices in disposing of the particular collateral, the length of time between the repossession and the sale, whether any deterioration in the collateral has occurred, the number of bids received, and the price obtained." See *Connecticut Bank & Trust Co., N.A. v. Incendy*, 540 A2d 32 [5 UCC Rep Serv 2d 857] (Conn 1988); see also *In re Crosby*, 176 BR 189 [25 UCC Rep Serv 2d 1032] (BAP9 1994) (identifying 17 factors, derived from case law and each of equal weight, that should be considered in determining a disposition's commercial reasonableness).

The Official Comments to Revised Article 9 offer additional insight into when a secured party's actions may not be commercially reasonable. Although Revised Article 9 specifically provides that a secured party may dispose of collateral either in "its present condition or following any commercially reasonable preparation or processing," the Official Comments indicate that under certain circumstances the secured party's failure to prepare or process collateral before a disposition may not be commercially reasonable. Rev. UCC §9-610(a) and cmt. 4. For example, if \$1000 in repairs to the collateral will increase its sale value by \$20,000, commercial reasonableness may require that the repairs be made before a disposition. Moreover, Revised Article 9 does not specify a time frame within which a disposition must occur. Rev. UCC §9-610, cmt. 2. The Official Comments caution, however, that a secured party who takes and holds collateral for an extended period may not have acted in a commercially reasonable manner if there was "no good reason for not making a prompt disposition." *Id.*

Revised Article 9 does recognize that a disposition by certain methods will be considered commercially reasonable as a matter of law. These dispositions include one made (1) in the usual course of any recognized market (i.e., a market in which items sold are fungible and prices are not subject to individual negotiation, such as the New York Stock Exchange); (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. Rev. UCC §627(b) and cmt. 4. In addition, a disposition will be deemed commercially reasonable if the method employed was approved in advance (1) in a judicial proceeding; (2) by a bona fide creditor's committee; (3) by a representative of creditors; or (4) by an assignee for the benefit of creditors. Rev. UCC §9-627(c) and cmt. 3. The absence of such advance approval, however, will not mean that the disposition was commercially unreasonable. Rev. UCC §9-627(d).

Low Price Disposition

Frequently, the basis of a claim that a disposition was not commercially reasonable is that a higher price or amount could have been obtained for the collateral. Under Revised Article 9, however, the fact that a higher amount could have been obtained in a disposition at a different time or by a different method from that selected by the secured party will not of itself preclude the secured party from establishing that the disposition was commercially reasonable. Rev. UCC §9-627(a). The Official Comments nonetheless add that "a low price suggests that a court should scrutinize carefully all aspects of a disposition to ensure that each aspect was commercially reasonable." Rev. UCC §9-627, cmt. 2. It may be prudent for the secured party to have the collateral's value appraised before a disposition, thus enabling it later to demonstrate that the amount realized from the disposition was fair.

Even where the disposition is found to be commercially reasonable, the secured party's entitlement to a deficiency may be eliminated or reduced when (1) the transferee in the disposition is the secured party, a person related to the secured party or a secondary obligor and (2) the amount of the disposition's proceeds is "significantly below" that which a complying disposition to a non-related entity would have brought. Rev. UCC §9-615(f). It is the burden of the objecting debtor or obligor to prove that the proceeds from the disposition to a related party were "significantly below" that which would have been realized from a disposition to a non-related party. Rev. UCC §9-626(a)(5). If the objecting party meets its burden, the deficiency or surplus must be calculated based upon the proceeds that would have been received in a disposition to a non-related party. Rev. UCC §9-615(f).

Consequences of a Commercially Unreasonable Disposition

The secured party's failure to dispose of its collateral in a commercially reasonable manner

may render it liable for damages or result in the elimination or reduction of its right to a deficiency judgment against an obligor (including a secondary obligor). In those instances where the disposition's commercial reasonableness is at issue, the secured party's entitlement to a deficiency or liability for the loss of a surplus will be determined by the "rebuttable presumption rule." Rev. UCC §9-626(a). (In consumer transactions, courts have the discretion to devise another rule for calculating a deficiency or surplus. Rev. UCC §9-626(b).)

Under the rebuttable presumption rule, a secured party seeking to enforce a deficiency following a disposition need not prove that the disposition was commercially reasonable unless the debtor (who in an action for a deficiency will also be an obligor) or secondary obligor alleges otherwise. Rev. UCC §9-626(a)(1). Once the issue is raised, the secured party will have the burden of establishing that the disposition was commercially reasonable. Rev. UCC §9-626(a)(2). If the secured party does not meet that burden, the liability of the debtor or secondary obligor for a deficiency will be eliminated unless the secured party can then demonstrate that a commercially reasonable disposition would have realized an amount less than the secured obligation. Rev. UCC §9-626(a)(3). Where the secured party establishes that a commercially reasonable disposition would have realized less than the secured obligation, the deficiency will be fixed at the difference between that lesser amount and the secured obligation. Rev. UCC §9-626(a)(4).

If it has failed to dispose of collateral in a commercially reasonable manner, the secured party may be responsible for a loss to others resulting therefrom. Rev. UCC §9-625(b) and (c). For example, a secured party will be liable to the debtor for the loss of surplus proceeds that would have been obtained if the disposition was commercially reasonable. Rev. UCC §9-625(d). Other than a debtor's damages for the loss of a surplus, a debtor or secondary obligor who has successfully eliminated or reduced a deficiency claimed against them may not recover additional damages from the secured party arising from the collateral's disposition. *Id.*

Conclusion

Revised Article 9 requires that the secured party proceed with care in the disposition of its collateral. By proceeding in a commercially reasonable manner, the secured party will not only preserve its rights against others for a deficiency, but will enhance the amount it receives from the disposition. Commercial reasonableness therefore should be viewed by the secured party not simply as a duty owed by it to others, but also as a means for it to achieve the ultimate goal following any default — full repayment.

MATTERS OF MAJOR INTEREST

FAILURE TO PROVE THAT PAYMENT ON LOAN OCCURRED

[See UCC Case Digest 1201.25(5), 1201.26(3), Rev3103.7, Rev3308, Rev3601, Rev4406.1]

According to the Court of Appeals of **Washington**, Division 3, Panel One, two checks drawn on the corporate account of a farm did not constitute payment on the loan obligations of the individuals who signed the checks. Payment requires both receipt of funds by the creditor and the intention on behalf of both parties that the funds should constitute payment, explains Judge Dennis J. Sweeney, writing for the panel. The obligation on a note is not discharged by an act of which the holder lacks notice. A person has notice of a fact when he or she (a) has actual knowledge; (b) receives notice; or (c) has reason to know of it under the circumstances. A person gives notice by taking the steps reasonably required to inform the other in the ordinary course of business. Here, the holder did not have actual knowledge of payment. It did not receive notice of a payment discharging the makers' obligation on the promissory notes. Plus, the circumstances did not give the bank reason to know. Neither can it be said that the makers took reasonably required steps to notify the bank that these checks were intended to discharge their mortgage obligation. The makers argued that the bankruptcy case number on the memo line of the checks constituted sufficient notice to the holder that the farm checks were tendered as payments on the makers' individual obligations. But a bank is not expected to read and act upon the memorandum portion of a check. Under the standard of ordinary care imposed by the UCC, a nonpayor depository bank is not obligated to the drawer of a check to examine the face of the instrument before accepting it for deposit. The bankruptcy case number on the memo line was the only clue from which the makers expected the holder to divine their subjective intent as to the destination of these checks. This is not the function of the memo line. The makers argued that the Seattle main branch of the holder had a duty to recognize that the checks were signed by individuals and to recognize that it was handling a transaction for the signatories, not the account holder. But the individual makers had no relationship to the Seattle branch of the holder, at least with respect to these checks. A bank owes no duty of care to a noncustomer with whom it has no relationship. The makers insisted that the farm had no duty with respect to the allegedly mishandled checks, and that the bank owed a duty to the