Default and Post-Default Article 9 Remedies

I. Default Under Article 9

A. Typical Payment Terms

1. **Installment Loan**: DR to repay in a series of payments, typically of equal amount, over fixed period of time
   - This provides DR with maximum “protection” b/c DR knows amount of payment and when payment is due; so, as long as the DR otherwise complies with the SA, DR is not at risk of default

2. **Single Payment (‘Lump Sum’) Loan**: DR to repay on a date certain or “on demand”
   - When loans are made payable on demand, the creditor can call the loan in at anytime requiring the debtor to pay or else be in default. This type of demand is referred to as “calling” the loan. However, most creditors do not wish to call in the loan until the debtor can pay

3. **Line of Credit**: SC (Bank) contracts to lend up to a fixed amount of money, or based on some agreed formula, as required by the DR
   - DR will generally borrow the money by simply writing a check on the bank account and the SC will cover it up to a fixed amount; as DR pays down outstanding credit, interest continues to accrue only on unpaid amount

B. **Default**: Any failure by the debtor to pay its debt or otherwise perform its agreement with its creditor when due.

C. **Acceleration**: In the event of default on an installment obligation, the creditor may demand payment of the entire outstanding debt immediately or within a fairly short time.
D. **Grounds for Default:** Typically what constitutes “default”—and, therefore, justifies acceleration—under a particular security agreement is spelled out in that agreement.

E. **Insecurity Clause:** A common “event of default” occurs when the creditor “deems itself insecure.”
   - If the security agreement includes such a provision, the creditor may only exercise it in good faith. §§ R1-309; 1-208.
   - In the absence of an objective basis upon which a reasonable person would have accelerated the note, the creditor may be deemed to have accelerated in bad faith.
   - Whether the creditor acts in good faith is a fact question based on the creditor’s knowledge at the time of the decision to accelerate.

F. A secured creditor who accelerates or exercises any other post-default remedy under the SA before the debtor actually defaults is liable for any damages caused to the debtor due to the creditor’s premature acts.

G. **Right to Cure After Default Under Article 9:** Debtor may cure after default, but not after acceleration (see Old Republic Ins. Co. v. Lee (p. 228)), unless the acceleration is subject to a reinstatement statute (see, e.g., Ill. Rev. Stat. ch. 110, ¶ 15-1602).

   § 9-623 cmt. 2: If accelerated, can only cure by full payment.

II. **Foreclosure**

A. **Foreclosure vs. Repossession**

   1. Foreclosure = transfer of ownership/title from debtor to purchaser
      - When you foreclose, the debtor loses his right to redeem once the debt is foreclosed.

   2. Repossession = exercising physical control over the collateral
      - Can occur before, during, or after foreclosure.
      - Does not (independently) affect debtor’s right to redeem.
      - If you are the secured creditor, you want possession of the collateral before foreclosure.
B. **Types of Foreclosure**

1. **Judicial:** Creditor sues debtor. Debtor and any subordinate lien holders have opportunity to assert defenses. Court issues an order and sets the date for the foreclosure sale. Court must “confirm” sale.
   
   a. If collateral sells for less than outstanding debt, creditor may seek a deficiency judgment.
   
   ♦ **“Antideficiency Statute”:** In some states, a creditor is barred from seeking a deficiency judgment for any debt left unsatisfied by the foreclosure sale.
   
   b. If collateral sells for more than outstanding debt, “surplus” goes first to junior lien holders, if any, and then to debtor.
   
   c. Debtor typically remains in possession of collateral until sale has been confirmed by the court.
   
   d. Debtor has right to redeem until sale is final; therefore, debtor has incentive to delay the proceedings by asserting defenses at the outset and by objecting to the sale prior to confirmation.
   
   e. Some states impose statutory delays on the foreclosing creditor – most often these “waiting periods” apply to real property, rather than personal property, foreclosures.

2. **Article 9:** After default, the SC is allowed to sell, lease, or otherwise dispose of the collateral and apply the proceeds of the disposition to the outstanding debt. The purchaser takes free of any unpaid balance on the debt, and the SC may then pursue a deficiency judgment against the debtor for what’s left.

III. **Repossession**

A. **Secured Creditor’s Interest in Pre-Foreclosure Possession**

1. The debtor has no incentive to maintain the value of the collateral that they are going to eventually lose. The debtor may actually waste/damage the collateral

2. The use of the collateral may have significant value in of itself. Most collateral has inherent value and use value.

3. It is easier for potential buyers to evaluate and view the collateral if it is in the creditor’s possession before foreclosure.
♦ A credible threat of repossession may give the SC leverage over the D, as long as D still values collateral; but, if D is able to retain possession, it may gain leverage over SC if SC values collateral more than outstanding debt

B. Personal Property Repossession

1. SC has the right to repossess upon default. § 9-609(a).

2. SC may repossess by judicial process (writ of replevin). § 9-609(b)(1).

3. SC may also repossess by self-help as long as he does not breach the peace. § 9-609(b)(2).

4. Breach of the Peace

a. Two basic factors:

   i. Potential for immediate violence

      ♦ If an actual confrontation occurs, the SC must cease self-help. However, the lack of actual confrontation does not mean the SC has not, nonetheless, breached the peace.

   ii. Nature of the premises intruded upon

      a). Residence vs. non-residential property

      b). Debtor’s property vs. third party’s property

         ♦ The fact that the third-party property owner is unaware of the SC’s actions doesn’t necessarily avoid a breach of the peace.

      c). Restatement (Second) of Torts § 198: If there was no confrontation and the timing and manner, including notice or lack of notice, are found reasonable, the entry is privileged. (Just says it must be reasonable, but doesn’t define reasonable)

         ♦ Interestingly, Restatement (Second) of Torts § 198 does not, according to its own comments, apply to actions by a lienholder against liened collateral. Such actions are the subject of Restatement (Second) § 183.
b. Compare White & Summers’s factors, discussed in *Giles*.

c. Generally speaking, the SC need not give prior notice as long as the collateral is in the debtor’s possession.

5. **Self-Help Repossession of Accounts**

a. Four common A/R lending arrangements

   (1) SC may give the debtor virtually complete freedom to collect the accounts and to use the proceeds in its business.

   (2) SC may agree to let the debtor collect the accounts, but require that debtor immediately apply a specified portion to the loan.

   (3) SC may arrange with the debtor that the account debtors will pay directly to the SC.

   (4) SC may require the debtor to direct its account debtors to make their payments to a P.O. box that is under the SC’s control.

b. SC may notify debtor’s account debtors directly and demand payment. § 9-607(a)(1).

c. An account debtor who fails to follow the SC’s instructions may be liable to the SC, even if the account debtor is not in default to the SC’s debtor (the account creditor). See *Marine Nat’l Bank* (p. 54)

IV. **Disposition of Foreclosed Personal Property**

A. **Strict Foreclosure**

1. Under the common law, if the security agreement waives the right of sale, the SC could strictly foreclose – provided it got court approval

2. Under Article 9, court approval is not needed. However, the debtor must waive its right to sale after default (and, in the case of consumer goods, repossession) – a pre-default waiver is unenforceable. §§ 9-620(a)(1) & (c) & 9-624; see also § 9-602(10).

3. **Notice Requirement:** Before strictly foreclosing, the SC must give notice to the parties identified in § 9-621.
4. **Implied Waiver:** If the SC does not receive a written objection from the debtor or any party entitled to notice under § 9-621 within 20 days to its proposal of intent to retain the collateral, the SC may strictly foreclose. If there is a valid objection, the SC must proceed by sale.

5. **Special Case: The “60% Rule”:** Once the debtor has paid 60% or more of the debt owed on a consumer good, the SC must sell the collateral, § 9-620(a) & (e), unless the debtor waives its right to sale in accordance with § 9-624(b).

6. **No Right to Deficiency:** A SC who elects to retain the debtor’s collateral in full satisfaction of the debt, rather than sell it, forfeits the right to seek a deficiency judgment against the debtor for any portion of the debt not “satisfied” by the foreclosure.

7. **Partial Satisfaction:** Under § 9-620, in non-consumer transactions, the SC may, with the agreement of the debtor, take the collateral in partial satisfaction of the debt. This option is unavailable if the collateral is consumer goods. § 9-620(g).

8. **Discharge of Liens:** The principal rationale for requiring notice to other lienholders is that, in addition to discharging the strictly foreclosing SC’s lien in whole or in part, full or partial strict foreclosure also discharges all liens subordinate to that of the strictly foreclosing SC. § 9-622(a)(3), (a)(4) & (b).

   ♦ **Nondischarge of Senior Liens:** If the strictly foreclosing SC is not the senior lienholder, it will take the collateral subject to any senior liens. § 9-622(a)(3).

B. **UCC Foreclosure-by-Sale:** The foreclosing SC may sell by auction, by private sale at stated price, or by negotiated sale between two or more parties. § 9-610.

1. No court intervention is required; but, a SC who elects to proceed by writ of replevin must still sell in accordance with Article 9.

2. The sale must be “commercially reasonable.” § 9-610(b).

3. **Required Notice:** Unless the collateral
   a. is perishable,
   b. threatens to decline rapidly in value, or
   c. is the kind of good customarily sold on a recognized market,
SC must give the debtor notice prior to the time of sale. § 9-611(c). This will enable the debtor to both observe and participate in the sale but also to inform other potential buyers in hopes of getting the best price – and, therefore, the smallest deficiency judgment

♦ In the case of non-consumer goods, SC must also give prior notice of sale to any other SC from whom she has received written notice of a claim against the collateral

♦ Any party entitled to notice of a sale or other disposition under § 9-611 may waive that right after default. See § 9-624(a).

4. **Redemption:** Debtor may redeem at any time prior to sale, by paying the entire outstanding debt, plus attorneys’ fees and expenses of sale, § 9-623; but Article 9 does not recognize post-sale redemption.

♦ Except where the collateral is consumer goods, any party granted a redemption right by § 9-623 may waive that right after default. See § 9-624(c).

5. **Distribution of Sale Proceeds** [§ 9-615(a)] (Sneak Preview)

   a. Reasonable expenses of retaking, holding, preparing for sale, and selling the collateral and, to the extent provided for in the SA, attorneys’ fees and costs

   b. Satisfaction of the debt to the foreclosing SC

   c. Satisfaction of subordinate liens, subject to notice and demand requirements

   d. Surplus to the debtor

6. **Deficiency:** SC may get a deficiency judgment against debtor for the amount of debt left unpaid after sale, unless the collateral is accounts or chattel paper for which the SA does not specifically entitle the SC to a deficiency. § 9-615(d)-(e).

7. **Discharge of Liens:** In addition to discharging the foreclosing SC’s lien, foreclosure by sale also discharges all liens subordinate to that of the foreclosing SC. § 9-617(a)(2)-(3).

♦ **No Discharge of Senior Liens:** If the foreclosing SC is not the senior lienholder, the buyer will take the collateral subject to any senior liens. § 9-617(a)(3).
8. **Challenging the Disposition:** Debtor (or any SC entitled to notice under § 9-611(c)) may challenge sale as “commercially unreasonable”; however,

a. The court’s review will focus on whether the sale was conducted in a commercially reasonable manner *not* whether the sale fetched a commercially reasonable price.

b. A sale or other disposition is *presumed* to be commercially reasonable if

i. The SC sells or otherwise disposes of the collateral in the usual manner in a recognized market for goods of that type;

ii. The SC sells or otherwise disposes of the good at the prevailing price in the market for goods of that type; or

iii. The disposition has been approved in a judicial proceeding – including, but not limited to, an action for a writ of replevin – or by a bona fide creditors’ committee.

§ 9-627(b)-(c).

c. **Failure to (Timely) Sell Collateral:** Subject to § 9-602(e) & (f), Article 9 permits, but does not require, sale, and does not set a specific time for sale. § 9-610(a). A debtor may challenge the commercial reasonableness of the foreclosure if

i. the SC decides to keep the collateral, rather than sell it, without obtaining a waiver of the debtor’s right to sale, or

ii. the SC delays in selling the collateral, and it devalues significantly during the interim

d. **Other Recognized Objections:** A foreclosure sale may be set aside for one or more of the following reasons:

i. the sale was not advertised in accordance with applicable statutes (and/or the judgment, if the sale follows a judgment of foreclosure);

ii. the sale was not held in precisely the location advertised;

iii. the debtor and/or other interested parties did not receive proper notice prior to the sale;

iv. some arrangement between interested parties “chilled” the bidding;
v. the sale was not otherwise “commercially reasonable”;
vi. the creditor did not act in good faith;
vii. the highest bid was “grossly inadequate;” or

9. **Remedies:** If a debtor or other SC successfully challenges a sale as not commercially reasonable, the remedies are set forth in § 9-625, including
   a. Rescission of the sale – *i.e.*, having it set aside
   b. Damages in the amount of the loss caused by the foreclosing SC’s failure to comply with the procedural requirements of Article 9
      ♦ In the case of consumer goods, the debtor (only) may recover an additional penalty, as set forth in § 9-625(c)

10. A **“good faith” purchaser** takes free of
   a. any right of redemption, and
   b. claims of commercial unreasonableness.
      ♦ So, if the SC sells to a GFP at a commercially unreasonable sale, the SC may have to answer to the debtor, but the GFP gets to keep the purchased collateral.