Legal Alert

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DISPOSITION OF PERSONAL PROPERTY COLLATERAL

Arizona has adopted the Uniform Commercial Code ("UCC"), which governs the creation, perfection, and enforcement of security interests in personal property. A.R.S. §§ 47-9101 *et seq*. If a creditor has a valid security interest, after default the creditor may take possession of the personal-property collateral (or render it unusable). A.R.S. § 47-9609. A secured creditor can also "sell, lease, license, or otherwise dispose" of its collateral. A.R.S. § 47-9610(A). A secured creditor can even keep the collateral for itself in full or partial satisfaction of the debt, subject to certain limitations. A.R.S. § 47-9620.

This paper outlines the procedures and gives guidelines for a secured creditor to dispose of collateral by public auction or private sale.

Standard of Commercial Reasonableness

Regardless of the specific type of disposition, every aspect—including the method, manner, time, place and other terms—must be "commercially reasonable." A.R.S. § 47-9610(B). So long as the terms are reasonable, parties may agree by contract on the standards by which commercial reasonableness is to be measured. A.R.S. § 47-9603.

A disposition of equipment is considered commercially reasonable if the creditor follows the practices generally used by dealers in the type of property at issue. A.R.S. § 47-9627(B)(3). This might entail identifying and advertising to potential interested purchasers of equipment. The fact that a greater amount could have been obtained at a different time or through a different method is not by itself sufficient to establish that the disposition was not commercially reasonable. A.R.S. § 47-9627(A). Nevertheless, a secured creditor should obviously try to maximize the value of its collateral. A secured creditor can also seek pre-approval of a disposition of collateral in a judicial proceeding, but such approval is not required, and the absence of such approval does not mean the disposition was not commercially reasonable. A.R.S. § 47-9627(C-D). A secured creditor seeking to recover a deficiency bears the burden of proving that its disposition was commercially reasonable. *Gulf Homes, Inc. v. Groubeaux*, 664 P.2d 183 (Ariz. 1983).

Advance Notice to All Interested Parties

The first step in selling collateral is giving advance notice. The secured creditor must send a signed notification of disposition to the following: (1) the debtor; (2) any secondary obligors on the debt; (3) any other secured parties or lienholders who gave the creditor prior written notice of an interest in the collateral; and (4) any other secured parties or lienholders who, at least ten days prior to the notification date, had filed a financing statement covering the collateral (or had a security interest that was perfected by compliance with some other law). A.R.S. § 47-9611(B-C).

To determine the other secured parties or lienholders who are entitled to receive notice, a creditor should—between 20 and 30 days prior to the notification date—request information concerning financing statements indexed under the debtor's name in the appropriate office for the type of collateral. A.R.S. § 47-9611(E). For debtors that are Arizona entities, this means searching the Arizona Secretary of State for UCC filings under the debtor's name and giving notice to all parties identified as having potential interests in the collateral. A debtor or secondary obligor may waive the right to receive notice, but only in a signed agreement that is entered into after default. A.R.S. § 47-9624(A). For collateral that includes registered vehicles, the creditor should search for parties listed as lienholders on the vehicles' titles.

Under federal law, the IRS is entitled to a lien against all personal property belonging to a person or entity who fails to pay taxes. 26 U.S.C. § 6321. A valid security interest that is perfected by a private party prior to the filing of an IRS lien generally has priority. 26 U.S.C. § 6323. In addition, a secured creditor can secure loan advances made after a tax lien is filed so long as the advance is made before the earlier of (a) the creditor's actual knowledge of the tax lien, and (b) 46 days after the IRS filed the tax lien. 26 U.S.C. § 6323(d).

To foreclose a junior tax lien, the creditor must give at least 25-days advance notice to the IRS. 26 U.S.C. § 7425(c)(1). Failure to give this notice means the tax lien survives and is elevated to first position. *Southern Bank v. IRS*, 770 F.2d 1001 (11th Cir. 1985); *USX Corp. v. Champlin*, 992 F.2d 1380 (5th Cir. 1993). The IRS publishes a form for giving the required notice.

Timing and Content of Notices

As for timing, a notification of disposition must be—you guessed it—"reasonable." A.R.S. § 47-9611(B). For non-consumer transactions, there is a safe harbor. A notification of disposition that is sent after default and at least 10 days before the earliest time of disposition is always considered reasonable. A.R.S. § 47-9612(B).

For content, a notification for a non-consumer goods transaction is sufficient if it contains the following information: (a) description of the debtor and the secured creditor; (b) description of the collateral that is the subject of the intended disposition; (c) method of intended disposition; (d) a statement that the debtor is entitled to an accounting of the unpaid indebtedness and the charge, if any, for an accounting; and (e) the time and place of a public auction or the time after which a private sale is to be made. A.R.S. § 47-9613(1). The statute provides a sample form for a notification that contains sufficient information. A.R.S. § 47-9613(5).

Particulars of the Sale

Determining whether to conduct a public or private sale is part of the determination of whether the disposition was "commercially reasonable." In *Old Colony Trust Co. v. Penrose Indus.*, 280 F.Supp. 698 (E.D. Pa. 1968), the court noted that a private sale was reasonable, in part, because the bank had solicited advice from a broker who opined that a private sale would produce the highest price. Other courts have suggested that creditors should obtain appraisals and contact competitors who might be interested in bidding for collateral. *United States v. Terrey*, 554 F.2d 685 (5th Cir. 1977). There also should be an inspection period. *Connex Press, Inc. v. International Airmotie, Inc.*, 436 F.Supp. 51 (D.D.C. 1997). With exotic or sophisticated equipment, a private sale probably makes more sense. If a secured creditor obtains appraisals and tries to contact the debtor's competitors about purchasing the equipment, then a private sale at an appraised price appears to be commercially reasonable. The secured creditor also might consider advertising the sale in newspapers and/or trade publications.

The collateral can be sold by "one or more" contracts and "as a unit or in parcels." A.R.S. § 47-9609(B). This is another question that is answered by reference to the fact-intensive standard of "commercial reasonableness." Some cases require a secured creditor to sell certain items of collateral on a piecemeal basis, if a higher price would result. *See, e.g., Cities Serv. Oil Co. v. Ferris*, 9 UCC Rep. 899 (Mich.App. 1971); *United States v. Terrey*, 554 F.2d 685 (5th Cir. 1977); *Liberty Nat'l Bank & Trust v. Acme Tool Div.*, 540 F.2d 1375 (10th Cir. 1976).

After giving notice and determining how to proceed, the secured creditor conducts the sale in accordance with the notice. The creditor may purchase the collateral for itself at a public auction, but not at a private sale (unless the collateral is of a kind that is customarily sold at a recognized market with widely distributed standard quotations). A.R.S. § 47-9610(c). With a public auction, the secured creditor must provide "meaningful opportunity" for competitive bidding. A.R.S. § 47-9610 cmt. 7. This entails advertising or public notice and making the property available in advance. *Id.*

Distribution of Proceeds and Collection of Deficiency

Following the sale, proceeds are distributed in the following order: (1) reasonable expenses of retaking, holding, preparing for disposition, processing, and disposing of the collateral, plus attorneys' fees to the extent provided for by agreement; (2) the obligations secured by the security interest being foreclosed; (3) the obligations secured by junior security interests who submit a signed demand for the proceeds before distribution (along with proof of a lien, if requested by the creditor); and (4) the debtor. A.R.S. § 47-9615(A-B, D). A secured creditor who receives cash proceeds of a disposition in good faith and without knowledge of a senior security interest owns the proceeds free and clear and is not required to pay anything to the senior creditor. A.R.S. § 47-9615(G).

If the sale proceeds are insufficient to pay the debt, then the debtor is liable for the deficiency (unless the collateral consists of accounts receivable or other payment intangibles). A.R.S. § 47-9615(D)(2), (E). However, if the collateral is acquired by the creditor or a related party, and the proceeds are significantly less than what a commercially reasonable sale would have produced, then the deficiency is calculated using the expected proceeds of a commercially reasonable sale. A.R.S. § 47-9615(F). As mentioned above, the fact that a greater amount could have been obtained does not automatically suggest an unreasonable disposition, but that fact certainly subjects the disposition to closer scrutiny. A.R.S. § 47-9627(A).

In a deficiency lawsuit, the secured creditor need not prove compliance with the UCC unless the debtor or a secondary obligor places compliance at issue. A.R.S. § 47-9626(A)(1). Once compliance is at issue, the secured creditor has the burden of proving compliance. A.R.S. § 47-9626(A)(2). If the creditor fails to satisfy this burden, then the deficiency liability is recalculated using the proceeds that would have been realized by a commercially reasonable sale—and the creditor bears the burden of proving that this amount is less than the total amount of the debt. A.R.S. § 47-9626(A)(3-4).

The contract for sale of collateral includes all warranties that would otherwise accompany a sale of such property by law, unless the creditor includes an express disclaimer. A.R.S. § 47-9610(D-E). The disclaimer is sufficient if it states as follows: "There is no warranty relating to title, possession, quiet enjoyment or the like in this disposition." A.R.S. § 47-9610(F). A transferee who acts in good faith acquires the debtor's rights in the collateral free and clear of the security interest under which the disposition is made and any junior security interests. A.R.S. § 47-9617(A-B).

The UCC provides limited redemption rights to the debtor, any secondary obligors, and any other secured parties or lienholders. A.R.S. § 47-9623(A). Redeeming collateral requires a

complete cure—payment of all obligations that were secured by the collateral, and payment of reasonable expenses and attorneys' fees. A.R.S. § 47-9623(B). Once the secured creditor has disposed of collateral, or entered into a contract for disposition, redemption is no longer available. A.R.S. § 47-9623(C). But if the debtor files for bankruptcy while the right of redemption is still open, the bankruptcy trustee (or debtor-in-possession) can demand turnover by providing adequate protection for the creditor's interest. 11 U.S.C. § 542.

In sum, the requirements for disposing of collateral by public auction versus private sale are very similar. The only most important differences pertain to the type of notice (i.e., giving notice that the sale is public or private) and that the secured creditor cannot acquire the collateral itself in a private sale. A.R.S. § 47-9610 cmt. 7. The single most important requirement—regardless of the type of disposition—is that secured creditors dispose of collateral in a "commercially reasonable" manner.