The Disposition of Equipment After Lease Default

Practical tips for equipment lessors and the "commercial reasonableness" of sale.

By Joshua A. Hasko, Esq.

The disposition of collateral after default is often a challenge for equipment lessors seeking to efficiently recover under a finance lease, while maintaining an enforceable deficiency against the lessee and any guarantor. As many lessors have experienced, the process of dealing with delinquent accounts and uncured defaults, often involves time consuming phone calls and personal meetings, site inspections, and default notices, just to name a few. Once the legal process is commenced, attorneys' fees are incurred and lessors must negotiate a voluntary surrender of the equipment or (more likely) seek a court order to obtain possession. During this time, the collateral may be declining in value and the re-sale market may be shrinking. Once the lessor is finally able to recover its collateral, there is an inclination to sell the equipment as fast as possible. But wait… must the sale be deemed "commercially reasonable" to avoid subjecting the sale process, and any remaining deficiency, to challenge?

Article 2A of the Uniform Commercial Code ("UCC"), which governs finance leases, [1] does not expressly impose a "commercial reasonableness" standard upon lessors seeking to dispose of collateral after default of a lease. Compare that to Article 9 of the UCC, which governs secured transactions, and requires that "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms". *UCC 9-610(b)*. Certain courts, however, have imposed the Article 9 requirement of "commercial reasonableness" into the disposition of collateral after default of an Article 2A lease transaction and equipment lessors should take heed.

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For example, in *Lyon Financial Services, Inc. d/b/a USBancorp Business Equipment Finance Group v. Oxford Maxillofacial Surgery, Inc., and Scott D. Whitaker*, United States District Court, District of Minnesota, 2009 U.S. Dist. Lexis 61347, the lessee and guarantor challenged the sale of collateral after default of an Article 2A finance lease by claiming that the lessor failed to mitigate its damages. [2] While finding that the lease was properly categorized as a "finance lease", the *Lyon Fin.* court also noted that "Under Minnesota law, the injured party upon a breach of contract has the duty to use reasonable diligence in mitigating damages." *Lyon Fin*. at *12. The Court went on to state that "[w]hile the Uniform Commercial Code's concept of 'commercial reasonableness' is not directly applicable in this case, Minnesota courts find it helpful in determining mitigation of damages issues when lease property is repossessed and resold." *Id.* [3] The Court turned to *UCC 9-610* noted above, and imposed the standard that: "*every aspect of the disposition … including the method, manner, time, place and other terms, must be commercially reasonable*." In another Lyon Financial case, arising in the Northern District of Illinois, Eastern Division, *Lyon Financial Services, Inc., d/b/a US Bancorp Business Equipment Finance Group, et al. v. Jude's Medical Center, Ltd. d/b/a Laser & Cosmetic Dermatology S.C. and Jawdat Abboud*, 2011 U.S. Dist. 139173, the court recognized that UCC Article 9 "is not directly applicable", yet still applied the concept of an Article 9 "commercial reasonableness" standard to determine whether a lessor sufficiently mitigated its damages.

In order to comply with UCC Article 9 (even if the transaction appears to fall under Article 2A), a lessor must first give notice. Notice is governed by *UCC 9-611*, and for commercial goods, requires notice of disposition before the sale be sent to the (1) debtor; (2) any secondary obligor; (3) and other person with a claimed interest or a lien in the collateral. *UCC 9-611(1)-(3.)* [4] The notice must describe the debtor (lessee) and the secured party (lessor); the collateral; the method of intended disposition; and inform the debtor (lessee) that it is entitled to an accounting. *UCC 9-613.* If a public sale, the notice must also include the time and place of disposition. *Id.* If a private sale, the notice can state a date after which the collateral will be sold. *Id*. Notice should be sent at least 10 days before disposition. *UCC 9-612*. In *Lyon Fin. v. Oxford*, the lessor wrote lessee stating that the collateral would be sold at a private sale and asked lessee to notify if it knew of interested buyers that might help in maximizing the price. The lessee did not respond. *Id.* at *13. [5] However despite these efforts, the court still found that Lyon had not provided sufficient evidence to establish "commercial reasonable as a matter of law." *Lyon Fin. v. Oxford* at *13. Thus, even with notice, the lessor must take steps ensure that the sale itself will be deemed commercially reasonable. Moreover, under Article 9 the failure to establish commercial reasonableness may even expose the secured party to liability or damages, or reduction or elimination of deficiency against debtor and/or any secondary obligor. *UCC 9-625; 9-626*.

Generally, commercial reasonableness is a question of fact and the burden is on the non-breaching party to demonstrate the reasonable mitigation of damages. *Lyon Fin. v. Oxford* at *12; *Lyon Fin. v. Jude's* at *13. The UCC provides guidance. *UCC 9-627(b)* provides that a "disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition." *UCC 9-627(b)*. But what happens when, despite notice and compliance with this standard, the lessee still argues that the lessor received too low a price? *UCC 9-627(a)* provides, "the fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different manner … is not of itself sufficient to preclude the secured party from arguing that [its manner and method] was commercially reasonable." However, the *official comment* to UCC 9-627(2) states, "[w]hile not itself sufficient to establish a violation of this Part, a low price suggests that a court should scrutinize carefully all aspects of a disposition to ensure that each aspect was commercially reasonable." Indeed, this concept of close scrutiny was applied in both *Lyon Fin.* cases to determine whether the lessor had breached its obligation to minimize damages, and sell in a "commercially reasonable manner". In *Lyon Fin. v. Oxford*, the court found that despite notice and despite following its usual resale practices, because the equipment sold at 6% of its original value when two websites offered similar equipment for a higher price, the lessor failed to establish the connection with the current market price and denied summary judgment on damages. *Lyon Fin. v. Oxford* at *14.

Given all the foregoing, what can a lessor do to increase the likelihood that the disposition of collateral under UCC Article 2A will be upheld? First, treat the disposition under Article 9 and follow the above process to demonstrate "commercial reasonableness" of sale. Second, consider providing the lessee all pre-sale information and obtaining the lessee's prior written consent and release of objection to the commercial reasonableness of the method, manner, and price of sale. [This is particularly attractive when the lessee and the lessor are cooperating to maximize the recovery and limit the expenses of sale and attorneys' fees]. Finally, although not required, *UCC 6-627(c)* allows a secured party to seek judicial (or creditor's committee in bankruptcy) approval of the manner, method, and price of the disposition. A lessor in an Article 2A disposition can, likewise, seek judicial approval of sale, and submit evidence of its mitigation efforts, including the notice, advertisement, and promotion of the sale, together with the recognized market. If available, an expert opinion as to the conformity with reasonable commercial practices and market price can be submitted. In short, when the lessor has reason to know that the sale may be challenged (or the offer price is low), seeking a court order is the safest way to ensure that the sale is deemed "commercially reasonable". [6]

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1. Factors for determining whether a transaction is a finance lease or a secured transaction can be found in UCC 1-203 and state specific case law, and are not specifically addressed herein.

2. Defendants asserted two affirmative defenses: estoppel and failure to mitigate damages. On the estoppel defense, the court affirmed summary judgment based upon defendants' failure to establish that the vendor's representatives were agents of the lessor. *Lyon Fin.* at *8-11.

3. Citing in part, *Duetz-Allis Credit Corp. v. Jensen*, 458 N.W.2d 163, 166 (Minn. Ct. App. 1990).

4. UCC 9-611 contains certain exceptions and requirements for perishable and consumer goods.

5. In *Lyon Fin. v. Jude* at *14, the court also found that reasonable notice was provided.

6. This article is for informational purposes and does not constitute an attorney-client relationship or legal advice. Contact an attorney regarding legal rights.