Chapter 3: Enforcement
or Debtors Under Water

Commercial Law I
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- How do we get to enforcement?
- First, the Creditor may not take action if Debtor is in bankruptcy.
- This rule is the "automatic stay" in bankruptcy.
- Make sure you understand Section 362 of the Bankruptcy Code!

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- The basic enforcement actions stayed by the filing of a bankruptcy petition are found in Section 362(a)(2) – (6).
- A creditor may not enforce judgments, take acts to obtain possession of debtor property or enforce liens.
- Remember: Under the Bankruptcy Code a "lien" includes a "security interest" even though the scope of these terms differs under the UCC.

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- We must contrast the enforcement actions that are prohibited by the automatic stay with certain permitted actions to perfect a lien or continue a financing statement.
- The exceptions from the automatic stay that we focus on appear in Section 362(b)(3).
- Initial perfection may be accomplished within a grace period under §547(e)(2) and continuation under §546(b).

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- The condition precedent to the exercise of remedies to enforce a security interest is the presence of a "default."
- Defaults are actions taken or not taken by the Debtor such as: not paying interest, principal or fees, granting security interests to other creditors in violation of a negative pledge, failing to maintain insurance, selling assets.
- Defaults are defined by contract.

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- Take a look at UCC §9-601, Official Comment 3. The UCC does not define "default" even though the rights of a Secured Party only arise after default.
- As a matter of contract, the occurrence of a "default" (however defined) must give the Secured Party the right to "accelerate" its debt.
- Acceleration makes the entire balance of a debt due, not just a missed installment.

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- Take a look at UCC §1-209[old]. A general right to accelerate a debt "on demand" or if the Creditor "feels insecure" can only be exercised by the Creditor in good faith.
- Similarly, a right to new or additional collateral can only be exercised in good faith.
- From prior lessons, what risk does a Creditor run if it demands collateral?

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- A demand for new or additional collateral, if provided by the Debtor, exposes the Creditor to a preferential transfer risk under BC §547.
- The Creditor might be prepared to take this risk during the 90 day preference period for the chance to improve its position.
- Can the transfer of collateral pursuant to such a clause be a fraudulent transfer?

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- Notice that under BC §548(d)(2)(A) the term "value" includes securing an antecedent debt. Thus, absent an actual intent to hinder, delay or defraud another creditor, the use of a "springing lien"—the right to demand collateral—likely is a preference risk but not a fraudulent transfer risk.
- Note, however, that the obligation secured might be a fraudulent transfer.

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- Demanding new or additional collateral is a right given by contract and is a soft remedy.
- Acceleration is a serious remedy and, if exercised, may lead a Debtor to file for bankruptcy.
- The acceleration of a debt may lead to "cross defaults" in other agreements of the Debtor, creating a chain reaction.

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- Acceleration is needed, however, to make an entire debt due and not simply a missed installment of principle or interest.
- If acceleration is not possible, then the Creditor may exercise remedies only to the extent needed to repay the missed installment.
- For the limitation that explains the need for an acceleration clause, see GECC v. Bankers Commercial Corp. Text 257.

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- The protection given a Creditor against unfair use of either a right to demand payment or additional collateral is weak, particularly if the test remains subjective.
- "Good faith" as used in UCC §1-208 is defined in UCC §1-201(19) as "honesty in fact."
- Courts have given an interpretation that creates Creditor liability against an objective "reasonable person" test.

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- One way to argue for a higher standard of good faith is to refer to UCC §1-203 which imposes a general obligation of good faith in connection with both performance and enforcement.
- However, even if you double up the use of "good faith," as a matter of statutory construction you remain with a subjective test, absent a judicial gloss or statute change.
- Take a look at UCC §9-102(43).

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- UCC §9-102(43) is an attempt to modify "good faith" as used in Article 9 to make it objective.
- Comment 19 to UCC §9-102 claims to apply the objective test to UCC §1-203 as applied to Article 9. However, no mention is made of UCC §1-208.
- Thus, in the context of a demand acceleration right or a request to provide collateral, it is a bit unclear whether the objective test must still come from case law or now can be found in statute. Of course, in other contexts of Article 9, good faith is objective by statute.

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- Contrast a demand note with a term note that contains a demand right. A demand note has no stated maturity and, by its terms, can be called for payment at any time.
- A note with a specified maturity date nevertheless may include a clause permitting demand upon insecurity, etc.
- The good faith rules we are discussing apply to acceleration of notes with stated maturities and not demand instruments. See Official Comment to UCC Section 1-208.

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- Acceleration differs from a refusal to extend additional credit, even if that credit is subject to a financing commitment.
- It is common for a loan agreement to contain a condition precedent that specifies the absence of defaults as a prerequisite for advancing additional funds under a revolving credit line.
- Refusal and acceleration—similarities.

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- Acceleration causes an immediate liquidity crisis because the Debtor was not expecting to need funds to pay back the loan.
- Refusal to fund upon failure of a condition precedent causes a liquidity crisis because the Debtor was counting on the commitment.
- Lenders prefer to refuse funding than to accelerate a loan.

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- In either an acceleration or refusal context, a Debtor may try to assert some form of lender liability, but lenders fear acceleration based lender liability more.
- We see an example of a refusal to fund in K.M.C. Co., Inc. v. Irving Trust Company. Text 260.
- The implied covenant of good faith and fair dealing.

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- The key fact in this case is that if Irving had advanced funds it still would have been fully secured.
- In a case of over security, it is hard for a Creditor to say that, in good faith, it deemed itself insecure.
- Note: This is not a case of UCC Section 1-208 because it is a ***refusal*** to fund, not an acceleration or collateral demand.

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- The lesson for a Creditor: If you intend to withhold a committed line of credit, give the Debtor time to find an alternate source of funding.
- In the real world, an alternate funding source may not materialize.
- Alternate funding is more likely to be found if sufficient collateral is available.

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- As a drafting matter, this case is a good example of why lender's boilerplate typically contains a waiver of a right to a jury trial.
- Cases like Kham v. Nate's Shoes, Text 265, show that lender liability is in some retreat.
- The best practical course is to give Debtors advance notice of action. Do not act in ways that may constitute waivers.

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- One way to protect a Creditor in negotiations is to spell out in a letter, prior to a meeting with Debtor, that the meeting should not be construed as a waiver and that Creditor reserves the right to take any action permitted under its contracts.
- A real risk exists if the first meeting is properly reserved but subsequent actions are not equally disclaimed as waivers.

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- The general rule is that remedies are cumulative
- This means that exercising one remedy does not prevent a creditor from later exercising a second, different remedy.
- A classic example of two remedies is sending the repo man to repossess a car while at the same time suing the owner in court on the car loan.

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- The UCC rule is that remedies are cumulative.
- See UCC §9-601 for a statement of the ability to pursue remedies on a cumulative basis.
- Warning: some states supplement the UCC rule with an election of remedies statute that may take away this Creditor right.
- Let us now consider the enforcement action of repossession.

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SCENE FROM REPO MAN:

Leila: Heh, one of them? You think you're pretty slick don't ya? I bet you're a used car salesman.

Otto: I am not.

Leila: You dress like one.

Otto: I'm a repo man.

Leila: What's that?

Otto: It's a repossesser. I take back cars from dildos who don't pay their bills. Cool huh?

--Screenplay by Alex Cox

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- Repossessing collateral can be dangerous business.

Otto: *Wow! This is intense.*

Miller: *The life of a repo man is always intense.*

- Sometimes repo men are killed trying to recover collateral.

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SCENE FROM REPO MAN:

Pakman *reading card*: I. G. Farben. . . What do you take me for, a moron? If I go in there, you're going to take this car away.

Bud: What, and lose my job? The law requires that I stay right here until you call my branch manager.

Pakman: That's the law, huh?

Bud: That's the law.

Pakman: I'll be right back.

Pakman goes inside and Bud and Otto leave with the car.

See Text at 280.

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- The right to self help repossession is discussed in Penney v. First National Bank of Boston.
- This right is found in the UCC so it need not be specifically mentioned in the security agreement, unless another law so requires.
- Thus, unless a security agreement provides to the contrary, Creditor can repossess collateral without giving Debtor notice of intent to repossess the collateral. Cf. UCC §9-602.
- See UCC Section 9-609(b).

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- Even though there is a general rule that notice of repossession need not be given absent a contrary contract provision, we might consider whether a general obligation to enforce in good faith under UCC §1-203, as modified by UCC § 9-102(43), would create a notice obligation in some cases.
- Consider whether notice of repossession might be given in commercial loan foreclosures in contrast to foreclosure of loans made to individuals.

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- The requirement that self help not disturb the peace is discussed in Williams v. Ford Motor Credit.
- The requirement that a self help remedy not disturb the peace is found in the UCC. See UCC Section 9-609(b).

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- When thinking about self-help remedies contrast collateral kept in a Debtor's home, garage or place of business with collateral such as an automobile that may be found in the open, on a public street or in a driveway.
- To take collateral kept in an enclosed space, a Creditor must either obtain Debtor consent or use judicial process.

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- The general rule is that if the Debtor makes an oral protest telling the Creditor or its agents to "stop" then the repossession must stop.
- Continuation of the repossession process after a clear oral protest may constitute a breach of the peace. See Text 279.

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- What if the Creditor dresses up a repo man as a police officer and the police officer asks for consent to repossess collateral kept in a home? What if a repo man is accompanied by an off duty police officer?
- There is a significant risk that both cases will be instances of intimidation which interfere with a Debtor's right to resist a self-help remedy.

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- Waiver of notice of default is a big problem for Creditors
- Typical question is: Did the Creditor waive a default by accepting late payments.
- If Creditor waived a default, its right to repossess vanishes and the act of repossession in fact is a tort of conversion.
- See Moe v. John Deere Company, Text at 281.

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- If a Creditor accepts late payments, the lesson is that a notice must be given to the Debtor to advise the Debtor that strict compliance with the loan contract will be required in the future.
- The contract drafting and interpretation issue is to what extent a contractual waiver of notice, etc. will be given effect. (Don't count on it!)
- As in the case of withholding a committed credit line, a letter may be sent advising that future strict compliance will be required.
- See Text 286. Multiple letters may be needed if multiple cases of estoppel or waiver exist.

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- What about the process of sale of collateral?
- There is a right to notice, §9-611, and to a commercially reasonable sale, §9-610.
- Compliance with these two requirements are often litigated.
- See Excello Press for an analysis of notice and sale. Notice that this sale occurred with court permission in bankruptcy.

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- Students must notice the right to make a sale of collateral in either a public or a private sale.
- Students must notice the different rights that a Secured Party has in a public or a private sale.
- Students must notice the distinction between a sale at retail and a sale at wholesale, and whether the UCC makes a distinction.

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