

The Transactional Lawyer

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Drafting for a Commercially Reasonable Disposition of Collateral

Stephen L. Sepinuck

When disposing of collateral after default, a secured party must conduct the disposition in a commercially reasonable manner. U.C.C. § 9-610(b). This rule cannot be waived or varied by agreement. U.C.C. § 9-602(a)(7). However, the parties may, by agreement, set the standards by which commercial reasonableness will be measured, provided those standards are not themselves “manifestly unreasonable.” U.C.C. § 1-302(b). Setting those standards in the security agreement can assist the secured party in defending against a claim for damages or in obtaining a judgment on a claim for a deficiency.

Drafting a clause that sets the standards of commercial reasonableness is challenging. Indeed, in a recent decision, one court ruled that a clause in a security agreement specifying what would be a commercially reasonable disposition was manifestly unreasonable, and therefore unenforceable. *In re Walter B. Scott & Sons, Inc.*, 436 B.R. 582 (Bankr. D. Idaho 2010). The contract clause at issue in that case also appeared in another recent case, *Financial Federal Credit Inc. v. Hartmann*, 2010 WL 4918980 (S.D. Tex. 2010), suggesting that the clause may be part of a form in circulation. Let us take a look at the clause, explain why it is inadequate, and then offer some advice on how such a clause should be drafted.

A Bad Example

With a bit of reformatting, solely for the purposes of advancing the discussion, the clause at issues reads as follows:

Debtor agrees that any public or private sale shall be deemed commercially reasonable:

(i) if notice of any such sale is mailed to Debtor (at the address for Debtor specified herein) at least ten (10) days prior to the date of any public sale or after which any private sale will occur;

(ii) if notice of any public sale is published in a newspaper of general circulation in the county where the sale will occur at least once within the ten (10) days prior to the sale;

(iii) whether the items are sold in bulk, singly, or in such lots as Secured Party may elect;

(iv) whether or not the items sold are in Secured Party’s possession and present at the time and place of sale; and

(v) whether or not Secured Party refurbishes, repairs, or prepares the items for sale. Secured Party may be the purchaser at any public sale.

The first numbered paragraph, in red, does not deal with the commercial reasonableness of the disposition at all. It deals instead with notification of the disposition, which is a completely separate requirement. See U.C.C. § 9-611 through § 9-614. Although the Code does require that such notification also be “commercially reasonable,” and courts sometimes confuse or conflate the requirement of commercially reasonable notification with the requirement of a commercially reasonable disposition, the fact remains that they are separate requirements best dealt with in separate clauses. In any event, as the court noted, a contractual term setting the standard for notification has no bearing on whether the disposition itself was conducted in a commercially reasonable manner.

The last three clauses, in green, indicate what the secured party may do in conducting a disposition, not what it must do. Those clauses are useful, but do not really set a standard at all. Rather, they purport to contain the debtor’s agreement not to complain about these particular aspects of a sale; in effect, they waive certain arguments about commercial reasonableness.

Only the second numbered clause really deals with how the disposition will be conducted. Yet all it does is specify the amount of advertising to be provided,

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something relevant to a public sale (*i.e.*, auction) but of limited utility if the disposition is to be by private sale, which the contract clause expressly contemplates the secured party may conduct. More important, Article 9 requires that all aspects of the disposition, “including the method, manner, time, place, and other terms” must be commercially reasonable. A clause specifying merely the amount of advertising for a public sale says nothing about the time or place of the disposition, nothing about whether the disposition should be by public or private sale, nothing about what warranties will be made, nothing about whether the collateral will be available for inspection, and nothing about any of the other myriad details that may affect the commercial reasonableness of a disposition. Thus, the court’s conclusion that this clause was manifestly unreasonable should not be surprising.

Advice

A clause on a commercially reasonable disposition should be phrased clearly as a safe harbor; it should not impose – by language or implication – a duty on the secured party to act in any particular manner. Otherwise failure of the secured party to abide by the terms of the clause opens the secured party up to liability, even if the secured party’s disposition was commercially reasonable. *Cf. Commercial Credit Group, Inc. v. Barber*, **682 S.E.2d 760** (N.C. Ct. App. 2009) (secured party not permitted to rely on clause detailing when a sale would be commercially reasonable because it had not complied with the clause).

Because the factors affecting commercial reasonableness are almost infinite, the clause should not attempt to define commercial reasonableness. That is one of the lessons of the *Walter B. Scott & Sons* case. Instead, the clause should target specified aspects of the disposition, such as the disposition method, the condition of collateral to be sold, and the warranties made by the secured party.

In targeting specific aspects of the disposition, the clause should generally disclaim a duty to do something in particular. This for example:

If, however, the collateral consists of one particular

Disposition of Collateral

(a) Condition of Collateral. In conducting a disposition of Collateral, the Secured Party has no obligation to clean or otherwise prepare the Collateral for sale.

(b) Warranties. In conducting a disposition of Collateral, the Secured Party has no obligation to make any warranty of title or quality. The Secured Party may disclaim any warranty of title or quality with respect to the Collateral.

(c) Credit. In conducting a disposition of Collateral, Secured Party has no obligation to provide credit to the purchaser.

item or one type of item, and the parties know in advance how the secured party may wish to conduct a disposition, the clause could identify that method as a commercially reasonable one. Thus, for example, if a floor plan financier of new automobiles plans, upon the debtor’s default, to sell the cars back to the manufacturer, the agreement should expressly authorize such a disposition. It should do so either by indicating that such a transaction is not commercially unreasonable or by indicating that disposition in such a manner is a commercially reasonable *method*. The clause should not indicate that such a disposition is commercially reasonable (in full) because even if a sale to the manufacturer is a commercially reasonable method, it might be unreasonable in other respects, such as if the Secured Party waited three years to conduct the sale, by which time the cars had substantially depreciated in value.

Disposition of Collateral

A disposition of Collateral consisting of new automobiles will not be commercially unreasonable if the Secured Party sells the Collateral to the manufacturer pursuant to the Manufacturer’s then prevailing buy-back program.

or

A disposition of Collateral consisting of new automobiles will be conducted in a commercially reasonable manner if the Secured Party sells the Collateral to the manufacturer pursuant to the Manufacturer’s then prevailing buy-back program.

Caveat

The secured party’s obligation to conduct a disposition in a commercially reasonable manner runs not merely to the debtor, but also to all obligors and all other secured parties. *See* U.C.C. § 9-625(b), (c)(1). However, a well-drafted clause in a security agreement on the commercial reasonableness of a disposition will bind only those who are parties to the security agreement, typically only the debtor. Other obligors can be bound if

the contracts that give rise to their obligations incorporate the terms of the security agreement. Other secured parties can be bound through an intercreditor agreement. Accordingly, the secured party should endeavor to make sure that all other interested parties agree to the terms in the security agreement regarding a disposition. That said, the secured party may not know of all other secured parties, particularly those who acquire their liens months or years down the road. Consequently, a secured party conducting a disposition must always assume that there may be someone unknown but relevant who has not agreed to the standards set.

Sources & Resources

ABA UNIFORM COMMERCIAL CODE COMMITTEE, FORMS UNDER ARTICLE 9 OF THE UCC (2d ed. 2009).

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Novation or Modification (a/k/a renewal)?

Linda J. Rusch

A debtor and its lender desire to negotiate changes to their existing transaction. Perhaps this occurs after a default or because the loan has matured. Perhaps it occurs because of changes in market conditions. No matter the reason, the lender should seriously consider whether to structure the transaction as a payoff of the original loan and creation of a new loan (a novation) or as a modification (often referred to as a renewal) of the original loan. This decision regarding how to structure the transaction can have numerous and significant consequences. Specifically, it can affect the characteristics of the debt, the liability of co-obligors or sureties, and in a variety of ways, the perfection or priority of a lien that secures the debt.

Characteristics of the Debt

Consider a consumer loan in which the creditor takes a purchase-money security interest in consumer goods to secure the loan and relies on automatic perfection pursuant to U.C.C. § 9-309(1). If the creditor and debtor

later enter into a novation – that is, the creditor makes a new loan to the same debtor and uses the proceeds of that new loan to pay off the earlier purchase-money loan, the security interest may no longer qualify as a purchase-money security interest. See U.C.C. § 9-103(f), (h). Even if the original security agreement contained a well-drafted future advance clause so that the new loan is a secured loan, if the effect of the novation is to make the loan a non-purchase-money loan, the creditor's security interest would no longer be automatically perfected.

In contrast, if the creditor and debtor merely modified the original loan by extending the due date or changing the interest rate, the security interest would in all likelihood retain its purchase-money status. This purchase-money status is relevant to a whole host of issues other than perfection. For example, it affects the debtor's right to avoid liens that impair exemptions, see 11 U.S.C. § 522, and to modify the transaction in a Chapter 13 bankruptcy case, see 11 U.S.C. § 1325. See *In re Naumann*, 2010 WL 2293477 (Bank. S.D. Ill. 2010). Whether the loan is a purchase-money loan may also affect whether the transaction constitutes an unfair credit practice. See 16 C.F.R. § 444.2(a)(4). Thus, a lender should consider the characteristics of the original debt, the importance of those characteristics to the lender's position, and the effect of a novation on those characteristics that are essential to the lender's position.

Obligations of Co-debtors and Sureties

A modification of the loan does not discharge the original obligors. A novation discharges the original debt. The original obligors would not be bound to the new obligation absent their agreement to liability on the new agreement. See *Thomas v. Bank*, 2009 WL 1410289 (M.D. Ga. 2009) (renewal of note signed by co-obligor ex-wife did not affect co-obligor ex-husband's obligation). Similarly, a novation may be more likely to discharge a surety who was not a party to it than would a modification to which the surety did not agree. Compare RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 39(c) with §§ 40(b), 41(b). Thus a lender should consider the effect of a novation on the obligations of primary and secondary obligors and whether a modification would better preserve the lender's rights against all obligors.

Effect on Liens

Structuring the transaction as a novation may affect the creditor's lien interest in at least two ways.

First, a novation may subject the lien to avoidance. For example, in *In re Motta*, **434 B.R. 193** (1st Cir. BAP 2010), the parties executed a note and recorded a mortgage in 1997. Ten years later, the same parties renegotiated the transaction and executed a new note and mortgage but the creditor failed to record the second mortgage. The debtors then filed bankruptcy. The bankruptcy trustee argued that the second transaction was a novation of the first transaction, and thus the unrecorded second mortgage was avoidable due to the trustee's strong arm powers. However, the court ruled that, based upon the facts of the case, there was no novation, merely a modification, and thus the second note was secured by the first recorded mortgage. Had the renegotiation resulted in a novation, the result would no doubt have been very different.

Second, a novation may also result in a loss of priority even if the new loan is a secured loan. This possibility is illustrated by *In re Louis Jones Enterprises, Inc.*, **2010 WL 4259977** (Bankr. N.D. Ill.), where the court found that the new loan was a novation and thus the creditor's security interest in newly generated accounts was junior to a federal tax lien because it was not made pursuant to a financing agreement entered into before the tax lien filing.

While these are just two examples of the possible effect of a novation on the security for a loan, the lender should consider the full ramifications of a novation on the continuation of its lien interest in any collateral and whether a novation would negatively impact its current priority position regarding that collateral.

Distinguishing a Novation from a Modification

Of course, merely calling the second transaction a modification (renewal) of the first is not sufficient to actually make that second transaction a modification (renewal) instead of a novation. As the court in *Naumann* stated:

A novation is the substitution of a new obligation for an existing one, whereby the existing obligation is extinguished. The four elements of a novation, which must be proved by a preponderance of the evidence by the party asserting the existence of a novation, are: (1) a previous, valid obligation; (2) a subsequent agreement of all the parties to the new contract; (3) extinguishment of the old contract; and (4) the validity of the new contract. . . .

“[T]he test for delineating between a novation and a renewal is the “degree to which the

original obligation of the debtor has changed and, to some extent, on any additional consideration which was conveyed by the debtor to the creditor. The greater degree of change in obligation or increase in obligation, the more likely a novation will be found.”

While the intention of the parties is relevant, it is not clear that the parties could agree to a change of all the major terms of the loan, and still have the court consider the second transaction to be a renewal of the first transaction, instead of a novation, even if the parties expressed the intention that the transaction be considered to be a renewal of the first transaction.

The Moral

A lender should carefully consider if there are any reasons why the second transaction with a debtor should be structured as a payoff (novation) or a modification (renewal) of the old loan. Whether a transaction will be considered a novation or a renewal, however, is ultimately a factual question based upon the degree to which the original obligation is changed and to some degree, the expressed intention of the parties.

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Protecting Sureties through a Contractual Right of Contribution

John T. Drake

When two or more persons jointly and severally guarantee the debt of a third party, they expressly promise the creditor to pay the full amount to creditor. They also, as a matter of common law, impliedly promise each other to contribute to that payment. In other words, when one surety pays *more* than its share of the obligation to the creditor, the payor may recover the amount of that overpayment from the co-sureties. *See* Restatement (Third) of Suretyship and Guaranty § 55(2).

Example 1:

Surety A and Surety B jointly and severally guaranty Debtor's \$2 million debt to Creditor.

After Debtor defaults, Creditor collects the full amount from Surety A. Surety A has a right of contribution against Surety B 1 for \$1 million, which represents Surety B's share of the common debt.

Unfortunately, the common-law right of contribution does not always protect an overpaying guarantor in such a straightforward fashion. Consider the following example:

Example 2:

Surety C and Surety D jointly and severally guaranty Debtor's \$2 million debt to Creditor. After Debtor defaults, Creditor sues both sureties for the full outstanding balance, but is unable to obtain personal service on Surety D. Surety C settles the action by paying Creditor \$500,000. Surety C then seeks a contribution from Surety D in the amount of \$250,000.

Pursuant to the common law, a surety's right of contribution from a co-surety does not arise unless the surety pays more than its contributive share. See Restatement (Third) of Suretyship and Guaranty § 55(1). In the context of this example, the question becomes whether Surety C's, contributive share is one-half of the *original* obligation (\$2 million) or one-half of the *settlement* amount (\$500,000). If the former, Surety C's \$500,000 payment will not represent more than Surety C's contributive share, with the result that Surety C will be entitled to no contribution from Surety D.

These were essentially the facts at issue in the recent case of *Lestorti v. DeLeo*, 4 A.3d 269 (Conn. 2010). Lestorti and DeLeo jointly and severally guaranteed a \$7.8 million debt of a corporation. After the debtor defaulted, the creditor sued to foreclose a mortgage and recover under the guarantees. However, the action against DeLeo was dismissed for failure to make proper service. After foreclosure, and facing a potential deficiency claim of \$2.1 million, Lestorti settled with the creditor by paying \$275,000. Lestorti then sued DeLeo for half that amount. The Supreme Court of Connecticut ruled against Lestorti because he had not shown that his \$275,000 payment was more than his share of the total \$2.1 million debt.

It was unclear from the court's opinion whether DeLeo remained liable for any portion of the indebtedness or whether DeLeo's liability was effectively eliminated by the terms of the settlement agreement or the applicable statute of limitations. Frankly, though, it should not matter. Most co-sureties probably expect to have a right of contribution for any payments they make to the creditor. However, for their contribution rights to

be that broad, the sureties need to supplement the common law rules with contractual duties.

In drafting contractual language to deal with this issue, counsel need to be aware that the default rule is that co-surety's contributive share is "the aggregate liability of the cosureties to the obligee divided by the number of cosureties." Restatement (Third) of Suretyship and Guaranty § 57(1). Put more simply, sureties contribute in proportion to their number. The Restatement holds out the possibility that a fact finder *may* find an implied agreement to contribute in some other percentage if, for example, the co-sureties own different percentages of the principal obligor, but provides no guidance on how to resolve that question. See Restatement (Third) of Suretyship and Guaranty § 7, cmt c, ill. 4. Thus, any express agreement on contribution should precisely delineate the parties' contributive shares. Moreover, if the contributive shares are to be based on the co-sureties' relative ownership of the debtor, the agreement must identify a date on which that relative ownership is to be measured. Otherwise, contribution rights might be easily manipulated.

Right to Contribution

Any payment by a Surety to Creditor of all or any portion of the Guaranteed Obligation will give rise to a right of contribution from the remaining [solvent] Sureties. Each [solvent] Surety shall contribute in proportion to the [solvent] Sureties' respective ownership of Debtor on the date of Debtor's first uncured failure to pay any portion of the Guaranteed Obligation.

or

Any payment by a Surety to Creditor of all or any portion of the Guaranteed Obligation will give rise to a right of contribution from the remaining [solvent] Sureties. Each [solvent] Surety shall contribute in proportion to the number of [solvent] Sureties.

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

Pearson v. Wachovia Bank,

2011 WL 9505 (S.D. Fla. 2011)

Security agreement that described the collateral as “[a]ll of the investment property ... held in or credited to” three designated securities accounts was sufficient even though the secured party later issued one monthly statement for all three accounts using a different, single account number because the three pledged accounts were not in fact consolidated into a new account. Even if the bank had consolidated the three accounts, the new account would still be covered by the security agreement, which expressly extended to “additions, replacements, and substitutions” of the listed collateral.

Perfection Issues

Hancock Bank of Louisiana v. Advocate Financial, LLC,

2011 WL 94425 (M.D. La. 2011)

Section 9-509(b)(1)’s authorization to file an “initial financing statement” allows the secured party to file a second financing statement after the first financing statement lapsed.

Priority Issues

Diesel Props S.R.L. v. Greystone Business Credit II LLC,

2011 WL 37813 (2d Cir. 2011)

Debtor’s supplier was not liable to secured creditor for unjust enrichment resulting from its acquisition the debtor’s order book, in which the creditor had a security interest, because the supplier had a contractual right to the order book that predated the secured creditor’s and a later-in-time assignee has no greater rights than its assignor.

Davis Forestry Products, Inc. v. Downeast Power Co.,

2011 WL 82179 (Me. 2011)

Subsidiary of secured party that purported to acquire debtor’s deposit account through a § 9-610 disposition did not have priority over subsequent lien creditor because the secured party never acquired control and the only way to foreclose on a deposit account is through § 9-607 or judicial process.

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Ex parte Textron, Inc.,

2011 WL 118255 (Ala. 2011)

Secured party did not, by bringing detinue action in Alabama, waive clause in security agreement making Rhode Island the exclusive forum for “all purposes in connection with” the financing agreement because Rhode Island had no jurisdiction over the collateral located in Alabama and such an exception to the forum-selection clause was necessary to harmonize it with the clause granting the secured party the right to repossess the collateral. The forum-selection clause was broad enough to cover tort claims against parent of secured party. However, guarantors’ separate consent to jurisdiction and venue in Rhode Island was not an exclusive jurisdiction clause and thus claim by guarantors would not be dismissed.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Haggard v. Bank of the Ozarks,

2011 WL 145194 (N.D. Tex. 2011)

Guaranty agreement that unconditionally guaranteed “the last to be repaid \$500,000.00 of the principal balance of the Loan” did not require that the creditor, before seeking payment from the guarantor, to collect or forgive enough of the principal to bring the balance due to \$500,000 or less.

Radiant Skincare Clinic v. Moore,

2011 WL 11021 (Cal. Ct. App. 2011)

Clause in contract between medical services corporation and independent contractor by which independent contractor promised to indemnify corporation for expenses, including attorney’s fees, incurred in defending claims of third persons, did not give corporation a right to attorney’s fees incurred in successfully suing the independent contractor for breach and related torts.

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