

# The Transactional Lawyer

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## Drafting for a Commercially Reasonable Disposition of Collateral

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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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