

News

Enforcing Rules on Security Interests

UCC revisions to fixtures and personal property offer clarity, if not certainty

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New York Law Journal

On July 1, 2001, revised Article 9 of the Uniform Commercial Code replaced the former Article 9 in New York. Revised Article 9 (Rev. UCC), like its predecessor, "provides a comprehensive scheme for the regulation of security interests in personal property and fixtures." Rev. UCC 9-101, cmt. 1. This article will highlight several of Revised Article 9's provisions applicable to a security interest's enforcement in a commercial secured transaction and discuss how those provisions affect both (a) the rights and duties of the parties to such a transaction and (b) the consequences that may result from a violation or breach of those rights and duties. (Revised Article 9 also includes numerous provisions, not discussed herein, which only apply to a consumer secured transaction.)



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Revised Article 9's enforcement provisions are contained in its Part 6 and consist of 28 sections, a substantial increase from the seven enforcement sections in Part 5 of Former Article 9 (or Former UCC). These provisions delineate the rights and duties of the parties to a secured transaction after a default has occurred. Such parties include the secured party (a holder of a debt secured by a security interest in collateral); the debtor (typically an owner of the collateral); the obligor (a party owing payment of the secured debt, including any secondary obligors); and in many transactions a secondary obligor (also an obligor; for example, a guarantor of the secured debt). Rev. UCC 9-102(a)(28), (59), (71) and (72). Thus, one may be both a debtor and an obligor in a secured transaction, such as where the maker of a promissory note secures the note's payment by granting the obligee a security interest in property the maker owns.

Five Rights Specified

Upon a debtor's default, the secured party may exercise against its collateral those rights both specified in Part 6 of Revised Article 9 and, except as may be limited by Part 6, "provided by agreement of the parties." Rev. UCC 9-601(a). Revised Article 9 does not identify when a default will have occurred, leaving it to the parties to decide for themselves by agreement, as supplemented by law other than Revised Article 9, the events and the time of a default. Rev. UCC 9-601, cmt. 3.

The enforcement rights afforded to a secured party under Revised Article 9 are substantially similar (albeit in many instances clarified and expanded) to those that were available under Former Article 9. Following a default, the secured party "may reduce a claim to judgment, foreclose, or otherwise enforce the claim [or], security interest . . . by any available judicial procedure." Rev. UCC 9-601(a)(1). Broadly stated, and depending upon the collateral's nature, Revised Article 9 specifies five rights (or remedies) that a secured party may exercise against its collateral.

Collection: where collateral consists of any intangible right to payment or performance due to the debtor from a third party or a third party is otherwise "obligated on collateral," the

secured party may notify such a third party to make payment or render performance to, or for the benefit of, the secured party. Rev. UCC 9-607(a)(1).

Enforcement: the secured party may enforce its rights to such payment or performance directly against the third party. Rev. UCC 9-607(a)(3).

Possession: the secured party may take possession of tangible collateral by judicial process (e.g., a replevin action) or without judicial process if so doing will not cause a breach of the peace. Rev. UCC 9-609.

Disposition: the secured party may sell, lease, license or otherwise dispose of both tangible and intangible collateral. Rev. UCC 9-610.

Acceptance: the secured party may effect an acceptance (strict foreclosure) of both tangible and intangible collateral, either in whole or partial satisfaction of the secured debt. Rev. UCC 9-620.

A secured party may decide initially not to exercise any of the aforementioned rights, but instead first proceed to obtain a monetary judgment for the secured debt and then elect to execute that judgment upon the collateral (assuming, of course, the judgment is against a debtor/obligor). Rev. UCC 9-601, cmts. 6 and 8. Such execution will not be subject to Revised Article 9, although the judicial lien created by the execution will be deemed a continuation of the original security interest (if perfected) and not the acquisition of a new interest. Rev. UCC 9-601(f) and cmt. 8.

The enforcement rights provided to a secured party in the agreement or Revised Article 9, including the right to enforce payment, are "cumulative." Rev. UCC 9-601(c).

Enforcement rights may also be exercised "simultaneously," provided both that such concurrent action is not barred by agreement or other statute or law (Rev. UCC 9-601, cmt. 5) and "the secured party acts in good faith" (Rev. UCC 9-604, cmt. 5). Rev. UCC 9-601(c). "Good faith," under Revised Article 9, is defined 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). This dual standard is broader than the subjective standard of good faith applicable under Former Article 9, and it is important to note that the exercise or discharge of all rights or duties specified in Revised Article 9 must be undertaken in good faith as defined therein. Rev. UCC 9-102, cmt. 19.

Following the collateral's collection, enforcement or disposition, the net proceeds received therefrom by the secured party should be applied in reduction of the secured debt. Rev. UCC 9-608(a) and 9-615(a). (Unless "commercially unreasonable," "non-cash" proceeds need not be applied until reduced to cash. Rev. UCC 9-608(a)(3) and 9-615(c)). After the proceeds' application against the secured debt, the secured party typically will be either required to account to the debtor for any surplus or entitled to recover from an obligor any deficiency. Rev. UCC 9-608(a)(4) and 9-615(d). A secured party may also recover from an obligor the deficiency remaining after an acceptance of collateral in partial satisfaction of the secured debt. Rev. UCC 9-622(a)(1). A debtor's entitlement to a surplus or an obligor's liability for a deficiency, however, will be subject to the terms of their agreement with the secured party. Rev. UCC 9-608(b) and cmt. 3. Moreover, as discussed below (II(B)), an obligor's liability for a deficiency may depend upon the secured party's compliance with Revised Article 9.

Debtors and Obligors

After a default, debtors and obligors (including secondary obligors) have the rights afforded to them by agreement, in Part 6 of Revised Article 9 and in revised 9-207 (which sets

forth the duties of a secured party in possession of collateral). Rev. UCC 9-601(d). Revised Article 9 further provides that certain of its provisions, to the extent that they give rights to a debtor or obligor and impose duties on a secured party, may not be waived or varied by agreement, either before or after a default. Rev. UCC 9-602. Such provisions include those specifying the duty of a secured party to collect, enforce or dispose of collateral in a commercially reasonable manner; the duty of a secured party to refrain from a breach of the peace in taking possession of collateral without judicial process; and the right of a debtor or obligor to hold a secured party liable for its failure to comply with Revised Article 9. Rev. UCC 9-602(c), (f), (g) and (m).

Debtors and secondary obligors may, however, waive or vary by agreement certain rights granted to them by Revised Article 9 provided that such agreement is entered into after a default has occurred. Rev. UCC 9-624. In a commercial secured transaction, such post-default waivers are limited to (a) a debtor's or secondary obligor's right to notification from a secured party of an intended disposition and (b) a debtor's redemption rights. Rev. UCC 9-624(a) and (c). The Official Comments, however, caution a court to scrutinize carefully such post-default waivers that appear in agreements "that also address many additional or unrelated matters." Rev. UCC 9-602, cmt. 5.

Revised Article 9 does not appear to overrule those cases that have upheld a debtor's or guarantor's pre-default agreement that the secured party will have no duty or obligation to protect or preserve collateral that is not in the secured party's possession or control. See, e.g., *Chemical Bank v. PIC Motors Corp.*, 87 AD2d 447 (1st Dept. 1982), *aff'd.*, 58 NY2d 1023 (1983). However, the duty imposed upon a secured party under revised 9-207, both before and after a default, to protect and preserve any collateral in its possession may not be waived. UCC 1-102(3).

Notwithstanding that certain rights and duties may not be waived or varied, the parties may determine by agreement the standards "measuring the fulfillment" of those rights and duties, provided that such agreed standards are not "manifestly unreasonable." Rev. UCC 9-603(a). Revised Article 9, however, specifically prohibits any agreement "measuring fulfillment" of the secured party's duty to take possession of its collateral without breaching the peace. Rev. UCC 9-603(b). Moreover, the Official Comments indicate that the parties are not restricted from settling, compromising or waiving any past conduct that may have constituted a violation or breach of those rights and duties. Rev. UCC 9-602, cmt. 3.

Secured Party's Liability

As compared with Former Article 9, Revised Article 9 substantially expands the scope of injunctive relief and monetary damages that a debtor, obligor or others may obtain when the secured party fails to comply with its provisions. Whereas Former Article 9 allowed a court to "order or restrain" the "disposition" of collateral on the basis of the secured party's failure to comply with the enforcement provisions in Part 5 of Former Article 9 (Former UCC 9-507(1)), Revised Article 9 authorizes a court to grant injunctive relief if it is established "that [the] secured party is not proceeding in accordance *with this article*." Rev. UCC 9-625(a) (emphasis supplied). A secured party may thus be enjoined from violating any of Revised Article 9's provisions and not just those contained in Part 6. In addition, a court may now order or restrain, on appropriate terms and conditions, the "collection, enforcement and disposition of collateral." Rev. UCC 9-625(a).

Under Former Article 9, "if the disposition [had] occurred, the debtor or any person entitled to notification or whose security interest [had] been made known to the secured party prior to the disposition, [had] a right to recover from the secured party a loss to others caused by a failure to comply with the provisions of this Part [5]." Former UCC 9-507(1). Revised Article 9, by contrast, renders a secured party potentially liable for any loss to others

caused by its failure to comply with any provision of Revised Article 9. Rev. UCC 9-625(b) and cmt. 2. It also eliminates an implication in the Former Article 9 that the recoverable damages were limited to those resulting from the collateral's disposition. Rather, damages for which the secured party may be liable "are those reasonably calculated to put an eligible claimant in the position that it would have occupied had no violation [of Revised Article 9] occurred." Rev. UCC 9-625, cmt. 3. While no specific provision is made for the recovery of consequential damages, a recoverable loss "may include loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing." Rev. UCC 9-625(b).

A party entitled to recover damages "for its loss" due to a secured party's non-compliance with Revised Article 9 is one who "at the time of [the secured party's failure to comply], was a debtor, was an obligor, or held a security interest in or other lien on the collateral." Rev. UCC 9-625(c)(1). The secured party, however, will not be liable to any of such parties not "known" to it. Rev. UCC 9-628(a) and (b). In addition to any actual damages, a secured party also will be liable for \$500 in statutory damages for its failure to comply with specific provisions of Article 9. Rev. UCC 9-625(e). For example, a secured party's failure to file a termination statement when required to do so under revised 9-513 will render the secured party liable to the debtor for the statutory damages, irrespective of any actual damages suffered by the debtor. Rev. UCC 9-625(e)(4).

Rebuttable Presumption

A secured party's failure to comply with its enforcement duties, such as a failure to collect collateral in a commercially reasonable manner or to provide any required notices prior to a disposition, may result in the elimination or reduction of its subsequent entitlement to a deficiency judgment. Former Article 9 did not specifically address the impact of a secured party's breach of its enforcement duties upon its entitlement to a deficiency judgment. The issue was therefore left to the courts, and the departments within the New York Appellate Division reached differing conclusions.

The First and Fourth Departments imposed a presumption, rebuttable by the secured party, that the value of the collateral equaled the amount of the secured debt. See, *General Electric Credit Corporation v. Durante Bros. & Sons, Inc.*, 79 AD2d 509 (1st Dept. 1980) and *Telmark, Inc. v. Lavigne*, 124 AD2d 1055 (4th Dept. 1986). The Second Department held that a secured party's non-compliance constituted an absolute bar to its recovery of a deficiency judgment. See, *Long Island Trust Co. v. Porta Aluminum, Inc.*, 63 AD2d 670 (2d Dept. 1978). Finally, the Third Department applied an "offset-rule," which placed the burden upon a debtor to prove it was damaged by the secured party's non-compliance. See, *Stanchi v. Kemp*, 48 AD2d 973 (3d Dept. 1975). Revised Article 9 has resolved this split by adopting the "rebuttable presumption" rule. Rev. UCC 9-626(a)(3).

A secured party, in an action to recover a deficiency, need not prove its compliance with the provisions relating to the collateral's collection, enforcement, disposition or acceptance unless the debtor (who, in an action for a deficiency, must also be an obligor) or a secondary obligor places the secured party's compliance in issue. Rev. UCC 9-626(a)(1). Once raised, the secured party will have the burden of establishing its compliance with those provisions. Rev. UCC 9-626(a)(2). If the secured party fails to meet its burden, the liability of a debtor or secondary obligor for a deficiency is limited to an amount by which the sum of the secured obligation, expenses and attorney's fees exceeds the greater of:

- (A) the proceeds of the collection, enforcement, disposition, or acceptance; or
- (B) the amount of proceeds that would have been realized had the non-complying secured party proceeded in accordance with the provisions [in Part 6] relating to collection,

enforcement, disposition or acceptance.

Rev. UCC 9-626(a)(3)(A) and (B). For purposes of (B) above, "the amount of proceeds that would have been realized is equal to the sum of the secured obligation, expenses, and attorneys' fees unless the secured party proves that the amount is less than that sum."

Rev. UCC 9-626(a)(4).

By way of illustration, assume that the secured obligation, expenses and legal fees equal \$100,000 and the secured party disposed of the collateral for \$50,000. The secured party then commences an action against a guarantor to recover the \$50,000 balance. If the guarantor objects and alleges that the secured party failed to comply with the enforcement provisions in Part 6 governing a collateral's disposition, the secured party will have the burden of proof as to its compliance with those provisions. If it cannot establish compliance, the secured party will not be entitled to a judgment against the guarantor unless it can prove that a disposition of the collateral in compliance with Part 6 would have realized less than \$100,000.

Thus, if the evidence establishes that a compliant disposition would have realized \$75,000 for the collateral, the secured party will be entitled to a \$25,000 deficiency judgment against the guarantor. The rebuttable presumption rule also applies in an action to determine the amount, if any, of surplus proceeds that a debtor may be entitled to recover from the secured party. Rev. UCC 9-626(a).

A debtor whose deficiency is eliminated under revised 9-626 may recover damages for its loss of any surplus proceeds. Rev. UCC 9-625(d). To avoid a "double-recovery," a debtor or secondary obligor who has successfully eliminated or reduced any deficiency claimed against it by the secured party may not recover any damages for the secured party's non-compliance with the provisions in Part 6 relating to collection, enforcement, disposition or acceptance of collateral. Rev. UCC 9-625(d). Presumably, such debtor or secondary obligor may recover any damages it sustained by reason of the secured party's non-compliance with other provisions of Revised Article 9.

'Low Price' Dispositions

Revised Article 9, unlike Former Article 9, incorporates a special method for the calculation of a deficiency or surplus following a disposition of collateral 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 is "significantly below" that which would have been realized from a disposition to a non-related party. Rev. UCC 9-626(a)(5). The Official Comments explain that the burden was placed upon the objecting party rather than the secured party to discourage challenges every time collateral is disposed of to a related party. Rev. UCC 9-626, cmt. 5.

If the objecting party meets its burden, and notwithstanding that the disposition otherwise complied with Part 6, the deficiency (or surplus) must be calculated "based on the amount of proceeds that would have been realized in a disposition complying with this part to a transferee other than the secured party, a person related to the secured party, or a secondary obligor." Rev. UCC 9-615(f). Such a result "recognizes that when the foreclosing secured party or a related party is the transferee of the collateral, the secured party sometimes lacks the incentive to maximize the proceeds of the disposition." Rev. UCC 9-615, cmt. 6.

Conclusion

Revised Article 9 sets forth, in substantially greater detail than did Former Article 9, the enforcement rights and duties of the parties to a secured transaction. Such clarity should assist both the parties and the courts in approaching and resolving disputes involving Revised Article 9. Clarity, however, does not always equate with certainty, and it may therefore be anticipated that the courts will be called upon to further interpret Revised Article 9's enforcement rights and duties.

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Date Received: April 04, 2002



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